

Identifying Accounting Problems and Adopting Practices to Detect Financial Misconduct: A Primer for Lawyers

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This article identifies frequently encountered misleading or deceptive accounting practices, discusses the legal responsibilities of attorneys representing a company to detect and deal with accounting irregularities, and suggests measures attorneys and companies can adopt to detect misconduct at an early stage and address the financial misconduct before it becomes catastrophic.

Lax accounting and business practices in the late 1990s and early 2000s were the catalyst for significant legal changes to prevent future financial misconduct. The Sarbanes-Oxley Act of 2002 (“SOX”) enhanced financial reporting requirements, created new criminal penalties for fraudulent financial reporting, and imposed stricter legal responsibilities on those in a position to detect financial misconduct.¹ However, financial misconduct is like water seeking the weakest point in a dam, persistent and very damaging when it locates a susceptible environment. Bernard Madoff used fraudulent financial reports to mislead investors² and an outsourcing firm in India recently acknowledged misreporting earnings and assets by up to \$1 billion.³

The consequences of financial misconduct can severely impact a company and frequently result in additional business costs, litigation expenses, and fines and penalties associated with government investigations. Additional business costs may arise from defaults in debt and financing agreements that are tied to financial performance and litigation expenses, including shareholder lawsuits for issuing financial re-

ports that mislead investors. In addition, regulatory agencies may fine a company, its officers, attorneys and employees for making or certifying misleading financial statements. This article identifies frequently encountered misleading or deceptive accounting practices, discusses the legal responsibilities of attorneys representing a company to detect and deal with accounting irregularities, and suggests measures attorneys and companies can adopt to detect misconduct at an early stage and address the financial misconduct before it becomes catastrophic.

OVERVIEW OF ACCOUNTING RULES

The collection, preparation and presentation of accounting information is subject to various methods and standards. In the United States, these methods and standards are known as Generally Accepted Accounting Principles (“GAAP”) and represent the accounting rules a company follows to record financial information such as revenues, expenses, assets, and liabilities.⁴ GAAP provides standard accounting rules companies follow to provide shareholders, directors,

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corporate managers, potential investors and regulatory agencies with information relating to a company's financial performance. Under GAAP, companies have some degree of flexibility to determine the timing and method of recording revenues and expenses, and the method used to value assets and liabilities. The Securities Exchange Commission ("SEC") requires a company to follow GAAP when reporting financial information.⁵

GAAP consists of cost, revenue, matching and disclosure principles. Under the cost principle, GAAP may permit a company to record the cost of an asset at its acquisition cost or at the asset's current fair market value. Revenue under GAAP is generally reported when it is realized and earned (*i.e.*, accrual basis of accounting) but not necessarily when payment is received. The matching principle requires revenue and expense to be recognized at the same time. If an expense cannot be matched to revenue, the expense is immediately recorded in a company's financial reports. The disclosure principle requires a company to provide information in its financial reports to assist in the understanding of the reports. Events that might be considered under the disclosure requirement include lawsuits, pending tax audits and expansion plans that could affect a company's financial position.

Understanding the purpose and limitations of GAAP is the first step in managing the legal risks associated with financial information and financial statements.

IDENTIFYING FINANCIAL MISCONDUCT IN FINANCIAL REPORTS

Careful examination of a company's financial reports can provide indications as to whether financial misconduct has occurred in a company. However, not all inconsistencies in financial information are the result of misconduct. The flexibility and discretion associated with the preparation and presentation of financials in accordance with GAAP need to be considered and weighed. When the interpretation and application of GAAP principles exceeds permissible discretion, it runs the risk of creating the opportunity for manipulating the cost, revenue, matching and disclosures principles to manage financial results. A brief discussion of common areas of manipulation follows.

Accelerating Revenue

A company may be entitled to accelerate revenue to boost its reported profits in financial reports. GAAP requires a company to record revenue when it is realized and earned, but a company in disregard of GAAP could accelerate the recognition of revenue and thereby boost its earnings. A company recognizes revenue when:

- There is evidence of a contract or transaction;
- The seller performs the service or delivers the product;
- The seller's price is fixed and determinable; and
- The seller reasonably expects collection of payment from the buyer.⁶

Allegations of improperly accelerating revenue resulted in General Electric Company ("GE") paying \$50 million to the SEC to settle charges of accounting fraud.⁷ In the fourth quarters of 2002 and 2003, GE sold locomotives to intermediaries who agreed to sell the locomotives to GE's railroad customers in the first quarters of the subsequent years. The SEC supported its charge that GE improperly accelerated \$370 million in revenue from the locomotive sales in the fourth quarters of 2002 and 2003 because GE continued to pay the storage costs and insurance on the locomotives sold to the intermediaries.⁸

Indications that a company is accelerating revenue include the following:

- A sudden change in a company's revenue recognition policies;
- Unexplained increases in profit;
- Increases in sales without a corresponding increase in cash;
- Sales, revenues or accounts receivable balances that are high or suddenly increasing;
- Large or unusual sales transactions occurring shortly before the end of the reporting period;
- Large amounts of returns or credits after the close of the reporting period; and
- Increases in revenue without a corresponding in-

crease in costs or offsetting increase in accounts receivable.

Channel Stuffing

Channel stuffing is the practice of offering customer discounts, extended payment terms, generous return policies or other concessions to induce the sale of products in the current reporting period. The products most likely would not have been sold until later reporting periods without the favorable concessions.

In 2006, McAfee, Inc. (“McAfee”) paid the SEC \$50 million to settle charges that it overstated revenue and earnings from 1998 through 2000 by \$622 million.⁹ As alleged by the SEC, McAfee sold software licenses to distributors in excess of amounts ordered. In return for purchasing excess software licenses and not returning them to McAfee, McAfee allegedly gave the distributors discounts, cash payments and rebates. The SEC charged McAfee with overstating revenue and failing to disclose in its financial reports the concessions given to its distributors to buy excess software licenses.¹⁰

Channel stuffing can be identified in financial reports by looking for an increase in shipments at or near the end of the seller’s accounting period.

Bill and Hold Transactions

In a bill and hold situation, the selling company records revenue from goods sold, but the buyer asks the selling company to delay shipment. The selling company might alternatively ship the goods to a warehouse for storage until the buyer is ready to accept delivery of the goods.

GAAP permits a selling company to record revenue under a bill and hold transaction if the following conditions are satisfied:

- The risks of ownership must have passed to the buyer;
- The buyer must have made a fixed commitment to purchase the goods, preferably in written documentation;
- The buyer must request that the transaction be on a bill and hold basis;

- The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
- There must be a fixed delivery schedule of the goods;
- The delivery date must be reasonable and must be consistent with the buyer’s business purpose;
- The selling company must not have further performance obligations to delay completion of the sale;
- The ordered goods must be separated from the selling company’s inventory and not used to fill other orders; and
- The goods must be complete and ready for shipment.¹¹

The SEC charged corporate executives of AstroPower, Inc. (“AstroPower”) with recognizing \$1.25 million in revenue generated by improper bill and hold transactions.¹² The SEC alleged that at the end of the third quarter of 2002, AstroPower sold two solar systems to a customer for \$1.25 million, but the customer did not take delivery of the solar systems until after the third quarter of 2002. Also, the purchase price of the solar systems was contingent upon the customer receiving rebates from the government for installing energy-efficient solar systems.

AstroPower allegedly provided the customer extended payment terms and agreed to store the solar systems at a warehouse until the customer was ready to take delivery. The SEC claimed AstroPower improperly recorded the \$1.25 million in the third quarter of 2002 because AstroPower, rather than the customer, initiated the bill and hold transaction, the purchase price was not established by the end of third quarter of 2002, the parties had not agreed upon a fixed delivery date and AstroPower retained ownership over the solar systems until delivery to the customer in the first quarter of 2003.¹³

Indicators of an improper bill and hold transaction might include excessive shipments made to warehouses rather than a buyer’s regular address, shipping information missing on invoices or high shipping costs at the end of the selling company’s accounting period.

Prepayments

Under applicable accounting standards, a selling company should not record revenue until the seller substantially delivers the product or provides the service. Such premature recording of revenue results in a distortion of financial results. GAAP requires magazine publishers, airlines, cruise lines and other companies that collect prepayments to record revenue when the good is delivered or the service is provided. For example, a magazine publisher that sells an annual subscription to its weekly magazine for \$26 should record revenue at \$0.50 per week for each subscription (\$26/52 weeks per year). The magazine publisher can not record the full \$26 at the time of prepayment.

In 2004, the SEC filed a suit charging corporate executives of US Foodservice, Inc. (“USF”) with securities fraud and insider trading.¹⁴ As alleged by the SEC, USF entered into an agreement with suppliers to pay the full wholesale price for a product in exchange for rebates from the suppliers on future purchases. Suppliers prepaid the rebates to USF but the SEC claimed USF improperly recorded the revenue from the prepayments before they were earned over time.¹⁵

Improper prepayments occur when payments are taken in advance before services are performed or the product is delivered.

Recording Revenue from Related Service Agreements

Revenue allocation can be an issue if the buyer and seller are related and enter into a service agreement. The seller could book all of the revenue from the related service agreement all in one year rather than over time as the services are performed. The SEC charged Informix Corporation (“Informix”) with improperly recognizing revenue from maintenance contracts as revenue generated from leasing licenses.¹⁶ The SEC investigation resulted in allegations that Informix employees recorded the renewal of software maintenance contracts totaling \$11.2 million as license renewals that inflated Informix’s quarterly profit.¹⁷

Long-Term Projects

Accounting rules provide for two methods to record revenue from services provided or projects built over a long-term (i) the completed-contract method, and (ii) the percentage of completion method. Under the completed-contract method, revenue is recorded upon the completion or substantial completion of the contract.¹⁸ The completed-contract method is used when the contractor cannot estimate with certainty the total cost of the project.

The percentage of completion method permits recording revenue before the completion of a project if the following requirements are met:

- The percentage of the work completed can be reasonably estimated;
- A company is likely to complete the contract; and
- There is no important uncertainty about the contract.¹⁹

The SEC charged corporate executives of Analytical Surveys, Inc. (“ASI”) with improperly recognizing revenue on long-term contracts.²⁰ ASI provided computerized mapping systems to customers under long-term contracts and recognized revenue using the percentage of completion method. The SEC alleged that ASI improperly recognized revenue on long-term contracts by directing employees to reallocate direct costs to indirect or overhead costs, shift direct costs to other contracts and lower estimates of direct costs.²¹

Delaying Expenses

In certain circumstances, a company can immediately expense a cost or delay expensing the cost into future years (*i.e.*, capitalizing the cost). Delaying costs into future years will boost earnings in the current year.

The SEC charged corporate executives of Buca, Inc. (“Buca”) with overstating revenues from 2000 to 2004 by improperly capitalizing nearly \$12 million in expenses.²² The SEC investigation alleged Buca capitalized the expenses for an annual conference of employees. Buca allegedly had vendors make contributions to fund the annual conference with the understanding that the vendors would later include the

amount contributed to the annual conference in bills for services (e.g., construction and information technology services) provided to Buca. Because the contributions for the annual conference were included in invoices for services, Buca capitalized the expense of the annual conference.²³ The SEC also charged Buca with improperly capitalizing repair, maintenance, general and administrative expenses that should have been immediately expensed.²⁴

To identify the improper delay of expenses into future years, look for large deferral of expenses.

Accelerating Expenses

To improve future earnings, a company might front-load expenses rather than delay expenses into future years. These are commonly referred to as “big bath” losses and occur when a company allocates expenses to a quarter or other reporting period when a company would record a loss in any case. From a company’s perspective, it may be better to have a bad quarter than several mediocre quarters. Also, a company can show that it rebounded from a quarter in which it recorded huge losses. In subsequent periods, expenses will be down and earnings will be higher.

The SEC charged Sunbeam Corporation (“Sunbeam”) with accounting fraud including taking a “big bath” charge to pad a \$337.6 million restructuring charge.²⁵ For the year ended 1996, Sunbeam’s corporate executives were charged with padding the restructuring charge with at least \$35 million in improper restructuring charges, excessive write-downs and premature recognition of expenses. The SEC claimed the excessive restructuring charges taken at the end of 1996 also distorted financial reports in 1997.²⁶

To identify big bath charges, search prior financial reports for large one-time losses in the past or for patterns where a company has significant losses in one period but reports higher earnings in the next period.

Improper Reduction of Selling, General and Administrative Expenses (“SG&A”)

SG&A expenses include the cost of supporting a sales force, marketing expenses, salaries and legal and auditing fees. Rising SG&A expenses may signal

that a company is not controlling costs. A company has an incentive to report reduced SG&A expenses to boost revenue and show a company is growing. For example, a company can use the flexibility GAAP provides to report that a profit of \$1 million was due to reduced SG&A expenses. If in fact the \$1 million profit was due to an unexpected one-time gain, the flexibility of GAAP permits a company to distort the source of the \$1 million profit. Showing that a company reduced SG&A expenses by \$1 million indicates a company reduced costs and became more efficient. In reality, the gain was unexpected and unrelated to reduced SG&A expenses.

The SEC charged Tyco International Ltd. (“Tyco”) and its auditor with using SG&A expenses to offset an unexpected charge that would impact Tyco’s financial results.²⁷ To offset an unexpected compensation charge of \$40 million due to corporate executives exercising stock options, Tyco allegedly reduced SG&A expenses by \$40 million. As reflected in the SEC investigation, reducing SG&A expenses by \$40 million permitted Tyco to offset the compensation charge without disclosing the \$40 million paid to corporate executives.²⁸

To identify improper reduction of SG&A expenses, look for significant changes in the SG&A expenses compared to prior years. A reduction of SG&A expenses in the current year to half of that in the preceding year would be suspicious. A company should be able to explain the change in SG&A expenses and categorize the SG&A expenses (*i.e.*, salaries, marketing, legal, etc.).

Overstating Inventory to Increase Profit

Inventory is the key component in determining a company’s cost of making products. A company’s cost is called Cost of Goods Sold (“COGS”). COGS are subtracted from revenue to determine a company’s gross profit. Generally, as inventory rises, the COGS fall. For a current accounting period, a company has the incentive to overstate inventory to reduce COGS and thereby enhance revenue.

In 2008, the SEC charged The Penn Traffic Company (“Penn Traffic”), a supermarket operator and wholesale food distributor, with overstating its profit by more than \$7 million.²⁹ As alleged by the SEC, an executive of Penn Traffic’s wholly-owned subsidiary

directed employees to overstate inventory and thereby improve the subsidiary's financial performance. Penn Traffic allegedly overstated revenue by including the subsidiary's revenue in its consolidated financial reports.³⁰

Indicators of improper treatment of inventory include inventory rising faster than actual sales, falling shipping costs while the total inventory has increased and sudden increases in inventory at the end of a company's accounting period.

Off-Balance Sheet Accounting

Off-balance sheet accounting generally includes the use of special purpose entities ("SPEs"), which are separate legal entities owned by a parent company and an independent outside investor. SPEs have been used to remove assets, liabilities, income or expenses from a company's financial reports. U.S. law requires a company to disclose all material off-balance sheet transactions, arrangements and obligations in financial reports.³¹ The disclosure prevents the use of SPEs to hide earnings or losses.

In 2002, the SEC brought an enforcement action against The PNC Financial Services Group, Inc. ("PNC") for failing to disclose in its financial reports SPEs used by PNC to hold investments generating losses.³² Recently, Biovail Corporation, a Canadian pharmaceutical company traded on the New York stock exchange, paid the SEC \$10 million to settle charges of accounting fraud including the use of SPEs in the years 2001 and 2002 to remove from its financial reports \$47 million in research and development expenses.³³

Pro Forma Reports

Pro forma reports are financial reports generally following GAAP but exclude unusual and nonrecurring transactions. These reports can be used to divert attention away from lower earnings reported in official financial reports.

In 2002, the SEC charged Trump Hotels & Casino Resorts, Inc. ("THCR") with announcing pro forma earnings that suggested THCR exceeded its earnings expectations through efficiency gains.³⁴ THCR recorded a one-time \$17.2 million gain due to a payment from a lease termination but in its pro

forma earnings, THCR allegedly failed to disclose the one-time gain.³⁵

The SEC also charged corporate executives of Ashford.com, Inc. ("Ashford") with misstating pro forma results by changing the classification of expenses without disclosing the change in pro forma reports.³⁶ Ashford allegedly changed its method accounting to immediately expense marketing expenses rather than capitalize and amortize the expenses. The SEC claimed that the change in accounting for the marketing expenses reduced Ashford's expected pro forma loss to \$0.30 per share when analysts expected a loss of \$0.31 per share.³⁷

The SEC adopted rules in 2003 to regulate the use of pro forma reports and the disclosure of information regarding pro forma reports.³⁸ The SEC rules require pro forma reports to include a directly comparable measure from the official financial reports.³⁹ Improper use of pro forma reports can be identified by large differences between pro forma and GAAP earnings.

Understating Bad Debts

Bad debts constitute the portion of money owed to a company that can no longer be collected. GAAP generally requires bad debts to be immediately expensed.⁴⁰ A company understating bad debts will overstate income in the current year, while reported income in future years will be reduced when the bad debts are eventually written off.

ConAgra Foods, Inc. ("ConAgra") paid \$45 million to the SEC in 2007 to settle charges of accounting fraud including the failure to record a bad debt expense.⁴¹ To meet financial targets, a subsidiary of ConAgra was charged with improperly reducing its bad debt reserves by \$7 million. ConAgra included the subsidiary's overstated earnings in its consolidated financial reports. The understatement of bad debts by the subsidiary allegedly resulted in ConAgra overstating its consolidated gross income by \$7 million.⁴²

To identify financial issues related to an understatement of bad debts, evaluate the quality of the amounts owed to a company by its customers. Compare the amounts that are current, past due 30 days, 50 days, etc., to determine if there is any inconsistency. For example, amounts that are currently due should

have a lower occurrence of nonpayment as compared to amounts that are 90 days or 120 days past due. Also, a company should use a consistent method to account for bad debts. Sudden changes in the assumptions used to determine the amount of bad debts or a large increase in sales without a corresponding increase in bad debts could signal a company is understating bad debts.

Changing Accounting Methods or Assumptions

A company generally uses a consistent method to account for revenue or expenses but changes in accounting methods or assumptions can be made for legitimate reasons. When the accounting methods or assumptions change, a company should disclose the reasons for the change in financial reports.

A notable example of a failure to properly disclose a change in accounting methods resulted in Xerox Corporation (“Xerox”) paying \$10 million to the SEC to settle charges of accounting fraud including the failure to disclose changes in the accounting method used to report revenue from financing agreements and service revenue.⁴³ The change in accounting method increased revenue by \$2.8 billion from 1997 to 2000 but Xerox was charged with failing to disclose in its financial reports that increased revenue resulted from changes in the accounting method.⁴⁴

Disclosures Made in Financial Reports

The SEC can bring a civil action or penalize a company for omitting or misstating material information in a financial report. An omission or misstatement of an item in a financial report is material if it is probable that a reasonable person relying upon the report would have been influenced by the inclusion or correction of the item.⁴⁵ The SEC applies an informal rule where an omission or misstatement is material if it is five percent or more of a specific measurement such as revenue, profit, expenses, etc.⁴⁶

Disclosures are made in the Management and Discussion Analysis (“MD&A”) section of the financial report. The MD&A describes a company’s mission, activities, programs, financial performance, systems, controls, legal compliance, financial position and financial condition. It also discusses the future

risks to a company and actions taken or planned to address the future risks. The SEC issued guidance regarding the MD&A section to make it easier to read, provide more information relating to a company’s performance, require accurate disclosure of current assets and liabilities, and estimate the cost or benefits of future events or actions.⁴⁷

Bank of America Corporation (“Bank of America”) recently agreed to pay \$33 million to the SEC to settle charges that it failed to disclose bonus payments it agreed to pay Merrill Lynch & Co., Inc. (“Merrill”) executives.⁴⁸ In materials sent to shareholders to approve the merger between Bank of America and Merrill, the SEC claimed Bank of America stated that Merrill agreed it would not pay bonuses to Merrill executives prior to closing the merger without Bank of America’s consent. However, Bank of America allegedly failed to disclose that it contractually authorized Merrill to pay up to \$5.8 billion in bonuses to Merrill executives for 2008.⁴⁹

Disclosures made in the MD&A should address the following questions:

- Are all important or significant company events or actions disclosed?
- Will investors understand the disclosures in the MD&A?
- Does a company explain pending litigation or negative performance?
- Have the impact of environmental and contingent liabilities been disclosed?
- Does a company explain how it is affected by current economic conditions?
- Is a company affected by changes in credit markets?
- How are customers affected by the credit market?
- Are there any trends affecting a company’s recognition of revenue such as a sudden increase in sales at the end of the year?
- How does a company explain one-time or isolated events affecting a company’s performance?
- Which segments of a company’s business have a disproportionate impact on a company’s revenue?

Financial Accounting Standards Board Interpretation No. 48 (“FIN 48”)

FIN 48 requires disclosure of a company’s tax and accounting strategy.⁵⁰ No disclosure is required if a company reasonably believes that there is more than a 50 percent likelihood that an Internal Revenue Service (“IRS”) agent would approve of a company’s tax and accounting strategy.⁵¹ A company may be required to record an estimated liability on its financial reports to account for the FIN 48 disclosure.

For example, a company, after purchasing a business line, decides to write-off the payment to the seller for goodwill rather than amortizing the goodwill payment. If it is not more than 50 percent likely that an IRS agent would approve of a company’s decision to accelerate the expense, then a company would need to disclose its accounting strategy and record a potential liability on its financial reports.

Circular or Wash Transactions

A circular or wash transaction, otherwise known as “round tripping,” occurs between companies that engage in a formal transaction but in substance, the transaction provides no benefit to either company. Instead, the companies benefit in other ways such as showing higher reported sales in financial reports.

The SEC charged the corporate executives of Suprema Specialties, Inc. (“Suprema”) for engaging in “round-tripping” transactions that allegedly generated \$700 million in fictitious sales revenues from 1998 through February 2002.⁵² As alleged by the SEC, Suprema, one of its customers and one of its vendors would enter into round-tripping transactions by creating false paperwork to show a purported sale of products from Suprema to the customer. The customer then would “sell” the products to the vendor and the vendor would “sell” the products back to Suprema. All three parties wrote checks to show purported payments. Suprema allegedly paid the vendor a kick-back or a commission for its role in the transaction. On June 25, 2009, the corporate executives of Suprema agreed to disgorge \$3.8 million in profits and pay \$1.2 million in pre-judgment interest to the SEC.⁵³

To identify financial misconduct due to circular or wash transactions, evaluate whether loans to cus-

tomers are legitimate and the chances that the customer will repay the loans. Also, transactions with a company related to the seller could indicate a circular transaction.

Sales to Straw Entities and Fictitious Contracts

Sales to straw entities arise from creating fictitious orders or contracts for existing or fictitious customers. False contracts or other documents are prepared that support the existence of a sale or service rendered. Indicators of sales to straw entities and fictitious contracts include customers with unknown names or addresses, a decrease in shipping costs compared to sales, significant revenue adjustments at the end of the accounting period or unexpected increases in sales.

LEGAL LIABILITY FOR ATTORNEYS

An attorney appearing or practicing before the SEC is subject to SEC rules,⁵⁴ and the SEC can hold an attorney responsible for participating in corporate financial misconduct. Participating in the submission of reports, 10-K filings or 10-Q filings to the SEC is enough for the SEC to bring enforcement proceedings against an attorney. The SEC could view an attorney as a decision-maker or gatekeeper rather than just as an attorney providing legal advice to a company.

An attorney directly or indirectly benefiting from financial misconduct such as reporting inflated earnings and thereby enabling the attorney to receive additional compensation (*i.e.*, stock options, bonus, additional retirements benefits, etc.) could be considered a decision maker and be subject to SEC enforcement actions. There is no clear test or set of factors to determine when the SEC will bring enforcement actions against an attorney. Also, there is no bright line test to determine when an attorney is acting as a decision maker rather than as a legal advisor.

Previous SEC enforcement actions against attorneys include:

- Corporate and general counsels involved in back-dating stock-option grants;⁵⁵
- General counsels failing to disclose material in-

formation regarding a company's strategy and performance in financial reports filed with the SEC;⁵⁶ and

- General counsels preparing documents supporting a company's financial misconduct.⁵⁷

An attorney found to be in violation of SEC rules could be forced to disgorge profits earned by engaging in the financial misconduct, pay civil penalties or be suspended from practice before the SEC.

SUGGESTED PRACTICES FOR ATTORNEYS AND COMPANIES TO DETECT FINANCIAL MISCONDUCT

Corporate counsels or attorneys working with a company to review financial reports must comply with ethical and legal obligations when financial misconduct is discovered. The ethical and legal obligations include proper application of the attorney-client privilege, protecting documents under the work product doctrine and understanding legal obligations upon discovery of financial misconduct.

ATTORNEY-CLIENT PRIVILEGE

An initial consideration for any attorney when financial misconduct is detected is the attorney-client privilege. An attorney cannot reveal a client's confidential information relating to the representation.⁵⁸ The attorney-client privilege applies if:

- There is an attorney-client relationship;
- The communication involves legal advice; and
- The communication is made and kept in confidence.

Identifying the Client

An attorney representing or working for a corporate client should also determine which employees of a company constitute "the client" for purposes of applying the attorney-client privilege. There are two concepts that courts use to determine which employees an attorney may communicate with in a privileged context:

- Under the "control group test," only those conversations between corporate counsels and a company's controlling executives and managers are eligible for protection.⁵⁹
- Under the "subject matter test," employees with pertinent information regarding the subject matter are deemed to be the client irrespective of their position within a company.⁶⁰

Courts vary on applying the "control group test" and "subject matter test." An attorney should be aware of the test used by courts in the applicable jurisdiction to determine which employees of a company include the client for purposes of privileged communications.

Providing Legal or Business Advice

An attorney for purposes of the attorney-client privilege includes a company's corporate counsel and outside counsel.⁶¹ When an attorney representing a company acts in a business capacity, the communication between the attorney and the employees are most likely not privileged. In addition, the attorney-client privilege might not apply to communications with both business and legal components. For example, emails between a corporate counsel and employees discussing both legal and business issues might not have the protection of the attorney-client privilege.

A federal district court recently ruled the attorney-client privilege applies when the primary purpose of a mixed legal and business communication is legal.⁶² In *Vioxx*, Merck & Co. Inc. ("Merck") asserted the attorney-client privilege over 30,000 documents, most of which were emails. Merck claimed that due to extensive government regulation of its drug manufacturing operations, the attorney-client privilege applied to virtually all of its communications with legal and non-legal departments. The court in *Vioxx* held that to establish the attorney-client privilege over communications with mixed business and legal advice, the primary purpose of the communication must be legal.⁶³ Also, the court indicated the communication should be sent in a method that retains its legal purpose.⁶⁴

Under the primary purpose test, the attorney's role in the communication must primarily be for legal purposes. The presence of attorneys or non-attorneys

in a communication does not determine whether the attorney-client privilege applies. Also, an attorney's involvement in a business transaction does not necessarily mean the communication is protected under the attorney-client privilege. Communications sent simultaneously to both attorneys and non-attorneys could lose the protection of the attorney-client privilege. Maintaining the attorney-client privilege over mixed business and legal communications requires the primary purpose of the message to be legal, and the method of distribution to be limited to the attorney and non-attorneys who need the legal advice or who are involved in the legal matter.

Other federal courts are adopting the primary purpose test from *Vioxx*. The federal district court for the Middle District of Florida followed the "primary purpose" test to hold that communications were not protected under the attorney-client privilege.⁶⁵ In *Seroquel*, the court held the attorney-client privilege does not apply to communications between attorneys and non-attorney employees for drafts of technological, science, public relations or marketing materials a company published because the advice was not primarily legal advice.⁶⁶ However, the court held the attorney-client privilege applies to any actual legal advice provided as part of the drafting process.⁶⁷

The attorney-client privilege protects communications with a mixed business and legal purpose if the primary purpose of the communication is legal and distributed only to those non-attorneys who need the legal advice or are involved in the legal matter. The attorney-client privilege should apply to legal advice written on drafts of financial reports so long as the drafts are distributed to non-attorneys who need the legal advice.

For example, when reviewing drafts of the financial reports, the corporate counsel sends an email to the Chief Financial Officer ("CFO") noting a discrepancy in the financial reports because a company's accounts receivables are growing at a faster rate than company's cash flows. The corporate counsel is concerned that a company is engaging in "channel stuffing." The CFO responds to the email and states a customer with a good credit rating made a large purchase on credit at the end of a company's year. The email communication could be viewed as business communication rather than primarily legal advice and the

attorney-client privilege would not apply to protect the email.⁶⁸

Waiving the Attorney-Client Privilege

Communication with a primary legal purpose sent to employees or other parties not involved in the legal matter could waive the attorney-client privilege. For example, in response to the corporate counsel's email regarding possible financial misconduct, the CFO includes a company sales representative in the response to the corporate counsel. The addition of the sales representative to the email could waive the attorney-client privilege if the sales representative is not involved in the legal matter or is not within the scope of the legal advice.

Preserving the Privilege

An attorney can show that the primary purpose of a communication between the attorney and employee is for legal advice and protected under the attorney-client privilege. The attorney or employee might mark written communications for legal purposes as follows:

- "Requests for facts so that legal advice can be given."
- "For the purpose of receiving legal advice."
- "Privileged and confidential."

Also, the attorney should make an official record noting when legal advice to a company is provided and raise the legal purpose of communications. To protect against waiver of the attorney-client privilege, the attorney should document the reason each person is receiving the communication. This could prevent waiver due to disclosure to employees not within the scope of the attorney-client privilege.

When communicating with employees on legal matters, a corporate attorney should:

- Use an official legal title such as attorney or corporate counsel but should not use a non-legal title such as Vice President;
- Separate legal and business issues in communications; and

- Send communication regarding legal matters only to employees who requested the legal advice or are involved with the legal issue.

WORK PRODUCT DOCTRINE

An attorney's work product prepared in anticipation of litigation is privileged unless the party seeking discovery has substantial need of the materials or is unable without undue hardship to obtain the substantial equivalent of the materials by other means.⁶⁹ Work product includes the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning litigation. Waiver of the work product doctrine occurs in a similar manner to the waiver of the attorney-client privilege.

To protect documents under the work product doctrine, attorneys should mark the documents for legal purposes as follows:

- "Attorney work product."
- "For the purpose of receiving legal advice."
- "Privileged and confidential."

Similar to protecting communications from waiver of the attorney-client privilege, corporate counsels should document why each recipient needs to receive the work product and use separate documents to address legal and business matters.

ETHICAL OBLIGATIONS UPON DISCOVERY OF FINANCIAL MISCONDUCT

Ethical Obligations Under SEC Rules

The SEC adopted rules to establish minimum standards of professional conduct for attorneys appearing and practicing before the SEC.⁷⁰ SEC rules require attorneys for public companies to report evidence of material violations of securities laws or other breaches of fiduciary duties to the corporation's chief legal officer ("CLO") or the chief executive officer ("CEO").⁷¹ A company may establish a committee of outside directors, known as the "Qualified Legal Compliance Committee" ("QLCC"), to which the at-

torney may report instead of the CLO or CEO.⁷²

An attorney making a report to a QLCC does not have to determine the appropriateness of the QLCC's response and is relieved from taking further reporting action.⁷³ If disclosure is made to the CLO or CEO and neither individual provides an appropriate response to the attorney's report, the attorney must report the evidence to a company's audit board or other appropriate committee of a company's board of directors.⁷⁴

Also, an attorney of a public company may have the option to reveal to the SEC confidential information to:

- Prevent a material violation of laws that is likely to cause substantial injury to the financial interest or property of a company;
- Prevent the commission of perjury; or
- Rectify the consequences of a material violation of laws that causes or may cause substantial injury to the financial interest or property of a company.⁷⁵

The SEC also proposes two alternative rules for attorneys to make disclosures when the CLO or CEO does not provide an appropriate response to the attorney's report. Under the first alternative, the attorney must withdraw from representation of a company or disaffirm an opinion and notify the SEC of the action taken.⁷⁶ The CLO must inform any new attorney of the previous attorney's withdrawal.⁷⁷

The second alternative requires the attorney to provide written notification that the attorney reasonably believes that the CLO or CEO have not provided an appropriate response to the attorney's report in a reasonable time.⁷⁸ The CLO would be required to report the attorney's written notification to the SEC within two business days of receiving the notice.⁷⁹

Ethical Obligations Under the Model Rules of Professional Conduct

An attorney is required to report within a company a violation of a legal obligation to a company or a violation of law that is likely to result in substantial injury to a company, unless the attorney reasonably

believes that it is not in the best interest of a company to report the violation.⁸⁰ If a company's highest authority (*i.e.*, CLO or CEO) insists upon a course of conduct that is a clear violation of law and the attorney reasonably believes that the violation will result in substantial injury to a company, the attorney is permitted to disclose confidential information to the extent reasonably necessary to prevent substantial injury to a company.⁸¹

In addition to disclosure of confidential information, an attorney must withdraw from representation of a company when:

- The representation will result in a violation of the rules of professional conduct or other law;
- The attorney's physical or mental condition materially impairs the attorney's ability to represent the client; or
- The attorney is discharged.⁸²

An attorney is permitted to withdraw if the client persists in a course of action involving the attorney's services that the attorney reasonably believes is criminal or fraudulent.⁸³ Mandatory withdrawal is required when the attorney is acting to further the illegal conduct of a company, while permissive withdrawal is appropriate when the client is engaging in illegal conduct but the attorney is not acting to further the illegal conduct.

Comparing the SEC Rules and Model Rules of Professional Conduct

Example to Compare Application of the SEC Rules and Model Rules of Professional Conduct

While reviewing drafts of financial reports prepared for a company's annual 10-K filing with the SEC, a company's corporate counsel discovers the existence of off-balance sheet entities a company is using to hide losses. Under the SEC rules, the corporate counsel would be required to report the financial misconduct to a company's CLO or CEO, while under the Model Rules of Professional Conduct, the corporate counsel could also report the financial misconduct to the CFO in addition to the CLO and CEO.

If the CLO or CEO does not provide an appropriate response to the corporate counsel's report, SEC rules permit disclosure of confidential information to the SEC about the use of off-balance sheet entities to hide company losses. Under the Model Rules of Professional Conduct, the corporate counsel would only be required to disclose confidential information to the SEC or other third parties if counsel's services were used to commit a crime or fraud. Because the corporate counsel must sign the 10-K report to be filed with the SEC, counsel's services would be used to hide losses in off-balance sheet entities and the corporate counsel would be required to disclose the violation to the SEC.

Finally, the Model Rules of Professional Conduct require the corporate counsel to withdraw from representation of a company because counsel's services would be used to file a false 10-K with the SEC. The proposed SEC rules would also require the corporate

SEC Rules	Model Rules of Professional Conduct
Requires reporting up of violation to CLO, CEO, audit committee or QLCC if in place.	Requires reporting up to a "higher authority" and possibly the "highest authority" as required by law.
Disclosure of confidential information for "reporting out" is <i>permitted</i> even if the attorney's services are used or not used in a crime or fraud.	Disclosure of confidential information for "reporting out" is <i>mandatory</i> only if the attorney's services are used in a crime or fraud.
No permissive or mandatory withdrawal rules. Proposed rules provide for mandatory withdrawal or written notification of withdrawal to the CLO.	Mandatory withdrawal if the attorney's services are used in a crime or fraud, otherwise the attorney is permitted to withdraw.

counsel to notify the SEC of the withdrawal from representation of a company or alternatively, notify the CLO of counsel's withdrawal from representation of a company.

NOTES

¹ Public Company Accounting Reform and Investor Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

² David Glovin and David Scheer, Madoff Charged in \$50 Billion Fraud at Advisory Firm (December 11, 2008), <http://www.bloomberg.com/apps/news?pid=20601087&sid=anWXzISP4XCg>.

³ Heather Timmons, Report Details Broad Scope of Fraud at Satyam (April 21, 2009), http://www.nytimes.com/2009/04/22/business/22satyam.html?_r=1.

⁴ Generally Accepted Accounting Principles, Federal Accounting Standards Advisory Board ("FASB"), available at <http://www.fasab.gov/accepted.html>.

⁵ The Securities Exchange Act of 1934, §§ 13(b)(2)(A) and 13(b)(2)(B), 15 U.S.C. §§ 78m(b)(2)(A) and 13(b)(2)(B) (2002).

⁶ SEC Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68936 (1999).

⁷ SEC Litigation Release No. 21166 (August 4, 2009) (The SEC also charged GE with improper disclosures in financial reports, failure to correct accounting for interest-rate swaps and improperly changing accounting methods to record revenue from sales of commercial aircraft engine spare parts).

⁸ *SEC v. General Electric Co.*, No. 3:09 CV 1235 (RNC) (D. Conn. 2009).

⁹ SEC Litigation Release No. 19520 (January 4, 2006).

¹⁰ *SEC v. McAfee, Inc.*, No. 06-009 (PJH) (N.D. Cal. 2006).

¹¹ SEC Staff Accounting Bulletin No. 104, 68 Fed. Reg. 74436 (2003).

¹² SEC Litigation Release No. 20938 (March 10, 2009); see also *SEC v. Barnett et al.*, No. 1:09-CV-00457 (D. D.C. 2009).

¹³ *Id.*

¹⁴ SEC Litigation Release No. 18797 (July 27, 2004).

¹⁵ *SEC v. Resnick et al.*, No. 04 CV 5824 (S.D.N.Y. 2004).

¹⁶ *In the Matter of Informix Corp.*, No. 3-10130 (January 11, 2000).

¹⁷ *Id.*

¹⁸ *Long-Term Construction-Type Contracts*, Accounting Research Bulletin No. 45. (Fin. Accounting Standards Bd. 1955).

¹⁹ *Id.*

²⁰ SEC Litigation Release No. 18387 (October 2, 2003).

²¹ *SEC v. Corder et al.*, No. 1:03-CV-1436-JDT-TAB (S.D. In. 2003).

²² SEC Litigation Release No. 20417 (December 27, 2007).

²³ *SEC v. Gadel*, No. 06-CV-2320 (D.C. Minn. 2006).

²⁴ *Id.*

²⁵ *In the Matter of Sunbeam Corp.*, No. 3-10481 (2001).

²⁶ *Id.*

²⁷ *In the Matter of Richard P. Scalzo*, No. 3-11212 (August 13, 2003).

²⁸ *Id.*

²⁹ SEC Litigation Release No. 20760 (September 30, 2008).

³⁰ *SEC v. The Penn Traffic Co.*, No. 08 Civ. 01035 (N.D.N.Y. 2008); see also *SEC v. McCracken et al.*, No. 8:04-CV-02288-SDM-MAP (M.D. Fl. 2006) (Corporate executives allegedly overstated inventory by falsifying inventory records).

³¹ Public Company Accounting Reform and Investor Act of 2002 § 401(a), Pub. L. No. 107-204, 116 Stat. 745.

³² *In the Matter of The PNC Financial Services Group, Inc.*, No. 3-10838 (2002).

³³ *SEC v. Biovail Corporation*, No. 08 CV 02979 (S.D.N.Y. 2008).

³⁴ *In the Matter of Trump Hotels & Casino Resorts, Inc.*, No. 3-10680 (2002).

³⁵ *Id.*

³⁶ *SEC v. Kurtzman*, No. 1:02CV01126 (D. D.C. 2002).

³⁷ *Id.*

³⁸ See SEC Final Rule: Conditions for Use of Non-GAAP Financial Measures (March 28, 2003), available at <http://www.sec.gov/rules/final/33-8176.htm>.

³⁹ *Id.*

⁴⁰ *Accounting for Contingencies*, Statement of Fin. Accounting Standards No. 5, § 8 (Fin. Accounting Standards Bd. 1975).

⁴¹ *SEC v. ConAgra Foods, Inc.*, No. 07cv01557-MSK-MEH (D. Colo. 2007); see also SEC Litigation Release No. 20206 (July 25, 2007).

⁴² *Id.*

⁴³ SEC Litigation Release No. 17465 (April 11, 2002).

⁴⁴ *Id.*

⁴⁵ *Quantitative Characteristics of Accounting Information*, Statement of Fin. Accounting Concepts No. 2, § 132 (Fin. Accounting Standards Bd. 1994) and SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (1999).

⁴⁶ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (1999).

⁴⁷ SEC Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (December 29, 2003), available at <http://www.sec.gov/rules/interp/33-8350.htm>.

⁴⁸ SEC Litigation Release No. 21164 (August 3, 2009). (A federal district court judge has not approved the settlement and requested Bank of America and the SEC to provide more information about the settlement).

⁴⁹ *Id.*

⁵⁰ *Accounting for Uncertainty in Income Taxes*, Fin. Accounting Standards Bd. Interpretation No. 48 (2006).

⁵¹ *Id.*

⁵² SEC Litigation Release No. 18534 (January 7, 2004).

⁵³ SEC Litigation Release No. 21107 (June 25, 2009).

⁵⁴ SEC Rule of Practice 102(e) and 17 C.F.R. § 201, *et seq.* (2006).

⁵⁵ *SEC v. Salterman*, No. CV 09-CV-6813 (S.D.N.Y. 2009); *SEC v. Lubben*, No. 08-CV-6454 (D. Minn. 2009); SEC Litigation Release No. 20836 (December 22, 2008); *SEC v. Olesnyckyj*, No. CV-1176-9HB (S.D.N.Y. 2007); and SEC Litigation Release No. 20056 (Mar. 27, 2007).

⁵⁶ *SEC v. Mintz*, No. H-07-1027 (S.D. Tex. 2009); *SEC v. Tenet Healthcare Corp. et al.*, No. CV 07-2144 (C.D. Cal. 2007).

⁵⁷ *SEC v. Sycamore Networks Inc., et al.*, No. 08-CA-111666 (DPW) (D. Mass. 2008); *SEC v. Heinen et al.*, No. 07-2214 (N.D. Cal. 2007).

⁵⁸ Model Rules of Prof. Conduct. § 1.6(a).

⁵⁹ *Philadelphia v. Westinghouse Electric Corp.*, 210 F. Supp. 483, 485 (E.D. Pa. 1962).

⁶⁰ *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981).

⁶¹ Model Rules of Prof. Conduct. § 1.13(a).

⁶² *In re Vioux*, 501 F. Supp. 2d 789, 813 (E.D. La. 2007).

⁶³ *Id.*

⁶⁴ *Id.* at 809.

⁶⁵ *In re Seroquel Products Liab. Lit.*, 2008 U.S. Dist.

Lexis 39467, 2008 WL 1995058 (M.D. Fla. May 7, 2008).

⁶⁶ *In re Seroquel Products Liab. Lit.*, 2008 U.S. Dist. Lexis 39467, *109-110, 2008 WL 1995058, *9-10 (M.D. Fla. May 7, 2008).

⁶⁷ *Id.*; see also *SEPTA v. CaremarkPCS Health, L.P.*, 254 F.R.D. 253 (E.D. Pa.) (Communication between a corporate counsel and employees regarding a draft of a contract was privileged because the communication contained primarily legal advice. Distribution of the draft to non-attorneys did not waive privilege because the distribution was made to non-attorneys who needed to remain informed of the legal advice.).

⁶⁸ See also *SEC v. Teo et al.*, No. 04-1815 (SDW) (D. N.J. 2009) (Court held that the attorney-client privilege protects any information contained in draft documents communicated between an attorney and client, which are not ultimately revealed in public filings.).

⁶⁹ Fed. R. Civ. P. 26(b)(3) (local rules regarding the work product doctrine may vary).

⁷⁰ 17 C.F.R. § 205, *et al.* (2003).

⁷¹ 17 C.F.R. § 205.3(b)(1), (4) (2003).

⁷² 17 C.F.R. § 205.3(c)(1) (2003).

⁷³ *Id.*

⁷⁴ 17 C.F.R. § 205.3(b)(3) (2003).

⁷⁵ 17 C.F.R. § 205.3(d)(2) (2003).

⁷⁶ Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6328-30 (proposed Feb. 6, 2003). See also SEC Securities Act Release No. 8186, available at <http://www.sec.gov/rules/proposed/33-8186.htm>.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Model Rules of Prof. Conduct. § 1.13(b).

⁸¹ Model Rules of Prof. Conduct. §§ 1.13(c) and 1.6(b)(2)-(3).

⁸² Model Rules of Prof. Conduct. § 1.16(a)(1)-(3).

⁸³ Model Rules of Prof. Conduct. § 1.16(b).