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Unlearned Lessons: Accounting and Financial Fraud

It is easy to blame the current financial debacles on the bursting of the proverbial economic bubble, but that may be more of an excuse than an explanation. Financial fraud starts with a combination of opportunity and financial incentive. Opportunity presents itself when those responsible for overseeing the efficacy of financial reporting allow abuse of loopholes in the rules. Financial incentive arises when the boom times of an unstoppable economy create the delusion that fraud will go unnoticed as long as everybody continues to make money.

Bruce L. Simon

The Genesis of Financial Fraud

This cycle of opportunity and financial incentive has been evident for many decades. In the early 1980's, the tax laws were designed to allow passive investors in real estate, gold mines and oil wells to claim deductions that were greater than their actual investment. This led to investments, such as real estate limited partnerships, which provided the opportunity for write-offs even when the actual investment had no real economic value. When Congress eliminated such write-offs, these investments

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What Civil Lawyers Need to Know about Criminal Sentencing

Potential or pending parallel criminal cases can substantially affect the consequences and outcomes of civil cases. Lawyers representing individual and corporate clients in civil matters in the fields of antitrust, securities and intellectual property need to understand the criminal penalties that their clients could face for the conduct at issue in the civil action. Defendants can take actions that may lead to downward departures (*i.e.*, shorter sentences) from the federal sentencing guidelines. Plaintiffs may be able to persuade defendants to provide information or cooperate in ways that could impact later sentencing decisions. Either way, civil lawyers would be well advised to learn about the mechanics of criminal sentencing in federal court.

Hon. Susan Y. Illston

The Sentencing Reform Act of 1984 established the U.S. Sentencing Commission to create sentencing policies for federal courts. The U.S. Sentencing Guidelines, first issued in 1987, prescribe guidelines for appropriate sentences for federal crimes. Their purpose is to standardize the sentences given to federal criminal defendants and introduce proportionality by basing the length of the sentence on the severity of the crime. Judges are required, except in "extraordinary circumstances," to sentence within the guideline ranges.

The guideline range — the number of months to be spent in prison — that a court must use in a particular case is determined by the Sentencing Table (on the inside back cover of the Guidelines Manual). The Sentencing Table is a matrix, with 43 different "offense levels" on the vertical axis. The offense level is based on the specific nature of the charged offense; the higher the offense

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Accounting and Financial Fraud

suddenly needed to generate cash flow. One easy way to do this was to obtain new investors to pay the returns due old investors in what amounted to "Ponzi" schemes. Ultimately, these schemes collapsed, and certain real estate and other limited partnerships fell victim to the bursting of a previous bubble.

The Savings and Loan crisis of the late 1980's and early 1990's also exemplified this opportunity-for-fraud cycle, compounded by ineffective regulation. In the 1980's, the Reagan Administration and Congress largely eliminated regulation of the banking industry, including S&L's, in order to boost the American economy. Lending institutions quickly developed ways to inflate assets, particularly real estate development properties. These development projects were booked at amounts that were unsupported by any previous performance of the properties. In fact, many of these properties had not even broken ground, and S&L's relied on projections of future revenues to support their evaluations. These projections, just like the high tech company that goes public without an actual product, were mere speculations about what revenues the property might someday generate. Historical financial statements showed losses and little or no cash flow. Ultimately, when the inflated numbers were exposed, properties had to be sold at only a small fraction of the projected value.

Over the last ten years, the unprecedented increase in the price of stocks — especially in the high tech, telecommunications, Internet and energy industries — has created a similar financial bubble. A total disregard for the basic principles of investing, and an undisciplined, irrational feeling on the part of the investing public, provided the opportunity. Companies used various devices to manipulate financial information to create the illusion of continued growth. Companies that were just starting up often used forecasts to tell the investing public where the company would be in the future. Forgotten was the rule that financial forecasts were only as good as the historical performance of the company.

Some companies that had gone public and had climbed the ramp to profitability viewed continued generation of revenues as the key to success. These businesses began to prepare their financial information to meet Wall Street's expectations as opposed to economic reality. Purported sales of product were, in fact, contingent on many different conditions, like the right of return, or were only executed in return for a reciprocal favor from the company to whom the sale was made. These companies violated the hallmark of financial reporting: never elevate legal form over economic substance.

Who Fulfills The "Public Watchdog" Role?

As with so much of history, the massive losses caused by the illusion of an economic bubble could have been avoided if investors had kept matters in historical perspective. The solution to the current crisis was foretold in the aftermath of other bubbles. Companies commit financial fraud because their executives believe they can get away with it. They believe they can get away with it because the financial reporting rules are vague on certain accounting issues, and there is no truly independent supervision of how these rules are implemented. In addition, the law on accounting liability has gotten progressively more lenient.

Up until the very recent past, the "public watchdog" was the independent public accountant. The very principles by which auditors are governed include protecting the public interest:

> Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism…. A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves. (*Principles of the Code of Professional Conduct, Article II, "The Public Interest."*)

One largely forgotten accounting scandal involved Equity Funding Corporation of America which collapsed within a period of weeks in 1973. The report of the Special Committee of the American Institute of Certified Public Accountants ("AICPA") on the Equity Funding debacle was prophetic:

> The Equity Funding debacle, like all disasters caused by human actions, offers the promise of useful lessons for the future. Of particular concern to the accounting profession is what may be learned from this debacle about the adequacy of standards governing the work of independent auditors. (AICPA Report of the Special Committee on Equity Funding, *The Adequacy of Auditing and Standards and Procedures Currently Applied in the Examination of Financial Statements*, 1975.)

The Equity Funding scheme sounds eerily familiar. The management of Equity Funding had failed to institute effective internal accounting controls that were capable of detecting the fraud. Internal accounting controls are the checks and balances needed within a corporate environment so managers cannot override the systems that are designed to produce reliable financial reports. If the systems are effective, those who may be tempted to cheat must first hurdle several levels of scrutiny. The primary lesson to be learned from Equity Funding was that auditors must challenge the representations of management. In the end, the Special Committee came to the conclusion that generally accepted auditing standards ("GAAS") did not have to be revised to make them more effective at uncovering fraud.

Ten years after Equity Funding, in 1985, the AICPA was asked again to testify before Congress on the quality of independent audits. The concerns that the AICPA addressed again appear prescient of the current crisis: (1) whether the accounting profession needed to be regulated from the outside; (2) whether the amount of fees paid auditors impaired their independence; and

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(3) whether the process of setting accounting standards should be opened to public scrutiny. As with the current crisis, the accounting profession vigorously fought any outside regulation. Their proposed method for assuring independence of the auditor, other than self-regulation, was to encourage the establishment of strong Audit Committees that would regularly provide oversight to financial reporting, review audit issues, and keep track of total fees paid not only for auditing, but other non-auditing related services as well.

In 1987, the Treadway Commission issued final recommendations on how to cure financial fraud. These recommendations, made 16 years ago, foreshadow today's efforts to stem the same types of fraud. Those recommendations included:

• All public companies should maintain internal controls that provide assurance that financial fraud does not occur;

• All public companies should have written and effective codes of corporate conduct;

• Audit Committees should constantly assess whether consulting engagements by the auditor impair independence;

• Criminal prosecution for financial fraud should be a higher priority; and

• The SEC should oversee the accounting profession and undertake enforcement actions to assure that self-regulation is effective.

The Demise of the Foreseeability Standard

In 1931, Justice Cardozo's opinion in *Ultramares Corp v. Touche*, (1931) 255 N.Y. 170, shielded accountants from liability by requiring privity for suits for professional negligence. In the 1960's, courts started to liberalize the standard, and a trend developed wherein the privity requirement was eliminated. In California, for example, a foreseeability standard was adopted, so that any third party who reasonably and foreseeably relied on audited financial statements could sue the auditor for material misstatements. That standard was at its apex in the mid-1980's. Then, the accounting profession made a concerted effort to convince the courts that the foreseeability standard had opened the floodgates of litigation. Accountants argued that despite their unique role as the "public watchdog," they should not be held responsible to the general public.

The tide finally turned when the California Supreme Court rejected the foreseeability rule in *Bily v. Arthur Young* (1992) 3 Cal.4th 370. Under *Bily*, only specifically intended beneficiaries of the audit report are able to sue, and then, only under a theory of negligent misrepresentation. In essence, the new rule requires that the plaintiff must not only be an intended beneficiary, but also that the plaintiff was known to the auditor and the audit report was rendered for the benefit of the plaintiff. In place of a flood of litigation from too liberal a standard, *Bily* created another shield for accountants that led to more financial fraud and ultimately the current flood of securities litigation.

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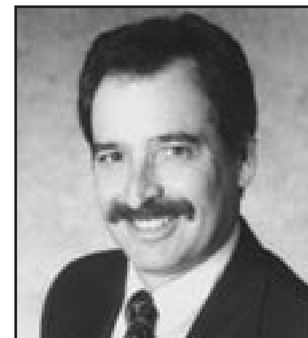
What Every Civil Litigator Needs to Know about SEC Investigations

The past several years have seen a dramatic increase in the visibility of the Securities and Exchange Commission's Enforcement Division. A corporate earnings restatement, which until recently might have resulted only in a class action lawsuit, is increasingly likely to lead to an SEC inquiry. The implosion of the internet bubble, the notorious collapse of Enron and Worldcom, and the passage of the Sarbanes-Oxley Act have placed the activities of the Enforcement Division squarely in the public eye, and have all but guaranteed that the SEC's enforcement budget will increase in the coming years. Securities litigators must increasingly be aware of the dynamics of SEC enforcement actions, and must consider the potential impact of SEC investigations on their corporate and individual clients. It is also important to bear in mind that an increasing number of SEC investigations are being conducted jointly with criminal investigations by U.S. Attorney's offices, although criminal law issues will not be addressed here.



William S. Freeman

The typical SEC investigation bears little resemblance to civil litigation in state or federal court. Unlike an adversary in the typical civil case, the SEC is not required to tell you or your client what it is investigating, what theories or leads it is pursuing, what information it is receiving, or who is providing it. The rules of procedure are idiosyncratic and partially unwritten. Even the terminology is different: the SEC attorneys are referred to as "the staff;" witnesses provide testimony under oath, not depositions. Developing strategies to deal with the unique challenges of an SEC investigation is critical to a successful defense.

Stages of an Enforcement Action

Unlike civil litigation, in an SEC investigation the complaint comes only at the end, if at all. The investigation is non-public, and your paramount goal is to prevent a complaint from ever being filed. If you can persuade the staff that your client should not be pursued, the investigation will be closed without action. Otherwise, you will face the choice of settling with the Commission, which involves a public announcement of the charges that are being settled, or proceeding to trial in an administrative action or a civil complaint in U.S. District Court.

Many investigations begin as "informal inquiries," with a letter or phone call from an Enforcement Division staff attorney inquiring about a transaction or occurrence and requesting voluntary production of documents. If these

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SEC Investigations

requests for voluntary cooperation don't produce the necessary information, or if the investigation becomes more urgent or high-profile within the SEC, the staff will seek, and the Commission will routinely issue, a Formal Order of Investigation. This empowers the staff to issue document subpoenas and compel testimony. It is in your client's interest to keep the investigation informal if possible, since it is probably easier for the staff to close the file without action before a Formal Order has been issued. Strategic cooperation with the staff may keep the proceedings informal. The staff may not seek a Formal Order if it can get the information it needs without one.

During a formal investigation, the staff will subpoena documents from the company or individuals under investigation, as well as from third parties, and will take testimony from witnesses in order to build its case. This phase of the proceedings can last months or years, since there is no judicial officer pushing the parties along. Among your greatest challenges will be keeping track of the information being gathered by the staff attorneys and where they are in their thought process, since the staff has no obligation to provide this information to you.

At the conclusion of the investigation, if the staff intends to recommend that the Commission institute proceedings against your client, it will send you a "Wells notice" — a minimalist letter that lists the statutes and rules that your client allegedly violated, but without supporting factual allegations. You will have the opportunity to prepare a "Wells submission," a brief setting forth your client's factual and legal defenses, for the Commission's consideration in deciding whether to initiate an action. It will be transmitted to the Commission together with the staff's recommendation, which you will not have an opportunity to see. The Commission then will determine whether or not to commence formal proceedings or accept an offer of settlement.

Because the SEC has never formally notified you of the factual basis or theories of its proposed case, you will have to infer them based on everything you have been able to learn during the investigation. For this reason, the key to an effective defense is learning everything you can from every possible source during the course of the investigation.

Should Your Client Cooperate with an SEC Investigation?

The first question you must confront is the extent to which your client should cooperate with the investigation. There is no single answer to this question. The appropriate course of action will depend on the client's relationship to the matter under investigation, the effect of voluntary cooperation on the SEC's ability to uncover the facts, and whether cooperation is likely to be rewarded by the staff.

Before you and your client decide whether to cooperate, you should review Securities Exchange Act of 1934 Release No. 44969, also known as the "Seaboard Release," issued by the SEC in October 2001. This Release lists the factors that the SEC takes into account in determining the severity of the sanction it may seek. Many of the factors deal with the nature, causes and severity of the alleged offense, and are therefore beyond your control by the time the investigation has begun. Other factors, however, may be within your control. If you are counsel to a company under investigation, you should be aware that the SEC will consider what steps the company has taken to uncover misconduct and to prevent possible recurrence. If an internal investigation has been conducted, the SEC will consider whether the investigation was thorough and unbiased.

One particularly controversial aspect of the Seaboard Release is the statement that the SEC will look favorably upon companies that turn over the fruits of an internal investigation, thereby waiving the attorney-client privilege and the attorney work product doctrine. There are significant risks inherent in such a waiver — most notably, the risk of waiver as to third parties in future litigation. In order to encourage this kind of cooperation, the SEC will, as a matter of policy, agree not to consider or claim that the production of privileged materials waives the privilege as to subsequent SEC requests or requests by other parties. If you decide to turn over privileged materials, be sure to get this agreement in writing signed by a supervising attorney, but remember that the usefulness or enforceability of such an agreement is uncertain at best.

Producing Documents to the Staff

One of the first steps you will have to take is to respond to an extensive document subpoena. If the investigation is still at the informal inquiry stage, the request may be a voluntary one, but it will look and feel like a subpoena, and will turn into a subpoena in a hurry if the staff is not satisfied with your client's response. Formal or not, the request will usually be far broader than you would like it to be, and will come with a very short response fuse — typically two weeks.

There are no rules comparable to the Federal Rules of Civil Procedure to guide you in your response. The timing and scope of document production can be negotiated, although the SEC tends to be unsympathetic to claims of undue burden, perhaps because it does not have reciprocal discovery obligations. One useful approach is to suggest that your client's responses be phased, with the more burdensome responses deferred until the staff has had an opportunity to determine whether your client's other responses have provided sufficient information. Any agreements extending the time to respond or narrowing the scope of the response should be documented in writing. Also, be certain to follow the procedures set forth at 17 C.F.R. section 200.83 for requesting "confidential treatment" under the Freedom of Information Act, to prevent your client's documents from being routinely released to third parties by the government.

Ultimately, a subpoenaed party has limited options for resisting document demands. Without a judicial officer to

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oversee the process, the SEC's recourse to a refusal to produce is a subpoena enforcement proceeding in U.S. District Court. This provides protection for your client, but at a cost: the subpoena enforcement process turns what had been a non-public process into a public one.

The Initial Interview

The staff may request your client's cooperation in the form of an informal interview, either in person or by telephone. Even if you feel she has nothing to hide, she should not submit to an interview until you have given her a thorough briefing about the process and she and you have a solid command of the underlying facts. The last thing you want is for subsequent discovery to undermine your client's statements. You should accompany her during the interview, and she should understand that she is free to assert her right against self-incrimination and to terminate the interview at any time.

The initial interview is not conducted under oath and there will be no transcript, but it should be treated like sworn testimony. The staff attorneys will ask pointed questions and they will be taking notes. Even though your client cannot be charged with perjury based on the interview, she could be charged with making a false statement to a government official — a felony under 18 U.S.C. section 1001.

Testifying Under Oath

At some point, your client will probably be subpoenaed to give testimony under oath. Although the process has some of the feel of a civil deposition, there are important differences.

First, even if your client is a target of the investigation, he and you have no right to be present at the testimony of other witnesses.

Second, the SEC staff controls the transcript, and there is no "going off the record" without the staff attorney's agreement. This can make it difficult for you to confer with your client. If you believe a conference with the client is necessary, you should request a break. If the staff refuses, your only recourse is to leave the room with your client, but you should do so only if the circumstances are urgent, the questioner is acting improperly, and you are certain that a review of the transcript will support your position. The SEC can seek to discipline attorneys for obstructing an investigation.

Third, formal objections are relatively unhelpful. Since the primary purpose of the testimony from the staff's perspective is to create a record supporting proceedings against your client, it is far more important that a fair record is created than it is to make formal objections. If a question is ambiguous, don't state an objection; suggest an alternative formulation that your client understands. If your suggestion makes sense, your question will often be adopted by the staff.

Fourth, while the proceedings are tape recorded, you must make a strategic decision whether to request a transcript. Access to the transcript can be extremely helpful during the later stages of the investigation — particularly when drafting a Wells submission. On the other hand, the transcript may be discoverable in other civil litigation.

Fifth, you are not permitted to keep copies of the exhibits introduced by the staff. If the staff shows your client an important document from a third-party source, take whatever notes you can to capture its essence, because it may be a long time before you see it again.

At the conclusion of the testimony session, the staff attorney will ask whether you wish to ask your client any questions. While you may instinctively recoil at the notion of giving free discovery to the staff and inviting follow-up questions, this may be your only chance to lay out your client's story under oath and in a compact package. If that story has not been thoroughly or coherently set forth through responses to the staff's questioning, it may be important to have it readily accessible to the staff at the time of the Wells submission.

Tracking What Other Parties Are Doing

The biggest difference between an SEC investigation and civil litigation is your lack of discovery of the facts available to the SEC. Fortunately, there are several ways to increase your access to what the SEC knows.

The first is to represent multiple parties or witnesses, provided you can do so consistent with applicable rules of professional conduct. The more witnesses you can ethically represent in testimony and document production, the more testimony sessions you will be able to attend, and the more you will detect pattern and direction in the SEC's questions.

The second is to enter into joint defense or other information sharing arrangements with counsel for other witnesses. Your client, however, should be warned against discussing the subject of the investigation, his recollection of events, or his testimony with other parties or witnesses. The staff will ask if such discussions have occurred, and takes a dim view of them.

The third is to develop a relationship with the staff that will allow you to exchange information that might be in each party's self-interest. While staff members are often reluctant to tell you anything about what they are doing or what leads they are pursuing, more seasoned hands will occasionally recognize the benefits of a strategic exchange of information.

Settle or Litigate?

The best way to conclude an investigation is to convince the staff that charges should not be brought against your client. Take every opportunity to present your client's arguments to the investigating attorneys and their superiors. Scheduling a meeting that includes more senior attorneys is often useful. If you have retained expert consultants, consider making their work product available to the staff. Don't wait for a Wells notice; by then, your best chance to convince the staff may already have passed.

If the staff is still inclined to proceed with formal charges, you should prepare your client for difficult choices. Once again, you will find that the normal civil process is turned on its head.

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Criminal Sentencing

level, the longer the sentence. There are six different "Criminal History Categories" on the horizontal axis, which take into account prior criminal history. Part 5H of the Guidelines specifically precludes judges from considering most other behavior characteristics, including age, education, physical condition, employment record, family ties and military, civic, charitable or public service contributions.

Sentencing Individual Defendants

The Guidelines Application Instructions. Part 1B1 of the Guidelines, "General Application Principles," prescribes sentencing procedures. Section 1B1.1 summarizes the process: determine the offense guideline section that is applicable based on the offense conduct (*i.e.*, the specific federal statute charged); apply relevant adjustments from Chapter Three (adjustments, up or down, may relate to the victim, to defendant's role in the offense, to defendant's obstructive conduct and to defendant's acceptance of responsibility); and determine the criminal history category. Section 1B1.2 specifies how to determine the applicable guideline section.

"Offense conduct" is generally the crime, charged in the indictment or information, of which the defendant was convicted, by plea or at trial. Section 1B1.3 outlines the ways that "Relevant Conduct" can affect the guideline range. Relevant conduct includes the conduct of the defendant during the crime — what exactly occurred during the commission of the offense and in preparation for the offense, what harm resulted, and whether that harm was intended. Finally, courts consult the sentencing table where the grid coordinates particular offense levels to the criminal history category, and prescribes, at each coordinate, a particular sentencing range.

Downward Departures and Adjustments. Once the sentencing range is established, courts may be asked to depart downward. Judges must sentence within the guidelines' range unless "the court finds that there exists an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described." 18 U.S.C. section 3553(b).

While downward departures are only allowed in "the extraordinary case — the case that falls outside the heartland for the offense of conviction" (*U.S. v. Jackson*, 30 F.3d 199, 201 (1st Cir. 1994)) — the Sentencing Reform Act specifically states that sentences must be "sufficient, but not greater than necessary" to comply with the designated statutory purposes (18 U.S.C. section 3553(a)). Downward departures from sentence ranges are available because the Sentencing Commission recognized that the guidelines cannot possibly be tailored to fit every case and every offender. Downward departures are reviewable by an appellate court, generally under an abuse of discretion standard; a refusal to depart is not appealable.

The Guidelines' explanation of circumstances in which downward departures may be warranted is found in Part K ("Departures"). The section that probably has the most relevance to civil lawyers with clients in parallel civil and criminal proceedings is section 5K1.1, "Substantial Assistance to Authorities" which states, "Upon motion of the government stating that the defendant has provided substantial assistance in the investigation or prosecution of another person who has committed an offense, the court may depart from the guidelines." Section 5K1.1 may only be invoked by the government, but once invoked, the court has discretion to depart downward as much, or as little, as it finds appropriate.

Another particularly relevant section is section 5K2.16, "Voluntary Disclosure of Offense," which provides that disclosure may be grounds for downward departure when the defendant discloses the offense prior to discovery by authorities, and authorities would not likely have discovered the offense but for disclosure.

Under section 5K2.0, "Grounds for Departure," the guidelines note that pursuant to 18 U.S.C. section 3553(b), sentences may be imposed under circumstances warranting departure that are not specifically enumerated in the guidelines. "With those specific exceptions, however, the Commission does not intend to limit the kinds of factors, whether or not mentioned anywhere else in the guidelines, that could constitute grounds for departure in the unusual case."

The Guidelines provide for reduction of offense levels when defendants accept responsibility for their crimes. Whether offense levels should be reduced on this basis is a question for the court in every case, and no government motion is required. Section 3E1.1 (a) states "If the defendant clearly demonstrates acceptance of responsibility for his offense, decrease the offense level by 2 levels." One more level of decrease is available where: (1) the defendant qualifies for a decrease; (2) the offense level is 16 or greater; and (3) the defendant has assisted authorities in the investigation or prosecution of his own misconduct. The commentary notes that "voluntary payment of restitution prior to adjudication of guilt" is an appropriate factor to consider when determining whether responsibility has been accepted.

Sentencing of Organizational Defendants

Organizational defendants, including corporations, partnerships, and other entities, are sentenced according to Chapter 8 of the U.S. Sentencing Guidelines, and may be subject to downward and upward departures. Crimes addressed in Chapter 8 include fraud, bribery, money laundering, theft, tax offenses, and antitrust offenses. The purposes of the organizational guidelines are: remedying the harm; divesting a criminal organization of its assets; basing fines for normal business organizations on the seriousness of the offense and organization's culpability; and probation to ensure that a sanction is carried out or that future criminal conduct is avoided.

When sentencing corporations, courts examine the connection between the bad actors and the corporation's key officers. The stronger the connection, the stiffer the

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Chip Rice

On LITIGATION STRATEGY

I like to go both ways. I mean, of course, that I like to do both plaintiffs' and defense work. It gives me an interesting perspective on the different sides of the "v." Here are some thoughts on what works for a plaintiffs' lawyer.

Being a Plaintiffs' Lawyer

The most important job for a plaintiffs' lawyer is to make things happen. At the most basic level, a plaintiff wants to change the status quo, and the defendant does not. Every day that something doesn't happen to move the case to a resolution is a victory for the defense and a defeat for the plaintiffs.

So a plaintiffs' lawyer has to be aggressive. Defense lawyers can be phlegmatic, overly meticulous, and even lazy, and it won't necessarily hurt their client. In fact, that temperament can be extremely effective for a defense lawyer. But it won't work for a plaintiffs' lawyer.

As a young lawyer, I attended a trial setting conference with a dozen big firms representing various defendants. The plaintiff was asking for an early trial date, while the defendants were demanding more time for discovery. The plaintiff's lawyer argued that lengthy discovery would eat away at the defendants' "wasting" insurance policy (*i.e.*, one where defense costs are taken from the policy limits) and leave less for his clients to recover. He walked behind one of the seated defense lawyers, put his hands on his shoulders, looked up pleadingly at the judge and said, "Your Honor, this man has my money!" Now, that's a plaintiffs' lawyer.

Speed Kills

Defendants usually hope that plaintiffs will run out of money or desire before they get to trial. So plaintiffs' lawyers must try to get to trial quickly and use their resources effectively. I think it is a mistake, however, to try to save money by putting things off. It's better to spend what you have, while you have it, on the discovery that you think will have the biggest positive impact.

As a defendant, I usually prefer to avoid taking a position on any particular issue as long as possible. If I don't have to explain myself now, I may think of a better explanation later. And there's always more that I would like to know before committing myself. As a plaintiff, I want to force defendants to take positions and make decisions as fast as possible. It's like a full court press in basketball: force the defendants to make decisions quickly and they will make more mistakes. For example, they will take some ill-considered position in writing or at a deposition before they have reviewed their own documents completely.

So, get a document request out right away and start taking depositions. Push for an early trial date. And keep looking for ways to make the case go faster.

Bring the Pain

As a plaintiff, getting to trial and winning is a backup strategy. What you really want to do is force a good settlement as quickly and efficiently as possible. You need to get your case ready for trial, but you should be doing it in a way that "brings the pain" to the defendants. I'm not talking about knee-capping anyone — just ways that maximize the pressure to settle by making the status quo less attractive.

Most defendants prefer aerial bombing. They want their lawyers to keep the case at a distance so they don't have to spend time or energy on it. You want to depose those defendants as soon and as thoroughly as possible. A deposition is the best possible way to force them to make decisions, give explanations, and confront the "smoking gun" documents. It will sharpen any internal contradictions in the defendants' case much faster than any other approach. It makes the case real for the principals on the other side, and it cuts through the "tiered" arguments that lawyers love to make. ("I wasn't there. I didn't do it. I'll never do it again.")

Chip Rice

It is surprising how often a deponent is ill prepared. This is especially true in a case that involves a complex sequence of events that occurred a few years ago and generated a lot of documents. With a little hard work, you can know the documents better than the witness. Then, it is just a matter of eliciting contradictions between the documents and the testimony that defendants will be stuck with for the rest of the case.

All of this may sound a little too aggressive. If so, stick to being a defense lawyer. One last story: an American researcher asked a Buddhist monk what the Tibetan word was for "victory." The monk replied that there was no such word because the Tibetans believed in avoiding conflict. He admitted that sometimes there were conflicts, but the side that won did not call that "victory." They called it "an excellent peace."

Peace is excellent when you're happy with the status quo, but not when you feel that you have been wronged. As a plaintiff, you want justice first and peace later. That's why you need a plaintiffs' lawyer who will make things happen. ❑

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Accounting and Financial Fraud

The Financial Motive To Commit Fraud

The investing public has always held a basic perception that corporate America is hardworking, that competition and free enterprise keep businesses honest, and that given the choice most executives will not act illegally. This is true for many companies. Both the law and the accounting rules accept this premise. Under the federal securities laws, if there is an explanation for the conduct that is equally susceptible to a legal, as well as an illegal interpretation, there will be no liability. Also, heavy burdens have been placed on plaintiffs to prove scienter.

In auditing, one of the primary sources of audit evidence is management's representation that nothing illegal has occurred that would materially impact the financial statements. In every audit of a company, management must provide its auditors with a representation letter which is typically drafted by the auditors. Even though the auditors cannot base their audit opinion solely on the representations of management, the starting presumption is that if management does not disclose that something is wrong, then it did not happen. The problem with this presumption is that the rest of the audit process is only as effective as the auditors' willingness to challenge the economic substance of certain transactions. Despite the fact that auditors are now required to look for, and report, fraudulent financial transactions, the act of blowing the whistle on a client is not done unless absolutely necessary. Under the auditing standards, the obligation to disclose fraud starts with a disclosure to management (which probably was involved in the first place), and then progresses to the Audit Committee. Thereafter, if nothing is done to remedy the situation, the auditor may resign. Needless to say, a resignation sends off alarm bells throughout the financial markets.

As a general matter, "the disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report." (AICPA Professional Standards, AU Section 316, "*Consideration of Fraud in a Financial Statement Audit*," ¶ 316.40.) The exception is where the fraud constitutes a reportable condition or is the source of disagreement between the auditor and the company.

Therefore, even under the current rules, substantial room exists for financial fraud before somebody has to blow the whistle. More importantly, all of the disclosure requirements are couched in terms of materiality, and if a particular transaction is fraudulent, but not material to the financial statements taken as a whole, this may be used as a reason not to disclose.

In this environment, the "public watchdog" function is essential. The decision to commit financial fraud is one that builds up over time. Recently, the decision to cross the line was driven both by the desire to cash in and by financial markets that developed unsupportable expectations for earnings growth. To let down the market by not making the forecasted numbers resulted in an instant and punitive drop in stock prices. To keep those prices up, financial manipulations had to be devised. Accountability, in the truest sense of the word, could and would have stopped the decision to cross the line.

The simple fact is that the corporate culture during the latest financial bubble was obsessed with meeting earnings expectations. This led to price-to-earnings ratios on the Nasdaq that went from an average of 40-to-1 in 1996 to a high of over 240-to-1 in 1999. During the same period stock market capitalization and stock prices hit all time highs. The frenzy to invest was broad-based. The atmosphere was driven more by psychology and greed than reality, and the urge to cheat became irresistible.

What Does The Future Hold?

In the last several months, there have been many efforts to curb the tide of financial fraud. This includes the Sarbanes-Oxley Act of 2002 which President Bush signed into law on July 30, 2002 in the wake of Enron and WorldCom. As directed by section 302(a) of that Act, the principal executive and financial officers of public companies are required to certify the financial statements contained in quarterly and annual reports. Rules promulgated by the SEC require the principal officers to certify that: (1) they are responsible for the effectiveness of internal accounting controls; (2) adequate disclosures about any internal control issues have been made to the Audit Committee and to the SEC; and (3) no fraud or illegality has occurred.

Other aspects of Sarbanes-Oxley, which the accounting profession is watching carefully, are the eight types of services that are deemed unlawful for an auditor to provide to a public company. Those include bookkeeping, information systems design and implementations, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, and legal/expert services. In addition, the SEC recently released proposed regulations regarding an auditor's independence. These proposed rules include: how non-audit services would impair an auditor's independence; prohibitions on partners in audit engagements from serving for more than five consecutive years; preclusions on auditing a company where auditors have gone to work at the company; and requirements for more detailed disclosures about high risk and critical audit issues.

Unfortunately, even before Sarbanes-Oxley got off the ground, the SEC staff was recommending softening the proposed rules.

> Some of the toughest proposals appear to be dead, watered down or postponed, SEC officials said today. Critics attributed the shift to heavy lobbying from prominent law firms, bar associations and some leading accounting firms and trade groups. (Stephen Labaton and Jonathan D. Glater, *The New York Times*, January 22, 2003; Section A1.)

For example, in what accountants call a "big win," the SEC will allow audit firms to provide tax services to audit

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Trent Norris

On ENVIRONMENTAL LAW

There's a new tool for attorneys defending companies against claims they have violated environmental and consumer protection laws. It's called the anti-SLAPP motion, and the plaintiffs bar is none too happy about it.

Code of Civil Procedure section 425.16 allows a defendant in a "Strategic Lawsuit Against Public Participation" to test the plaintiff's case at the outset. In the paradigm situation, a community activist sued for defamation by a company she has criticized can have the suit dismissed (and her attorneys' fees paid) if: (1) she shows that it arises from an act in furtherance of her right of free speech or petition on a public issue; and (2) the company cannot show the case's merit. In this way, the California Legislature — at the behest of then-Senator, now Attorney General Bill Lockyer — sought to prevent "participation in matters of public significance" from being "chilled through abuse of the judicial process."

Of course, public participation comes in many forms, including commercial speech and business lobbying. Originally, business lawyers cautioned overzealous clients against suing activists, but it wasn't long before they discovered that the anti-SLAPP law might also protect their clients against overzealous activists.

For years, environmentalists bringing citizen suits alleging, at their core, environmental violations, have included claims under false advertising and unfair competition laws. These laws carry restitutionary and injunctive remedies not always available under environmental laws. They call for individualized determinations based on standards of a "reasonable consumer" or an "unfair" business practice, so suits based on them are difficult to defeat on summary judgment. Such suits — where plaintiffs allege no injury — are also difficult to remove to federal court.

These laws also often implicate defendants' rights of free expression on issues of public interest. In a groundbreaking decision in *DuPont Merck Pharmaceutical Company v. Superior Court*, 78 Cal. App. 4th 562 (2000), the California Court of Appeal ruled that the anti-SLAPP law protected a drug manufacturer from allegations that its statements and lobbying about a competing product violated consumer protection laws. The Court did not consider the motivation of the drug company — presumably to sell more of its product — but found that its lobbying was covered by the anti-SLAPP law. It also found, in a holding with broad significance, that the company's statements were "in connection with an issue of public interest," because of the number of people who use the drug and the life-threatening nature of the conditions it treats.

Under this reasoning, where there is an identifiable issue of "public interest," causes of action attacking a company's efforts to promote its products are subject to higher scrutiny. Furthermore, since any speech that concerns an issue of "public interest" triggers the law's application, the characterization of the speech as "commercial" or "political" under the First Amendment is inconsequential.

The courts have not provided much guidance for determining what issues qualify as being of "public interest;" in fact, observers have referred to a "know it when they see it" standard. Viewed in light of the Legislature's admonition that the anti-SLAPP law be "construed broadly," the public relations and promotional efforts of many companies sued for environmental violations at least arguably relate to issues of public interest, including land development, environmental remediation, energy exploration, and product safety. In order to avoid an early dismissal, plaintiffs therefore need to tailor their complaints narrowly or prepare to show a reasonable likelihood of prevailing.

The anti-SLAPP motion provides numerous strategic benefits. Its mere filing stays all discovery in the action (even as to defendants who do not join in the motion). It requires plaintiffs to disclose their best facts and arguments without the need for discovery. And the court's ruling is immediately appealable, without the need to seek discretionary review. That guarantees even an unsuccessful movant a respite that may be invaluable.

Trent Norris

There are risks as well. If the trial court deems the motion "frivolous or solely intended to cause unnecessary delay," it may order the movant to pay the plaintiff's attorneys fees. And it is inevitable that a judge hearing an anti-SLAPP motion will hear an abbreviated, and potentially prejudicial, version of the facts.

To plaintiffs lawyers, it is a travesty that a law prompted by hardball tactics of well-heeled companies has become its own hardball tactic. But to beleaguered business trial lawyers, weary of explaining California laws to incredulous general counsel, the *DuPont Merck* court's view of the anti-SLAPP law is a potential vehicle for vindicating their exasperated clients' sense of fairness. And its use to protect the speech of companies on "matters of public significance" is consonant with the law's stated purpose — if not its original political motivation.

The defense bar's use of the motion has not escaped the notice of the Legislature. Last year, it voted to overturn the *DuPont Merck* decision by exempting representative actions implicating the commercial speech of businesses. Governor Davis vetoed that bill, stating his concern that it would "unduly interfere[] with the court's discretion" to "guard" the First Amendment right to free speech. Instead, the Governor stated a preference for expediting appellate review of anti-SLAPP rulings.

Additional legislative activity is likely this year. Until then, business trial lawyers will keep the anti-SLAPP tool handy.

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Criminal Sentencing

penalties. For example, section 8C2.5, "Culpability Score," considers the organization's size and the level of involvement that "high level personnel" had with the offense. Culpability of organizational defendants generally turns on steps taken to prevent, remedy and detect offenses, and whether assistance was provided to law enforcement after the discovery of an offense. The culpability score determines the number by which to multiply the fine imposed.

Illustrative Example

The following hypothetical illustrates how the Guidelines work, and how the defendant's conduct in the civil case can affect sentencing.

> Bill Blue, CEO of Blue Corporation (BlueCo), was investigated by the SEC for securities fraud. Blue held 25% of this publicly traded corporation's stock. BlueCo made public statements that earnings were expected to triple in the second quarter, which increased stock prices and sales. In fact, the company's sales volume in the second quarter was half the volume of the previous quarter. An SEC investigation revealed that Blue instructed the press office to publish false information about projected earnings after learning about a projected sharp decline in sales for the second quarter. When the SEC investigation began, Blue immediately turned over information showing insider knowledge that the statement regarding projected earnings was false when made. During the investigation, Blue admitted sharing insider knowledge with Red, who owned a significant percentage of stock in BlueCo. Red, Blue told the investigators, told Blue that on the basis of this information he would sell his shares before stock prices fell. Red sold his stock at the height of its value and its worth subsequently declined by half. Blue was indicted for insider trading and securities fraud, resulting in a $1.5 million loss to stockholders. Red was indicted, tried and convicted, based in part on the information provided by Blue.
>
> Simultaneously, shareholders brought suit against Blue, in his individual capacity, and against BlueCo. This suit alleged that Blue knowingly issued fraudulent statements about BlueCo, in reliance upon which they purchased stock in BlueCo at inflated prices and subsequently lost $1 million.
>
> While the criminal prosecution was pending, the civil suit settled for $750,000. As part of the settlement, Blue admitted making the false statement. Blue, who had no prior criminal history, accepted a plea agreement in which he pled guilty to fraud and insider trading.

At sentencing, the court refers to section 2B of the U.S. Sentencing Guidelines, titled "Theft, Embezzlement, Receipt of Stolen Property, Property Destruction, and Offenses Involving Fraud and Deceit," which applies to fraud and insider trading. Section 2B1.1 provides a Base Offense Level of 6. By examining the specific offense characteristics, the court determines how much to increase the level of the offense. The most important specific offense characteristic in this case will be the amount of the loss suffered. Here, the loss suffered was $1.5 million as a result of Blue's insider trading. For a loss of $1.5 million, 16 points are added to the base offense level, raising the offense level to 22. Because there were more than 50 victims of Blue's criminal activity, the offense level is increased by 4, to 26.

Next, the court makes any adjustment to the offense level warranted under Part 3 of the Guidelines. There is evidence that the defendant has accepted responsibility for his actions and provided restitution to the victims, which warrants a reduction in offense level by 2. Because defendant provided assistance to authorities in the investigation of his own wrongdoing and his offense level is over 16, his offense level is decreased by an additional one point, to 23. Because defendant does not have a prior criminal record, he is in criminal history Category I, and the sentencing range to which he could be subject would be from 46 to 57 months.

The government moved for downward departure pursuant to section 5K1.1 for Blue, based on his substantial

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SEC Investigations

In most civil securities cases, the defendant's worst day is the day the complaint is filed and the plaintiff's fraud allegations are broadcast. By the time the case settles, possibly years later, the public's attention has likely moved on to other matters, and the defendant can part with money while loudly denying liability and asserting that he settled to get on with his life.

Because SEC investigations are typically non-public, the first announcement of the existence of an investigation usually comes on the day the charges are settled. The SEC settles cases by filing, and simultaneously dismissing, an administrative action before the Commission or a complaint in federal district court, and it simultaneously issues a press release setting forth in great detail the charges against your client. Moreover, although your client will not be required to admit the charges, under SEC policy he must agree not to deny them; if he issues a denial, the SEC has the option to void the settlement and continue litigating.

While the settlement may have no collateral effect in other litigation, your client may find the notion that he can't issue a denial far more difficult to stomach than any of the fines, penalties or other conditions of the settlement. If you are going to settle with the SEC, prepare your client for the fact that even though he may be making an economic decision, he will have to bite his tongue and endure a spate of negative publicity.

As with most civil matters, relatively few SEC investigations proceed to trial. But if your client does not settle and the SEC files a civil complaint in federal court, the SEC must step out of the shadows of its investigative process and abandon the advantages of surprise and secrecy that it previously enjoyed. Finally, you will be competing on a level playing field governed by the federal rules, and your normal civil litigation skills should leave you in good stead.

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Kate Wheble

On TRADEMARK & COPYRIGHT

In *Eldred v. Ashcroft*, 123 S.Ct. 769 (2003), the Supreme Court upheld the "Sonny Bono Copyright Term Extension Act" (officially known as the Copyright Term Extension Act ("CTEA")), which extends the duration of copyright protection for both existing and future works by 20 years. Under the CTEA, copyright protection for works created by named individuals lasts from creation until 70 years after the author's death, and protection for anonymous works and works for hire lasts for 95 years from publication or 120 years from creation — whichever period expires first. The decision was a victory for Hollywood studios and other corporate copyright holders, who could earn billions of dollars from exploiting films and other works protected by copyrights about to expire.

The CTEA was challenged by individuals and businesses seeking to use works that were about to revert to the public domain (the "Petitioners"). The Petitioners did not take issue with longer terms for newly created works, but only with extending the term of already existing works, which they argued violates both the "limited Times" prescription of the Constitution's Copyright Clause and the First Amendment.

In a 7-to-2 decision, the Court rejected these arguments and held that Congress acted rationally and within its established authority in adopting the CTEA.

The "limited Times" provision of the Copyright clause states in part: "Congress shall have Power…[t]o promote the Progress of Science…by securing [to Authors] for limited Times…the exclusive Right to their…Writings." The Court determined that "limited Times" does not require that the term be "fixed" or non-extensible at the time the work was created. The Court gave great weight to the fact that in 1831, 1909 and 1976 Congress had extended copyright terms for both existing and future works. The Court reasoned that if those earlier extensions did not create perpetual copyrights in violation of the limited times clause, then neither did the CTEA. It found that CTEA's extension makes sense because it would be unjust not to give the same protection to an author whose work was created immediately before enactment of the CTEA as to an author whose work was created immediately after enactment.

The Court also noted that the CTEA brings the U.S. in line with a European Union directive requiring member countries to extend copyright protection for a term of life plus 70 years and to deny this longer term protection to works from countries that do not have the same extended term. Thus, reasoned the Court, through the CTEA Congress ensured that U.S. authors will be competitive with foreign right holders.

Petitioners also argued that the CTEA is a content-neutral regulation of speech that fails heightened review under the First Amendment. The Court responded that "[t]he Copyright Clause and First Amendment were adopted close in time," which indicates that "copyright's limited monopolies are compatible with free speech principles." Moreover, the Court noted that the "[t]he First Amendment protects the freedom to make — or decline to make — one's own speech; it bears less heavily when the speakers assert the right to make other people's speeches." The Court pointed out that copyright law has built-in First Amendment accommodations such as allowing free communication of facts and ideas — as opposed to the particular expression created by an individual author — and by providing "fair-use" exceptions that allow the public to use copyrighted expression in certain circumstances.

In addition, the CTEA itself supplements existing First Amendment safeguards with provisions allowing libraries and similar institutions to use and reproduce copies of certain published works in the last 20 years of their copyright terms, "for purposes of preservation, scholarship and research," and allowing small businesses such as restaurants to use music from licensed media (such as radio and television) without paying performance royalties.

Kate Wheble

In conclusion, the Court stated that "the Copyright Clause empowers Congress to determine the intellectual property regimes that, overall, in that body's judgment, will serve the ends of the Clause." Thus it is within Congress' authority to extend copyright terms to both existing and future works.

Justice Breyer dissented on the ground that the extension makes the copyright term "virtually perpetual." He argued that the extended term did not benefit authors so much as their estates or corporate successors. He also maintained that the practical effect of the extension would be to inhibit the primary purpose of the copyright laws — to promote the progress of knowledge through free dissemination of scholarly and artistic works.

Justice Stevens also dissented, calling the extension a windfall for current copyright holders. He claimed that the public was entitled to rely on promised access to protected works at the termination of terms dictated when the rights were first granted.

Where will it stop? It's highly unlikely that this will be the last time copyright terms are extended, given the attitude of copyright holders. For example, Jack Valenti, president of the Motion Picture Association of America, acknowledges that perpetual copyrights are unconstitutional, but has proposed that terms could lawfully be extended to forever minus one day.

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Accounting and Financial Fraud

clients despite prior indications to the contrary.

In addition, Sarbanes-Oxley requires the establishment of a huge bureaucracy. The Public Company Accounting Oversight Board established by Sarbanes-Oxley now becomes watchdog for the "public watchdog." However, its broad responsibilities and lack of funding make it potentially ineffective. In addition, the passage of time since the height of the public outcry about the current financial scandals is dampening the reform spirit behind Sarbanes-Oxley.

Companies following the rules should not be tarred with the conduct of those who make the wrong choice. Effective federal and state regulation, public and private prosecution of securities fraud cases, truly independent audits, and strong Audit Committees will be the vehicles to find the way through the inevitable next round of financial scandals. One thing is absolutely clear: if we do not learn from the mistakes of the recent economic bubble, then history is bound to repeat itself — again.

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Criminal Sentencing

assistance during the investigation of Red. It is clear that Blue's assistance led to Red's conviction; thus, he qualifies for a downward departure. The government's motion suggests a 5-level downward departure to offense level 18, range 27 to 33 months. Defense counsel may argue for a greater departure. The court will evaluate all of the factors presented in making its decision.

In any event, Blue's civil lawyers should advise him or assure that he is advised, that settling the parallel civil case early, admitting wrongdoing and/or providing information about related corporate wrongdoing could have dramatic consequences on the sentence imposed.

Assume the corporation was also convicted of fraud. During the sentencing of the corporation, the court considers the appropriate fines and restitution to be made. If the corporation is particularly helpful to authorities in the prosecution or investigation of another organization or individual not directly affiliated with the defendant who has committed an offense, the government may move for downward departure under section 8C4.1. The court also may depart downward where there are organizational mitigating factors, such as section 8C4.7 (corporation is a public entity); section 8C4.8 (where members or beneficiaries of the organization were victims); section 8C4.9 (where remedial costs greatly exceed criminal gain); and section 8C4.10 (where organization implements mandatory program to prevent and detect violations of law). Since section 8C4.1 provides that Chapter 5, Part K is applicable to organizations, courts might consider departing downward from the fines and restitution guidelines range for a corporation that promptly settled with consumers. Alternatively, the Court may depart upward where warranted.

The fines guidelines, while serving the goals of punishment, deterrence and disgorging defendant corporations of ill-gotten gains, do not serve the goal of providing restitution to the harmed consumers. Downward departure may be appropriate where a corporation commits to paying restitution to harmed plaintiffs.

Conclusion

Many white collar crimes have both civil and criminal consequences. Civil lawyers should have a working knowledge of the common grounds for adjustments and departures from the guidelines. This will equip them to advise their clients about how their conduct in the civil case could affect the criminal sentencing result.

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