Securities Litigation and Criminal Implications: A Little Knowledge Can Be Dangerous

by Stanley H. Marks

The Civil Litigator column addresses issues of importance and interest to litigators and trial lawyers practicing in Colorado courts. *The Civil Litigator* is published six times a year.

This article uses a typical securities litigation scenario to illustrate some of the pitfalls that may face a civil practitioner in a securities case due to the interplay, and sometimes conflict, between applicable civil and criminal laws.

Editor's Note: *In light of today's corporate environment, to avoid potential liability and malpractice, civil litigators need to be careful when they represent clients in securities investigations and litigation. This article hypothetically illustrates some of the complexities of securities litigation. It is not based on any real-life lawsuits, SEC investigations, or actual situations.*

Experienced trial attorneys, in their efforts to provide representation in complex securities, class action, and derivative litigation, often are treading on the cusp of malpractice by their inadvertent ignorance of certain basic principles of criminal law. Usually, by the time an epiphany occurs, the horse is out of the barn, the white collar client is being fitted for stripes, and the civil litigator is looking over his shoulder for a process server.

This article provides a typical fictional scenario illuminating several of the pitfalls that may face the civil practitioner. The article reviews some of the practical and legal issues in a hypothetical situation in both the civil and criminal areas.

Securities Litigation: A Common Scenario

Attorney Joe Smith receives a call from Don Edge, who informs Smith that he and his company have been named in several class action and derivative lawsuits and are the subjects of an investigation ordered by the Securities and Exchange Commission ("SEC"). Smith has substantial experience in both federal and state courts and, on several occasions, has appeared before the SEC in response to an order directing a private investigation of his corporate clients.

Smith meets with Edge, who indicates he is a director and chief financial officer of a publicly traded (NASDAQ) company. The company has approximately five million outstanding shares of common stock. Edge hands Smith a copy of an SEC Order Directing a Private Investigation and Designating Officers to Take Testimony ("Order"). A quick review of the Order references Edge's prospective company as an issuer whose common stock is registered with the SEC pursuant to the Securities Exchange Act of 1934 ("Exchange Act") § 12(g).

The Order indicates the SEC is investigating the company's annual reports (Form 10-KSB) and quarterly reports (Form 10-QSB) for several quarters in 1996. The Order questions whether the reports may have contained untrue statements of material facts. It further raises the possibility that the company's reports overstated revenue for the relevant periods, in violation of Exchange Act Rule 10b-5(a)-(c). The Order also indicates the

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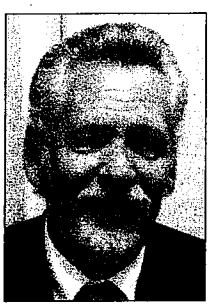

possibility of the overstatement of assets and an improper capitalization of costs.

The Order contains numerous other allegations regarding the condition of the company's books and records and its failure to implement a system of internal accounting controls, as required by Exchange Act § 13(b)(2)(A). Finally, the Order indicates that the SEC, after reviewing its staff reports, would consider possible violations of Exchange Act §§ 10(b), 13(a), and 13(b); and Rule 10b-5.

Smith is particularly attuned to the increased scrutiny brought to bear based on the recent Enron, Andersen, Qwest, TyCo International, WorldCom, and other criminal investigations. He is aware that the SEC has proposed changes in corporate governance rules[1] designed to improve financial reporting and disclosure requirements for U.S. companies subject to the reporting requirements of the Exchange Act.

Client Addresses The Allegations

Edge indicates to Smith that, even though he believes he has done nothing wrong, he is aware that an erstwhile comptroller—in an effort to pump the bottom and top line revenues—was particularly creative in prematurely assigning and transferring purchase orders to base income. The shareholder litigation alleges that the company falsely recognized revenue during the class period and that several officers and directors engaged in improper insider sales. The bottom line is that the company, among other things, is alleged to have understated expenses and correspondingly overstated net revenue and, thus, committed fraud.

Smith's prospective client informs him that, subsequent to the filing of Form 10-QSB, he attended a luncheon with a representative of the company's outside auditing firm, the company's president, and the company's comptroller. They discussed the accounting methods employed during the period of concern. The company's outside auditor chided the comptroller for pushing the envelope, but indicated that, in his opinion, the impact on the earnings per share was minimal. The outside auditor also suggested that the comptroller back out the excess revenue over the next several quarters. The outside auditor mumbled under his breath, "This is getting close to a 10A letter, but no harm, no foul."[2]

Smith also is advised that, during the relevant periods, the company committed substantial dollars to an outside marketing firm in an effort to promote the company's then-new "tech image." In fact, the company went to great lengths to catch the eye of several institutional investors that subsequently put the company on their "strong buy" list based on the company's transition into high-tech manufacturing. Edge recalls discussing with the company's president the sky-high price earnings multiples that were prevalent in the world of techs and dot-coms. Edge had speculated that the company's new tech marketing approach would cause analysts to apply the new price earnings multiples to the company.

Within twelve to eighteen months after the company's most recent Form 10-QSB was released, the company's common stock remained relatively flat, trading between $8 and $10 per share. However, over the next eighteen months, the stock traded in the range of $24 to $35 per share, with increasingly heavy daily volume. Although the comptroller had only retrieved a portion of the overstated revenue, all revenue accounting practices going forward appeared to be GAAP compliant. During the period in question, the price-to-earnings ratio of the stock rose drastically, from approximately 16:1 to 40:1. It appears that the tech marketing worked, because the stock price dramatically increased, irrespective of relatively flat earnings.

Coincidentally, during the relevant time frame, insiders, such as Smith's prospective client, elected to sell stock options representing 400,000 shares of common stock at an average stock price of approximately $25 per share. The average option price was approximately $8.50 per share. The company's market cap over the last two years rose from approximately $40 million to nearly $150 million. The insiders collectively garnered profits in excess of $7 million.

Internal Investigation

The board of directors' audit committee began its own internal investigation into the SEC's allegations. Immediately after the issuance of the SEC's Order, Edge, the company, and other officers and directors were named in derivative and class action suits.

Edge informs Smith that everyone had told him to cooperate with the company and the audit committee to ensure that he would be covered by the company's Directors, Officers, and Company Liability Policy ("D&O Policy"). Edge wants the company and its insurers to pay his attorney fees under the policy. The company's primary and excess carriers have been notified, and they are calling daily to arrange a meeting to ascertain the basis for the SEC's inquiry and whether there is any substance to the recently filed civil litigation. The insurers have alluded that there may be an issue with regard to coverage based on allegations of fraud in the insured's application.

Use of the Fifth Amendment

Edge also advises Smith that he has just been served with an SEC subpoena *duces tecum*, which requires him to testify and produce a myriad of records. Smith makes a note to contact the SEC staff attorney immediately to defer production and to reschedule Edge's deposition to a later date.

Smith reviews the company's D&O Policy and locates the following language:

> In consideration of, and subject to, the payment of the premium, the Insurer and the Insureds agree as follows: The Insureds shall, as a condition precedent to their rights under this Policy, give to the Insurer all information and cooperation as the Insurer may reasonably require and shall do nothing that may prejudice the Insurer's position or its potential or actual rights of recovery.

This standard form policy language provides an additional dilemma for the prospective client and his civil counsel. Smith knows that it is generally prudent to emphasize a client's willingness to cooperate under the terms of the D&O Policy in response to inquiries by the company and the insurer. However, as counsel for an officer or director, Smith also is compelled to assist the client in protecting his Fifth Amendment privilege against self-incrimination.

Representatives of the company and the insurer would be hard-pressed to deny coverage on the basis that an insured officer or director has failed to cooperate, as required under the terms and conditions of the D&O Policy, by invoking basic constitutional rights. Contrary to protecting the client's criminal interest, the civil practitioner may be inclined to advise the client to respond to unlimited inquiries by counsel for the company and the insurer. The conflict becomes apparent in evaluating the divergent courses of action available.

Smith happens to glance at the SEC's subpoena *duces tecum* again, and some stock language gets his attention. Specifically, Smith notes that, under 18 U.S.C. § 1001, "[w]hoever . . . knowingly and willfully . . . makes any false . . . or fraudulent statement [testimony] . . . shall be fined under this Title or imprisoned for not more

than five years." This does not give Smith a great deal of pause because Edge has assured him that he has nothing to hide and will tell the truth. After all, this is just a civil matter, right? Preliminarily, Smith sees no problem with Edge testifying before the SEC and fully cooperating with the company's audit committee and the insurers.

However, as Edge continues to relate potentially damaging information, Smith's eyes happen to slip to the perjury section of the SEC's subpoena *duces tecum*, which more fully references 18 U.S.C. § 1621. Contemporaneous thereto, Smith's ancient recollection of "Criminal Law 101" clicks in, and he vaguely recalls certain terms such as Fifth Amendment—FRAUD; Perjury—FRAUD; Waiver of Privilege—FRAUD; Self Incrimination—FRAUD.

Civil Versus Criminal Issues

Smith makes an offhand reference to the Fifth Amendment, at which time Edge interrupts and says, "But this is just a civil case, right?" What a coincidence. Smith had just asked himself the same question. Edge asks, "What's it got to do with the Fifth Amendment? I'm no criminal." In an effort to settle Edge down, Smith confidently responds with only a hint of a quiver in his voice, "Yeah, just a civil case, just a civil case."

In a slight fog, Smith continues to read through the SEC's subpoena *duces tecum* and stops when he reads a paragraph entitled, "Fifth Amendment and Voluntary Testimony: [I]nformation you give may be used against you in any federal, state, local, or foreign administrative, civil, or criminal proceeding brought by the commission or any other agency." The paragraph further indicates,

> You may refuse, in accordance with the rights guaranteed you by the Fifth Amendment to the Constitution of the United States, to give any information that may tend to incriminate you or subject you to fine, penalty, or forfeiture.

Smith has reviewed SEC subpoenas before, but, until now, he has never really given them much thought. Smith advises Edge that the gist of this paragraph is that he has a right not to testify by invoking his Fifth Amendment constitutional right against self-incrimination.

Edge interrupts, saying that he is confused. He understands that he has a right not to testify, but it appears that he may be *required* to testify in the pending civil proceedings. If he has to testify in those proceedings, why not provide the testimony to the SEC at the first instance? Edge further notes that, under the D&O Policy, he is obligated to cooperate with the company as well as the insurers. He asks, "How does all this square with the Fifth Amendment? What should I do?" Smith is asking himself the same questions, and realizing that Edge's "options" increasingly are becoming reduced to a Hobson's choice.

Smith tells Edge that it is his understanding—albeit limited—that if Edge testifies before the SEC and in the civil cases, or if he simply talks to anyone outside of his attorney, he may be considered to have waived his Fifth Amendment privilege against self-incrimination. Thereafter, he could be compelled to testify. Alternatively, his prior testimony or statements could be used against him in future criminal or civil proceedings.

Edge indicates that he had always heard that one cannot be forced to testify against oneself at a criminal proceeding. He states that, in the unlikely event that he ever

were charged with a crime, he certainly would want to invoke his Fifth Amendment privilege against self-incrimination. Nonetheless, he needs to protect his interest in the pending civil actions and before the SEC.

Smith feels compelled to remind Edge that, if he is in fact subpoenaed to testify in one or more of the civil proceedings, and if he elects to take the Fifth Amendment, the finder of fact (jury) may be instructed of his invocation of his Fifth Amendment right against self-incrimination. As such, the jury may draw an adverse inference against him or the company in considering its verdict.[3] Smith explains that such a jury instruction could be devastating, resulting in a significant monetary judgment against Edge and the company.

Edge harkens back to what he believes are his obligations under the D&O Policy. He wants to know whether statements he made to attorneys for the insurers or the company also could be used against him in a criminal proceeding. Alternatively, what would happen if he elected not to cooperate with the company by invoking his Fifth Amendment right? Would his refusal to cooperate negate the company's and the insurer's statutory and contractual obligations to defend him in the derivative and class action suits, as well as the future SEC and criminal proceedings?

Smith is not sure how Edge should respond. Statements made by Edge to attorneys for the insurers are fair game to be used against him by a prosecutor before a grand jury. Additionally, under certain circumstances, the attorneys for the insurers, as recipients of information from Edge, could be called as witnesses against Edge in future criminal prosecutions.

Considering a Joint Defense Agreement

Edge suggests that, due to the magnitude of the allegations against him and others, the attorneys for all officers and directors should get together to develop a unified defense. Smith considers the potential utilization of a joint defense agreement, taking into account that there may be a rat in the camp. Smith considers the dynamics of entering into such an agreement with a party who currently may be cooperating with the government and who ultimately may testify against Edge. At first, this does not appear to be a viable tactic. Nonetheless, contrary to Smith's instincts, entering into a joint defense agreement with a prospective adverse witness may be to Edge's benefit.

Assessing Strategies

An appropriate strategy to be employed by attorney Smith would be to advise Edge to employ co-counsel to assist in his defense —or defenses. In Edge's evaluation of the appropriate co-counsel to employ, specific consideration should be given to the prospective criminal counsel's familiarity with the inner workings of the U.S. Federal Sentencing Guidelines ("U.S.S.G.") and its application to the specific factual circumstances of the case under investigation. Ultimately, from a penalty perspective, the U.S.S.G. are driven by a complex loss calculation that relates to the dollar amount of damage (loss) sustained by the collective victims.

In a securities fraud or inside trading case, the dollar loss calculation may be monumental. Therefore, criminal counsel's familiarity with the manner in which loss may be determined in this particular case (for example, whether through inside trading, fraudulent sales, false reporting of revenue, or misstated earnings) is one of the primary considerations in ascertaining the potential sentence that may be imposed in the event the client sustains a conviction.

Also to be considered is counsel's relationship with the U.S. Attorney's Office in the investigating jurisdiction. Many cases of this nature are resolved, pre-indictment, based on a negotiated settlement driven by factors such as the amount of loss, role in the offense, and the defendant's cooperation.

Depending on his or her level of expertise, a civil practitioner can assist clients in dealing with the obvious civil proceedings that await them. However, the civil practitioner's advice may directly conflict with a client's penal or criminal interests. For example, the byproduct of the civil advice may provide the government with the crux of a case presented to the federal or state grand jury, which could result in the client being indicted. For all practical purposes, violations of the Exchange Act or Securities Act of 1933 have criminal statutory counterparts with accompanying sentences of up to five years' imprisonment or more.[4]

Contact With the SEC Or U.S. Attorney

Notwithstanding Smith's recognition of the obvious conflicts in the nature of the advice that he has given Edge, what would happen if he plows forward and approaches the SEC staff attorney in an effort to extricate Edge from his dilemma? The SEC staff attorney probably would suggest that Smith review Rule 5(f) of the Commission's Rules of Informal and Other Procedures,[5] which states that the SEC does not have the authority to resolve any prospective criminal charges that may be brought against Edge.

Alternatively, Smith might consider contacting the Assistant U.S. Attorney ("AUSA") assigned to the case. This is very tricky. The first thing the AUSA might do is inform Smith that the AUSA has never heard of the referenced SEC investigation but will look into it. This tack may not be a great idea, because Smith may inadvertently put Edge on the AUSA's radar screen. Historically, the AUSA heading up complex white collar litigation may have no knowledge of a given SEC inquiry—that is, until it is mentioned.

Based on these facts, the SEC ultimately would make a referral to the office of the U.S. Attorney requesting that this case be investigated by representatives of the FBI, U.S. Postal Service, or the Internal Revenue Service. The AUSA assigned to

the case could use the information that Edge provided to the SEC in his deposition or Wells Submission.[6] In this situation, Smith may wish from the outset that he had invoked his client's Fifth Amendment right against self-incrimination.

On the other hand, it may be to Edge's benefit to make it clear to the AUSA or SEC staff attorney that he (for the right deal) may be available to assist the government. However, Edge will provide assistance only as part of a global settlement. As previously discussed, an arrangement of this nature must be made directly with the AUSA, because the SEC attorney lacks the requisite authority to resolve the potential criminal implications.

Federal Sentencing Guidelines

If Smith represents Edge, he also must be aware of, and give serious consideration to, the U.S.S.G. A primary factor is the dollar loss calculations set forth in U.S.S.G. §§ 2F1.1(a) and (b)(1)(A) through (S). This measure of loss may be determined by comparing the total market cap of the company's common stock prior to the release of false information to the market cap after the company's admission of their use of false or misleading information. In other words, this reduction in market cap may be the figure the AUSA or SEC staff attorney will attempt to use against Edge in ascertaining potential criminal and civil penalties.

If there is a sustainable claim of insider trading, a more forgiving way to view the loss calculations under U.S.S.G. § 2F1.1 may be to: (1) take as the numerator the amount of gain derived by Edge's inside trading; (2) use as the denominator the amount of gain derived by all officers' and directors' inside trading; and (3) multiply this fraction by the total market capital loss for the period. Hopefully, Edge's inside trading gain constituted a small portion of the gain derived from the illegal trading by all insiders. Under this approach, Edge would be responsible for only a fraction of the diminution of market loss and, therefore, may face a significantly reduced criminal penalty.

Numerous other considerations will come into play, such as "Role in the Offense," "Abusive Position of Trust or Use of Special Skills," "Acceptance of Responsibility," and "Substantial Assistance to Authorities."[7] If Smith accepts the case, these factors should be on Smith's radar screen from day one of his civil representation of Edge.

Once Smith has ascertained that there is even a remote probability that Edge faces criminal liability, it is essential that he consider whether Edge wishes to provide substantial assistance to the government under U.S.S.G. § 5K1.1. As they say in the business, does the client wish to be on the train or under it? Providing substantial assistance to the government often is the client's key to the jail. It is important that the civil practitioner does not unwittingly give away the client's key as a result of a lack of understanding and appreciation of the criminal process.

Conclusion

As of this writing in July 2002, the task of the civil practitioner in his or her representation of corporate officers and directors becomes even more daunting in the face of President Bush's "Plan to Improve Corporate Responsibility and Protect America's Shareholders." Such plan is evidenced by the SEC's proposed changes in corporate governance rules designed to improve the financial reporting and disclosure systems for U.S. companies.

The SEC's proposed rules require a domestic reporting company's principal ex-

ecutive officer and principal financial officer to certify the accuracy of the contents of the company's quarterly and annual reports, subject to potential civil and criminal liability. These proposed changes, when implemented by the adoption of the accompanying new and enhanced criminal penalties, should significantly pique the civil practitioner's concerns about providing conflicting legal advice to current or prospective clients who have come under scrutiny.

At first glance, it appears that a conflict of interest may exist in representing a client in both the civil and criminal forums. Specifically, in a criminal forum it rarely is in the client's best interest to waive the Fifth Amendment right against self-incrimination and to testify in advance of trial. This is particularly true if the client may be subpoenaed as a criminal target before a state or federal grand jury, where counsel's ability to assist his or her client may be limited.

In the civil forum, a client's invocation of the Fifth Amendment right against self-incrimination in response to an adverse party's request for disclosure by way of deposition, or otherwise, may result in adverse consequences against him or her. For example, the opposing party may seek and obtain a jury instruction allowing the finders of fact to draw an adverse inference against the client, the result of which may substantially impact the ultimate outcome of the civil litigation.

In practical terms, the conflict or dilemma that exists for the practitioner attempting to represent the client's civil and criminal interests lies in the nature of the advice provided. As illustrated, the best advice from a criminal law perspective often will be in direct opposition to the advice given from a civil law perspective. Counsel needs to be prepared to present both sides of the coin so that the client ultimately can make an informed decision based on *the client's* priorities.

Unfortunately, most attorneys are not adequately equipped in both the civil and criminal arenas. Therefore, the client never has the opportunity to select the option that best fulfills his or her objectives. It is often this lack of appreciation of the potential divergence in advice that is the cornerstone of a malpractice claim against the civil practitioner.

To provide the client and civil counsel with a meaningful understanding of the client's criminal exposure, the attorney needs to understand co-counsel's relationship with the AUSA assigned to the investigation, the variables that comprise the U.S.S.G., and the prospective defenses available to the client. With this understanding, the client may be able to weigh the options that comprise the inherent conflict between divergent legal advice.

Remember—a little knowledge can be dangerous.

NOTES

1. On July 16, 2002, the U.S. House of Representatives adopted new criminal penalties for business fraud by creating stiffer penalties and jail terms for executives who deceive investors.

2. Exchange Act of 1934, 15 U.S.C. § 10A states than an issuer with a reporting obligation under the Exchange Act is required to provide a summary of the independent accountant's report. This report must include a description of the act that the independent accountant has identified as likely to be illegal and the possible effect of that act on all affected financial statements of the issuer for a prescribed period of time. Exchange Act Regulation § 240.10A-1.

3. *Asplin v. Mueller*, 687 P.2d 1329 (Colo.App. 1984).

4. Securities Act of 1933, 15 U.S.C. § 77x; Securities Exchange Act of 1934, 15 U.S.C. § 78ff.

5. 17 C.F.R. § 202.5(f).

6. The Report of the Advisory Committee on Enforcement Policies and Practices, submitted to the SEC on June 1, 1972, suggested recommendations to afford persons under investigation by the SEC an opportunity to present their position to the SEC prior to the authorization of an enforcement proceeding. Obtaining a written statement from a person under investigation, known as a Wells Submission, is authorized by Securities Act of 1933 § 20(a), 15 U.S.C. § 77t(a); and Securities Exchange Act of 1934 § 21(a), 15 U.S.C. § 77u(a).

7. *See* U.S.S.G. §§ 3B1.1 (Aggravated Role); 3B1.2 (Mitigating Role); 3B1.3 (Abusive Position of Trust or Use of Special Skills); 3E1.1 (Acceptance of Responsibility); 5K1.1 (Substantial Assistance to Authorities); and 5K2.0 (Grounds for Departure). ■