
SEC Provides Further Guidance on Cooperation Credit

2011-02-17

When the U.S. Securities and Exchange Commission entered into its first non-prosecution agreement in December 2010 with children's clothing manufacturer Carter's Inc., the SEC reaffirmed the tremendous importance of cooperation when facing an investigation. The Carter's order, however, did not elaborate on what counts as cooperation sufficient to warrant non-prosecution in that matter. (See [WilmerHale Client Alert](#), January 11, 2011.)

In a February 9, 2011 Order Instituting Cease-and-Desist Proceedings against medical device company ArthroCare Corporation, the SEC shed additional light on the level of cooperation necessary to avoid the most serious securities charges.¹

ArthroCare Restates, Describes Misconduct Regarding Revenue Recognition, Other Matters

ArthroCare announced in July 2008 that it would restate certain financial statements with respect to revenue recognized on sales to distributors and entities.² It also disclosed that its Audit Committee had initiated an internal review of the company's internal controls (the "Review"), for which the Audit Committee retained the assistance of outside counsel and forensic accountants.³

As described in the company's Form 10-K for fiscal year 2008, the Review revealed a management team heavily focused on meeting quarterly revenue targets and analysts' expectations at the expense of proper accounting and compliance practices.⁴ Specifically, the Review indicated that the company: structured transactions to occur at or near quarter-ends to satisfy such goals; deviated from existing revenue recognition policies developed for sales to a particular distributor; requested and allowed returns and exchanges contrary to its policy; encouraged distributors to place orders even where they did not need additional inventory; shipped nonconforming goods; split a single purchase order into multiple smaller purchase orders to recognize revenue over multiple periods; sold to customers without sufficient evidence that collectibility of the related receivable was reasonably assured; and shipped products in advance of due dates identified in purchase orders to prematurely recognize revenue.⁵

The Review also identified at least one instance in which ArthroCare management reversed an accrual and delayed the recording of certain expenses to achieve a particular earnings per share, or EPS target.⁶ Not only did sales personnel and a former executive officer fail to communicate information bearing on revenue recognition to finance personnel and the company's auditors, the former executive officer made affirmative misrepresentations bearing on revenue recognition to the vice president of finance.⁷ According to ArthroCare, the conduct occurred before its internal controls even had a chance to catch it.⁸

ArthroCare conceded that certain conduct may have run afoul of state and federal fraud-and-abuse, anti-kickback and false claims statutes.⁹ To date, the company has paid \$5.7 million in settlements with certain insurance companies related to those insurers' prior payments to ArthroCare for

procedures involving ArthroCare products.¹⁰

Cooperation Yields Settlement Without Fraud-Based Charges

Despite the gravity of the misconduct committed by ArthroCare's management, the company was nevertheless able to settle its SEC proceeding without any fraud-based charges or financial penalty.¹¹ Specifically, the Commission's cease and desist order against ArthroCare finds only that the company's financial statements were inaccurate and that its books and records and internal controls were deficient.¹²

The Commission's order first describes its findings in a way that generally mirrors the company's disclosures, but omits mention of the most egregious conduct—including the former executive officer's affirmative misrepresentations concerning revenue recognition.¹³ The order then explains that the Commission settled with the company on lenient terms because of ArthroCare's "remedial acts" and "substantial cooperation" during its investigation.¹⁴ On the remediation front, ArthroCare:

- replaced its senior management team;
- expanded its legal department and created a compliance department headed by a new compliance officer;
- hired a new corporate controller and international controller and expanded its internal audit function;
- instituted enhanced preventative and detective controls relating to revenue recognition;
- instituted quarterly ethics communications from senior management to employees;
- implemented a sub-certification process as part of its quarterly and annual financial reporting;

- adopted standard customer contracts and established rigorous approval requirements for modifying contracts;
- hired a contract administrator; and
- provided regular training on proper revenue recognition accounting and appropriate procedures for handling contracts.¹⁵

ArthroCare's cooperation included:

- regularly updating the SEC Staff on its internal investigation;
- providing critical documents (organized by subject matter and witness) without waiting for Staff requests or subpoenas;
- responding promptly and completely to the Staff's requests for additional information;
- routinely granting the Staff access to the company's consulting expert, to discuss accounting and internal controls issues;
- voluntarily producing for testimony witnesses residing outside the United States and beyond the SEC's subpoena power; and
- providing the Staff with a detailed analysis of its restatement, including a schedule of restatement categories and the impact on the company's historical financial statements.¹⁶

ArthroCare's cooperation and remediation appear similar to the "exemplary and extensive cooperation" and "extensive and substantial remedial actions" that permitted Carter's to secure a non-prosecution agreement ("NPA")—*i.e.*, a no-charge resolution now in the SEC's cooperation arsenal.¹⁷

The difference between Carter's NPA and the cease-and-desist order against ArthroCare is likely premised on (i) the nature and apparent pervasiveness of the misconduct by ArthroCare's former management and (ii) the dispatch with which each of the companies brought the issues to the attention of the SEC. In the press release accompanying the Carter's NPA, the SEC remarked that: (i) the misconduct was of a "relatively isolated nature; and (ii) Carter's "prompt[ly] and complete[ly] self-report[ed] ... the misconduct to the SEC."¹⁸ The ArthroCare order, as well as the company's prior public filings, makes evident that the misconduct was not "isolated." Nor have either the company's disclosures or the SEC order suggested that ArthroCare self-disclosed to the SEC.

In the emerging jurisprudence of cooperation with the SEC, the ArthroCare order provides additional guidance about the criteria to which the SEC will look when evaluating respondents' approaches to enforcement inquiries.

¹ Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of ArthroCare Corporation*, Administrative Proceeding File No. 3-14249 (Feb. 9, 2011) [the "Order"]. Please note that WilmerHale represents a party in ArthroCare-related proceedings.

² News Release, "ArthroCare to Restate Financial Statements (Jul. 21, 2008), available at phx.corporate-ir.net/phoenix.zhtml?c=100786&p=irol-newsArticle&ID=1176935&highlight=.

³*Id.*

⁴ ArthroCare Corporation 2008 Form 10-K (Nov. 18, 2009), at 39.

⁵*Id.* at 39-40.

⁶*Id.* at 40.

⁷*Id.* In addition to accounting problems, the Review highlighted insurance reimbursement and healthcare and compliance problems in several of the company's business units, including billing and coding inaccuracies, as well as the provision of free goods and services, and inappropriate discounts to customers in connection with their use of the ArthroCare products.

⁸*Id.*

⁹*Id.*

¹⁰ ArthroCare Corporation Form 8-K (Jun. 2, 2009) at 2; ArthroCare Form 8-K (Feb. 23, 2010) at 2; ArthroCare Form 8-K (Mar. 4, 2010).

¹¹ Order, at IV, 4.

¹²*Id.* at IV, 4.

¹³ Order, at III, 2-3.

¹⁴*Id.* at 4. Indeed the company's remediation and cooperation were so substantial that they warranted a separate section in the Order.

¹⁵*Id.* at 4.

¹⁶*Id.*

¹⁷ See U.S. Secs. & Exch. Comm'n, Release No. 2010-252, *SEC v. Elles*, Civ. Action No. 10-CV-4118 (N.D. Ga. Dec. 20, 2010), available at www.sec.gov/news/press/2010/2010-252.htm.

Authors



Christopher Davies

PARTNER

Vice Chair, Securities &
Financial Services Department

✉ christopher.davies@wilmerhale.com

☎ +1 202 663 6187



Michael Mugmon

PARTNER

Partner-in-Charge, San
Francisco Office

✉ michael.mugmon@wilmerhale.com

☎ +1 628 235 1006