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SEC Enforcement Developments Affecting Public Companies – First Half of 2011

August 2011

See note below about Hogan Lovells.

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During the first half of 2011, the SEC continued to focus on prosecuting violations of the FCPA and also filed several actions against public companies and their officers and directors charging them with making false or misleading financial and other disclosures. Perhaps the most important development affecting public companies, because of its future implications, was the Commission's issuance on May 25 of its long-awaited rule implementing the whistleblower provision of Dodd-Frank providing for bounties to whistleblowers whenever the resultant recovery by the SEC exceeds $1 million. We summarized the Rule in a June 8 update that can be found on our website.

Moreover, even though Dodd-Frank authorized the Commission to obtain civil penalties against public companies and their officers and directors in administrative proceedings, it appears to be following its longstanding practice of instituting civil actions in federal courts where it believes that a company and its officers or directors engaged in fraudulent conduct. Finally, the SEC continued to use its expanded authority under Sarbanes-Oxley by seeking to recoup bonus compensation and stock profits from a CEO who was charged with no violation of the federal securities laws.

Two other actions are significant because they suggest new areas of focus. The first was a civil action charging a company with, among other things, violating a cease-and-desist order prohibiting violations of the internal control and books-and-records provisions of the Securities Exchange Act. The second was a civil action charging outside directors with failing to disclose executive perquisites and related-party transactions. This comes on the heels of a civil action filed against the chair of the audit committee of InfoGroup last year for similar failures.

The SEC imposed penalties of $1 million and $25 million in actions involving misleading statements to shareholders and $300,000 and $2 million in FCPA actions. The three rather modest penalties are not indicative of a more compassionate SEC but rather the financial conditions of

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the companies that were charged. Note that the SEC during the period imposed penalties totaling $333 million (and ranging from $1 million to $133 million) on eight financial services companies for engaging in conduct that allegedly violated the federal securities laws and resulted in harm to customers rather than shareholders. Further note that companies settling parallel criminal actions brought by the Department of Justice (DOJ) for FCPA violations paid fines ranging from $3.5 million to $21.4 million in addition to disgorging to the SEC all profits resulting from the improper payments to foreign officials. Total recoveries by the SEC in half of the 18 actions summarized below exceeded $1million so the potential impact of the Whistleblower Rule cannot be overemphasized.

In regard to the Division's cooperation initiative, the Commission entered into its first deferred prosecution agreement (DPA). Because the DPA, discussed below, contains many draconian provisions, it will be interesting to see whether other companies choose to execute similar agreements rather than consenting to injunctive or cease-and-desist orders.

The Significant Enforcement Actions

Foreign corrupt practices

SEC v. Jennings, Press Release 2011-21 (January 24, 2011). The SEC filed a consented-to complaint charging the former CEO of Innospec with violating the FCPA by approving payment of bribes to officials in Iraq and Indonesia. Jennings consented to entry of an injunction, disgorgement of $129,000 and payment of a civil penalty of $100,000, with the SEC citing his cooperation. Innospec previously settled claims brought by the SEC and DOJ. No parallel DOJ action was filed against Jennings.

SEC v. Maxwell Technologies, Inc., Press Release 2011-31 (January 31, 2011). The SEC filed a consented-to injunctive action against the company charging it with paying bribes of at least $2.5 million to Chinese officials for more than eight years to secure business for a subsidiary. Maxwell agreed to disgorge $6.3 million, representing its profits and interest, and separately paid a criminal fine of $8 million to settle charges filed by the DOJ.

SEC v. Tyson Foods, Inc., Press Release 2011-42 (February 10, 2011). The SEC filed a consented-to injunctive action against the company charging it with paying bribes of about $100,000 to government veterinarians in Mexico to approve export sales of chickens produced by its Mexican subsidiary. The SEC noted that more than two years passed from the time that Tyson Foods learned of the payments until its counsel instructed the Mexican subsidiary to cease making them. Tyson Foods agreed to disgorge $1.2 million, representing its profits and interest, and separately paid a criminal fine of $4 million to settle charges filed by the DOJ.

IBM Corporation, Litigation Release 21889 (March 18, 2011). The SEC filed a consented-to injunctive action

against the company charging it with violating the internal control and books-and-records provisions of the FCPA by making cash payments and giving gifts, travel and entertainment to South Korean officials over six years and Chinese officials over five years. IBM agreed to disgorge $8 million, including interest, and pay a $2 million civil penalty. There was no parallel criminal action.

Ball Corporation, Securities Exchange Act Release 64123 (March 24, 2011). The SEC filed a consented-to administrative proceeding against Ball Corporation for violations of the FCPA because of payments of just over $100,000 made to Argentine officials to secure importation of prohibited used machinery and exportation of raw materials at reduced tariffs. Accounting personnel learned of one of the payments and inaccurately described it in company records. Ball agreed to pay a civil penalty of $300,000. There was no parallel criminal action.

SEC v. Johnson & Johnson, Press Release 2011-87 (April 7, 2011). The SEC filed a consented-to injunctive action against J&J charging it with paying bribes to public doctors in Greece, Poland and Romania and kickbacks to Iraqi officials to obtain 19 contracts under the UN Oil for Food program. J&J agreed to disgorge profits and interest of $48.6 million and to pay a criminal fine of $21.4 million to the DOJ.

Tenaris, S.A., Press Release 2011-112 (May 17, 2011). The SEC, having entered its first non-prosecution agreement (with Carter's, Inc.) in December 2010, executed its first deferred prosecution agreement (DPA) with Tenaris, a foreign issuer whose ADRs trade on the NYSE, in a matter involving alleged violations of the FCPA. The SEC alleged that Tenaris bribed government officials in Uzbekistan to win a bid to supply oil and gas pipelines to that country. Tenaris agreed to disgorge $5.4 million in profits and interest and separately paid a criminal fine of $3.5 million as part of entering into a Non-Prosecution Agreement with DOJ.

This DPA contains some provisions that could have serious repercussions that companies should be aware of. First, if the company breaches any part of the agreement, all facts set forth in the agreement will be deemed admitted in the subsequent civil action brought by the SEC. Also, the company undertakes not to violate any federal or state securities law, not just the FCPA, for two years and must during the two years report to the SEC (1) any charge or conviction by a US federal, state or local law enforcement organization or regulatory agency (not limited to a violation of the securities laws) and (2) any charge or conviction by a foreign law enforcement organization or regulatory agency relating to any anti-bribery or securities law, regulation or rule.

False/misleading disclosures

SEC v. NIC, Inc., Lit. Release 21890 (January 12, 2011). The SEC filed a complaint charging NIC and its former and current CEOs and former and current CFOs with misleading investors by not disclosing in proxies and other SEC filings about $1.18 million in perquisites received by

its former CEO over 6 years and about $1 million in related party transactions for planes for the CEO over roughly the same period, while stating that the CEO was working virtually for free. All but the current CFO agreed to settle the charges. NIC and the current CEO agreed to consent to charges of non-scienter fraud and to pay civil penalties of $500,000 and $200,000. The former CEO consented to fraud charges and agreed to an officer-and-director bar, disgorgement of more than $1.5 million (including interest), and payment of a $500,000 civil penalty. The former CFO consented to charges that he created false and misleading records and aided and abetted NIC's violations of the periodic filing, internal control, and books-and-records provisions of the Securities Exchange Act, a $75,000 civil penalty and to a one-year suspension from appearing before the Commission as an accountant.

SEC v. Perry, Keys and Abernathy, Press Release 2011-43 (February 11, 2011). The SEC filed a complaint charging the former CEO and two former CFOs of IndyMac Bank F.S.B. with misleading investors concerning IndyMac's deteriorating financial condition in its 2007 annual report and offering materials for the sale of securities at about the same time. IndyMac was closed by the Office of Thrift Supervision in July 2008 and then petitioned for bankruptcy. The SEC brought no charges against it but did revoke the registration of its securities. One former CEO settled the SEC's charges, agreeing to be enjoined from violating the non-scienter fraud provisions of the Securities Act, to disgorge $25,000, to pay a $100,000 civil penalty, and to be suspended for two years from appearing before the Commission as an accountant. The former CEO and the other former CFO are litigating the SEC's fraud charges.

SEC v. DHB Industries and *SEC v. Krantz, Chasin and Nadelman*, Press Release 2011-52 (February 28, 2011). The SEC filed a complaint charging DHB and three outside directors who sat on its audit committee with defrauding investors by not disclosing substantial perquisites, many of which were misappropriated by, received by its former CEO who along with two other former officers were previously charged by the SEC and criminally by the DOJ for their conduct. The complaint indicates that the three directors sold shares of company stock after becoming aware of the misappropriations by the former CEO, who also benefited from undisclosed related party transactions of more than $10 million, but did disclose the perquisites to investors. The company, which had petitioned for bankruptcy, agreed to settle with the SEC and was awaiting approval of the bankruptcy court.

SEC v. Orr et alia, Press Release 2011-104 (May 4, 2011). The SEC filed a complaint charging the former CEO and five other former officers of Brooke Corporation, an insurance franchisor, and two of its subsidiaries with misleading investors concerning Brooke's deteriorating financial condition in its 2007 and 2008 public filings and other statements. Brooke is no longer in business so the SEC filed no charges against it. Five of the six officers settled with the SEC, agreeing to be enjoined from violating the antifraud and other provisions of the

Exchange Act and to be barred permanently from serving as officers or directors of public companies. Three former officers also agreed to pay civil penalties ranging from $130,000 to $250,000, with the other two agreeing to allow the court to set their penalties. One former officer also disgorged about $240,000. One former CEO settled the SEC's charges, agreeing to be enjoined from violating the non-scienter fraud provisions of the Securities Act, to disgorge $25,000, to pay a $100,000 civil penalty, and to be suspended for two years from appearing before the Commission as an accountant. The former CEO and the other former CFO are litigating the SEC's fraud charges.

False/misleading financial statements

SEC v. NutraCea, Press Release 2011-10 (January 13, 2011). The SEC filed a complaint charging NutraCea and five of its former officers with fraudulently overstating its revenues by 37% in 2007 as a result of recognizing revenues improperly from a bill-and-hold transaction and a fictional sale to another customer whose down payment was funded by a loan from NutraCea's former chief operating officer. NutraCea, its former CEO, and its former corporate secretary consented to entry of injunctions that they not violate the antifraud provisions of the Securities Act and the Securities and Exchange Act. The former CEO also agreed to reimburse NutraCea $350,000 for bonuses he received in 2008 based on the fraudulent financial statements, to pay a civil penalty of $100,000, and to be permanently barred from serving as an officer or director of a public company. The corporate secretary also agreed to a five-year officer-and-director bar. The former controller and former director of financial services consented to entry of injunctions that they not violate Rules 13b2-1 and 13b2-2 and not aid and abet violations of the periodic reporting, internal control and books-and-records provisions of the Exchange Act and to be suspended for one year from appearing before the SEC as an accountant. The company's former CFO is litigating the SEC's charges that he violated the antifraud provisions.

Arthrocare Corp., Exchange Act Release 63883 (February 9, 2011). The SEC filed a consented-to administrative proceeding against this medical device manufacturer charged with overstating its revenues over 10 quarters through a variety of improper practices such as channel stuffing with one customer who was allowed extended payment terms on products shipped during each quarter. Indeed, company employees asked this customer to return some shipped devices so as not to record them as sales and thus exceed analysts' revenue estimates because this might cause Arthrocare to have to ship even greater amounts the next quarter in the event analysts increased their estimates. The order requires Arthrocare to cease and desist from violating the periodic reporting, internal control, and books-and-records provisions of the Exchange Act, citing in detail its extensive remedial efforts, such as replacing its entire senior management team, and cooperation. No civil penalty was imposed.

SEC v. Satyam Computer Services Limited, Press Release 2011-81 (April 5, 2011). The SEC filed a consented-to injunctive action charging this foreign issuer

whose ADRs trade on the NYSE with having used false invoices and forged bank statements to inflate the company's balance sheet. The government of India took control of the company and has filed criminal charges against certain of its officers and two partners of its auditor. Satyam agreed to be enjoined from violating the antifraud, periodic reporting, internal control and books-and-records provisions of the Exchange Act. The company also agreed to pay a $25 million civil penalty. The SEC and PCAOB also filed actions against the company's audit firm.

SEC v. Michael Baker Corp. et alia., Litigation Release 21962 (May 11, 2011). The SEC filed a consented-to injunctive action charging this company and a former manager of accounting for making false journal entries that overstated the company's pre-tax income from 13% to 100% over four quarters. The company consented to entry of an injunction prohibiting violations of the periodic filing, internal control and books-and-record provisions of the Exchange Act but paid no civil penalty. The former accounting manager consented to violating the antifraud and other provisions of the Act and to pay a $35,000 civil penalty. In a parallel administrative proceeding, the former CFO settled SEC charges that he caused the company to violate the above-reference provisions of the Act.

SEC v. Thor Industries and Schwartzhoff, Litigation Release 21966 (May 13, 2011). The SEC filed a consented-to injunctive action charging this company with having violated the periodic reporting, internal control and books-and-records provisions of the Exchange Act from December 2002 through January 2007 and thus having violated a 1999 order that the company cease and desist from violating the latter two provisions of the Act. The former VP of Finance for a company subsidiary, who had created false documentation to understate cost of goods sold by approximately $27 million over 18 quarters, consented to a permanent officer-and-director bar and to disgorge $395,000. The company agreed to pay a civil penalty of $1 million. The former VP of Finance agreed to disgorge bonus compensation plus interest of $395,000 and to be permanently suspended from appearing before the Commission as an accountant. He also pleaded guilty to criminal charges.

SEC v. Jensen and Tekulve, Litigation Release 22014 (June 27, 2011). The SEC filed a complaint charging the former CEO and CFO of Basin Water, Inc. with violating the antifraud provisions of the Securities and Exchange Acts by overstating quarterly and annual revenues by 10 to 161% over a period of two years in connection with six sales transactions where the customer had not accepted the water system during the reporting period. The company was not charged as it had previously been liquidated in a bankruptcy proceeding.

Claw back of executive compensation

SEC v. McCarthy, Press Release 2011-21 (March 3, 2011). The SEC filed a consented-to complaint under Section 304 of Sarbanes-Oxley seeking to have the CEO of Beazer Homes USA, Inc. reimburse the company all

incentive compensation and stock sale proceeds he received during the 12-month period following the filing of fraudulent financial statements by the company for fiscal year 2006. The CEO, who was charged with no wrongdoing, consented to pay Beazer $6.479 million in cash and return restricted stock units and restricted stock that he had received as part of his incentive compensation for the company's pre-restatement performance. Beazer consented in 2008 to entry of a cease-and-desist order that it refrain from violating the antifraud provisions of the Securities Act and Securities Exchange Act and its former chief accounting officer is still litigating charges of fraud that the SEC filed against him.

Commentary

All public companies should prepare for increased scrutiny from the SEC Enforcement Division as the SEC Whistleblower Rule has already resulted in the receipt by the SEC of thousands of complaints, according to public statements made by SEC officials. To assist, we have formed a Whistleblower Task Force that includes Securities Enforcement, Corporate Governance and Employment lawyers to assist public companies in dealing with the SEC Whistleblower Rule as well as many other whistleblower and false claims statutes and rules. Note that the SEC has indicated that it intends to refer most of the complaints back to the affected companies for internal investigations so you need to be prepared to deal both with such referrals as well as with internal whistleblower complaints.

FCPA compliance remains a top priority of both the SEC and DOJ and heavy fines and full disgorgement of profits are the order of the day. To assist, our White Collar and Investigations group practice has lawyers in the United States and many other offices around the world who are well-versed in providing compliance advice, conducting internal investigations, and defending against SEC, DOJ, and other regulatory investigations regarding corruption allegations.

Even aside from the numerous FCPA prosecutions, the extraterritorial reach of the SEC was driven home by the civil action against Satyam, a company that is based in India and whose ADRs were traded on a US exchange. To assist such companies, as well as those based in the US, our Securities Enforcement and Litigation group has a number of former SEC lawyers and DOJ prosecutors who regularly represent public companies in conducting internal investigations, defending SEC investigations, and providing compliance advice regarding the full range of possible violations of the securities laws.