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Defending against Securities Fraud and Related Claims

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ENDING "THE NUMBERS GAME" – RECENT SEC ENFORCEMENT CASES INVOLVING FINANCIAL FRAUD, FINANCIAL REPORTING AND ACCOUNTANTS

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INTRODUCTION

In the past few years, financial fraud and earnings management have been on the rise. Both the number of companies restating earnings and the number of class action complaints alleging accounting irregularities has steadily increased. Headlines such as "Pick a Number, Any Number;"[1] "Corporate Earnings – Who Can You Trust?;"[2] and "Lies, Damn Lies, and Managed Earnings"[3] are gracing the popular press, simultaneously dampening investor confidence in our securities markets. Fears of missing analyst targets as well as increased use of incentive compensation have emboldened some to tinker with the numbers. As accurate financial reporting is the bedrock of our capital markets, the Division of Enforcement has deemed combating financial fraud our number one priority.

This Outline review some of the Division's significant recent activity involving financial fraud, financial reporting, the responsibilities of officers, directors, employees, and accountants, and the foreign corrupt practices act.

FINANCIAL FRAUD AND OTHER DISCLOSURE AND REPORTING VIOLATIONS

A. In the Matter of British Biotech PLC, Keith McCullagh, Peter Lewis, and James Noble, SEA Rel. No. 41505 (June 10, 1999).

On June 10, 1999, the Commission instituted and settled cease-and-desist proceedings against British Biotech PLC, Keith McCullagh, its CEO, Peter Lewis, Director of Research and Development, and James Noble, Finance Director of British Biotech. British Biotech is a British pharmaceutical research and development company registered with the Commission as a private foreign issuer. McCullagh, Lewis and Noble caused the company to make misleading statements concerned the promise that marimastat, a British Biotech pharmaceutical product, had shown in clinical trials involving the treatment of various types of cancer. McCullagh, Lewis, and Noble reviewed and approved all company press releases, which were incorporated in reports filed with the Commission. British Biotech, McCullagh, Lewis and Noble consented to the entry of a cease-and-desist order which contained findings that, from November 30, 1995 through October 1996, British Biotech, through the actions of McCullagh, Lewis and Nobel, made materially misleading statements in reports it filed with the Commission.

The order requires British Biotech, McCullagh, Lewis and Noble to cease and desist from committing or causing any violation or future violations of certain periodic reporting provisions.

1 FORBES, March 23, 1998.
2 BUSINESS WEEK, Oct. 5, 1998.
3 FORTUNE, August 2, 1999.

B. In the Matter of Terex Corporation, KCS Industries, L.P., f/k/a KCS Industries, Inc. and Randolph W. Lenz, SEA Rel. No. 41312; AAE Rel. No. 1126 (April 20, 1999); In the Matter of Larry L Skaff and John F. Liechty, SEA Rel. No. 41313, AAE Rel. No. 1127 (Apr. 20, 1999).

On April 20, 1999, the Commission instituted cease-and-desist proceedings against Terex Corporation, KCS Industries, L.P. and Randolph W. Lenz, and against Larry L. Skaff and John F. Liechty, for misstated financial condition in public filings, arising out of improper application of purchase accounting principles to Terex's acquisition of certain assets of Fruehauf Corporation. Randolph W. Lenz, Terex's and Fruehauf's former chairman, John F. Liechty, Fruehauf's former chief financial officer, Larry L. Skaff, Terex's former CFO, and KCS Industries were causes of Fruehauf's and Terex's violative conduct. KCS, a management consulting firm partially owned by Lenz, provided consulting and management services to Fruehauf and Terex.

Fruehauf's financial condition was misstated primarily by improperly excluding losses of certain subsidiaries held for sale from its consolidated earnings and through the use of undisclosed reserves established as purchase accounting adjustments. For example, in accounting for the acquisition, Fruehauf established reserves for future costs. Fruehauf then charged current period costs incurred in the restructuring and downsizing of its trailer business against these reserves instead of reflecting the costs as operating expenses in the income statement.

In addition, the Management's Discussion and Analysis sections of the companies' financial statements failed to reflect accurately that the companies positive public financial picture was enhanced by undisclosed, non-recurring purchase accounting adjustments. The Commission also found proxy provision violations stemming from Terex's and Lenz's failure to adequately disclose a related party transaction in a proxy solicitation.

Without admitting or denying the Commission's findings, the respondents consented to the entry of cease-and-desist orders based upon Terex's and Lenz's committing or causing record keeping, reporting and proxy solicitation violations, and based on KCS's, Liechty's, and Skaff's causing the record keeping and reporting violations laws.

C. In the Matter of Sunrise Medical Inc., SEA Rel. No. 41096, AAE Rel. No. 1110 (Feb. 24, 1999); In the Matter of Sharon Longview, Christie Rockwood, Vicki Kranawetter, and Luther Dale Robinson, SA Rel. No. 7640, SEA Rel. No. 41097; AAE Rel. No. 111 (Feb. 24, 1999); SEC v. Robert S. Barton, Lit. Rel. No. 16068 (Feb. 24, 1999); In the Matter of Robert S. Barton, CPA, SEA Rel. No. 41181; AAE Rel. No. 1118 (March 18, 1999)

On February 23, 1999, the Commission filed an enforcement action in federal court charging Robert S. Barton, the former CFO of Bio Clinic Corporation, a division of Sunrise Medical Inc. with orchestrating a large-scale accounting fraud, and with insider trading for exercising Sunrise Medical stock options when he knew that the company's financial statements materially overstated its earnings. He perpetrated the fraud to ensure that Bio Clinic met the earnings targets previously agreed upon between Bio Clinic's management team and Sunrise Medical's corporate management team.

To carry out the accounting fraud, Barton solicited the help of Bio Clinic's controller, Sharon Longview, and its accounting manager, Christie Rockwood, to make improper accounting entries. He had the manager of Bio Clinic's information systems, Vicki Kranawetter, and Bio Clinic's outside computer consultant, Luther Dales Robinson, alter accounting software to conceal the improperly recorded accounting entries. The scheme involved hiding expenses in accounts receivable and property and equipment, overstating inventory, and creating a sham rebate. To avoid detection by Sunrise Medical's auditors, Barton, and the others acting at his direction, falsified accounting records that were given to the auditors. Barton lied to an internal auditor who had discovered a discrepancy in one of the falsified records. With the help of others, Barton then further falsified the accounting record to hide the discrepancy. Simultaneously with the filing of the complaint and without admitting or denying the allegations, Barton consented to the entry of a permanent injunction against him. Barton was not required to pay disgorgement, and no penalties were imposed, based on his demonstrated inability to pay.

Also simultaneously with the filing of the complaint, the Commission instituted two related administrative proceedings. The first charged Sunrise Medical with filing materially inaccurate financial statements with the Commission in 1994 and 1995, maintaining falsified books and records, and failing to maintain adequate internal accounting controls. Without admitting or denying the Commission's findings, Sunrise Medical consented to a cease-and-desist order finding that the company violated the periodic reporting, books and records, and internal controls provisions of the Exchange Act.

The second related administrative proceedings was against Longview, Rockwood, Kranawetter, and Robinson for their roles in the accounting fraud. Without admitting or denying the Commission's findings, Longview and Rockwood consented to a cease-and-desist order finding that they violated the antifraud provisions of the Securities Act and the antifraud, books and records, and internal controls provisions of the Exchange Act. The order directed Longview to disgorge her annual bonus for 1994. Kranawetter and Robinson, without admitting or denying the Commission's findings, consented to a cease-and-desist order finding that they violated the internal accounting control provisions of the Exchange Act and caused violations of the books and records provisions.

On March 18, 1999, the Commission instituted proceedings pursuant to Rule 102(e) of its Rules of Practice against Barton, based on the injunction entered against him. Without admitting or denying the Commission's findings, Barton consented to an order denying him the privilege of appearing or practicing before the Commission as an accountant.

D. SEC v. William T. Craig and Scott R. Sieck, Lit. Rel. No. 16056; AAE Rel. No. 1108 (Feb. 10, 1999)

On February 10, 1999, the Commission filed an enforcement action in federal court against William T. Craig, the former Chairman and CEO of Madison Group Associates, Inc., a now defunct microcap entertainment company. The Commission also sued Scott R. Sieck, a former consultant to the company. The Commission alleged that from February 1992 through March 1994, Craig caused Madison Group to overstate dramatically the value of its assets in financial statements filed with the Commission. The unconventional assets at issue, including aging libraries of country music video programs, were obtained in exchange for Madison Group stock and were generally valued on the basis of overly optimistic projections about their commercial potential. This misstatement of asset values allowed Madison Group to maintain a listing for its stock on the NASDAQ national market system and to sell its stock to the public at inflated prices. During the same period, Madison Group issued numerous press releases making false claims about its capital position, revenues and business activities. In addition, in an offering purportedly conducted pursuant to Commission Regulation S, the company issued stock to an offshore entity controlled by Craig and Sieck that shortly thereafter sold the shares into United States markets. Craig also failed to comply with the Commission's disclosure requirements in connection with his numerous purchases and sales of Madison Group stock

Without admitting or denying the Commission's allegations, Craig consented to a permanent injunction and an order barring him from serving as an officer or director of a publicly held company, and Sieck consented to a permanent injunction and a civil penalty.

E. In the Matter of Donnkenny, Inc., SA Rel. No. 7636, SEA Rel. No. 41012, AAE Rel. No. 1104; SEC v. Richard F. Rubin, Edward T. Creevy, Ronald H. Hollandsworth, and Kymberlee W. Kulis, Lit. Rel. No. 16051 (Feb. 2, 1999)

On February 2, 1999, the Commission filed two related enforcement actions. The first, filed in federal court, charged four former senior executives and employees of Donnkenny, Inc. with perpetrating a financial fraud at the company and engaging in illegal insider trading. The second was a settled administrative proceeding against the company.

The complaint against the individuals alleged that beginning in at least early 1994 and continuing until at least August 1996, Donnkenny's former chief executive officer and chairman, Richard F. Rubin, fraudulently managed the company's reported revenues and earnings. Rubin directed a scheme whereby the company improperly reported revenue both on bogus transactions as well as on sales before they occurred. Assisting Rubin in the scheme were three company employees: Donnkenny's former chief financial officer, Edward T. Creevy, its former controller, Ronald H. Hollandsworth, and former assistant controller, Kymberlee W. Kulis. While aware that the company's publicly reported financial results were materially misstated, Rubin, Creevy, Hollandsworth, and Kulis each also engaged in illegal insider trading by selling Donnkenny securities.

Without admitting or denying the complaint's allegations, Kulis agreed to settle the charges against her by consenting to a final judgment. The final judgment prohibits Kulis from violating or aiding and abetting or causing violations of Section 17(a) of the Securities Act of 1933, and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-13, and 13b2-1 thereunder. The judgment also orders Kulis to pay $34,576.66, representing disgorgement of her trading profits and losses avoided (plus prejudgment interest thereon) and civil penalties.

The Commission also instituted a settled administrative proceeding against Donnkenny. Without admitting or denying the Commission's findings, Donnkenny consented to an order finding that the company violated the antifraud provisions, periodic reporting, books and records, and internal accounting control provisions of the federal securities laws. The order directed Donnkenny to cease and desist from committing or causing violations of these provisions.

On the same day, the Rubin, Creevy, and Hollandsworth pleaded guilty to conspiracy to commit securities fraud, a felony.

F. In the Matter of Livent, Inc., SA Rel. No. 7627, SEA Rel. No. 40937, AAE Rel. No. 1095; SEC v. Garth H. Drabinsky, Myron I. Gottlieb, Robert Topol, Gordon C. Eckstein, Maria M. Messina, Diane J. Winkfein, D. Grant Malcolm, and Tony Fiorino, Lit. Rel. No. 16022 (Jan. 13, 1999); In the Matter of Christopher M. Craib, SA Rel. No. 7628, SEA Rel. No. 40938, AAE Rel. No. 1096; In the Matter of Gordon C. Eckstein, SA Rel. No. 7629, SEA Rel. No. 40939, AAE Rel. No. 1097 (Jan. 13, 1999).

On January 13, 1999, the Commission filed a civil injunctive action in federal district court alleging that former senior officers, directors, and members of the accounting staff of Livent Inc. engaged in a multi-faceted and pervasive fraud spanning eight years from 1990 through the first quarter of 1998. The complaint alleges that Garth Drabinsky, Livent's former chairman and chief executive officer, and Myron Gottlieb, the company's former president and a director, were the architects of an accounting fraud designed to inflate earnings, revenues, and assets reported by the company in financial statements filed with the Commission and disseminated to the public. The fraudulent scheme involved multiple violations of the antifraud, books and records, and internal controls provisions of the federal securities laws. As a result of the fraud, Livent made at least seventeen false filings with the Commission that materially overstated the results of Livent's operations and its financial condition.

According to the complaint, Drabinsky and Gottlieb manipulated income and operating cash flows with the active participation of several individuals, including Gordon Eckstein, Livent's former senior vice president of finance and administration, Robert Topol, the company's former senior executive vice president and chief operating officer, as well as several individuals in the company's accounting department. Maria Messina, Livent's former chief financial officer, also participated in the scheme. While in possession of material nonpublic information concerning the fraudulent conduct at Livent, the complaint alleges that, Topol, Gordon C. Eckstein, Tony Fiorino, Livent's former theater controller, D. Grant Malcolm, Livent's former senior production controller, and Diane J. Winkfein, Livent's former senior corporate controller, engaged in insider trading of Livent securities.

The Commission's complaint seeks to permanently enjoin Drabinsky, Gottlieb, Topol, Eckstein, Messina, Winkfein, Malcolm and Fiorino from violating or aiding and abetting violations of the antifraud, books and records, and internal controls provisions of the federal securities laws, and seeks civil monetary penalties against them. The complaint further seeks to bar Drabinsky, Gottlieb, Topol and Eckstein from serving as officers or directors of a public company. Finally, the complaint seeks disgorgement, prejudgment interest and penalties from Topol, Eckstein, Fiorino, Malcolm, and Winkfein for insider trading.

Eckstein, Winkfein, and Malcolm consented, without admitting or denying the allegations of the complaint, to the entry of a final judgment permanently enjoining them from violative conduct. Eckstein also was barred from acting as an officer or director of a public company. Winkfein was also ordered to pay $8,137 in disgorgement and prejudgment interest based on his insider trading profits.

The Commission also entered three administrative orders related to the conduct described in the complaint. Without admitting or denying the Commission's findings, Livent consented to an order directing Livent to cease and desist from its violative conduct. In addition, Eckstein and Christopher Craib, another former controller at Livent, each consented, without admitting or denying the Commission's findings, to orders pursuant to Rule 102(e) of the Commission's Rules of Practice, finding that each engaged in improper professional conduct and willfully violated the federal securities laws, barring Craib from appearing or practicing before the Commission for three years and Eckstein for a period of five years, and ordering Craib to cease and desist from his violative conduct.

Also on January 13, 1999, Drabinsky and Gottlieb were indicted based on their violations of the federal securities laws. In addition, Eckstein and Messina pleaded guilty to one felony count each for violations of the federal securities laws.

The case against Drabinsky, Gottlieb, Topol, and Fiorino are pending. The Commission is continuing its investigation in this matter.

G. SEC v. W.R. Grace & Co., Lit Rel. No. 16008 (Dec. 22, 1998); SEA Rel No. 41578, AAE Rel. No. 1140 (June 30, 1999); In the Matter of Jean-Paul Bolduc, Brian J. Smith, CPA, Richard N. Sukenik, CPA, Philip J. Ryan III, Constantine L. Hampers, A. Miles Nogelo, and Robert W. Armstrong III, CPA, SEA Rel. No. 40819, AAE Rel. No. 1090 (Dec. 22, 1998).

The Commission today instituted and settled administrative and cease-and-desist proceedings against W. R. Grace & Co. The Commission also announced today that it will voluntarily dismiss with prejudice the civil injunctive action against Grace that the Commission filed in December 1998 in federal district court.

In the order, the Commission finds that during 1991 through 1995, former senior management of Grace and National Medical Care, Inc., which was then Grace's main health care subsidiary and comprised the bulk of Grace's Health Care Group, engaged in fraudulent conduct by falsely reporting results of the operations of Grace and those of its Health Care Group and by making false and misleading statements in press releases and at teleconferences with analysts. As a result of this fraudulent activity, Grace made materially false filings with the Commission, publicly disseminated materially false statements, failed to maintain accurate books and records, and failed to maintain adequate accounting controls.

According to the Order, during 1991 through 1995, former Grace and NMC senior management deferred reporting income earned by NMC primarily to smooth the earnings of the Health Care Group, i.e., to bring the reported earnings of the Health Care Group in line with Grace's targeted earnings. The Commission also finds that at the direction and/or with the knowledge of former Grace and NMC senior management, Grace deferred reporting income by increasing or establishing reserves not in conformity with generally accepted accounting principles. The Commission finds that Grace, as directed by former Grace senior management and implemented by former NMC senior management, used the reserves to manipulate the reported quarterly and annual earnings of the Health Care Group. The Commission also finds that at various times, former Grace senior management decided to release some of the excess reserves to increase Grace's earnings per share.

The Commission further finds that when Grace reversed the reserves from its financial statements in the fourth quarter of 1995, the reversal was improperly netted with other charges and adjustments associated with discontinuing the Health Care Group operations. The Commission also finds that former Grace senior management falsely described this reversal of the excess reserves in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of Grace's Form 10-K for 1995 as "a change in accounting estimate." Without admitting or denying the findings of the Order, Grace consented to the entry of the Order which orders Grace to cease-and-desist from committing or causing any violation and any future violation of Sections 10(b), 13(a) and 13(b) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, and 13a-13 thereunder. Grace also agreed to undertake to establish a fund of $1 million for programs to further awareness and education relating to financial statements and generally accepted accounting principles.

On the same day, the Commission also instituted cease-and-desist proceedings against Eugene Gaughan and Thomas Scanlon, both CPAs and partners at PricewaterhouseCoopers LLP (PwC). Gaughan was the engagement partner on the audits of the consolidated financial statements during fiscal years

1991 - 1994. Scanlon was the concurring partner on the 1991 and 1992 audits of the consolidated financial statements of Grace and was the engagement partner on the 1995 audit. Without admitting or denying the Commission's findings, Gaughan and Scanlon consented to an order finding that they caused Grace's reporting violations.

Previously, on December 22, 1998, the Commission instituted administrative and cease-and-desist proceedings against Jean-Paul Bolduc, Brian J. Smith, CPA, Richard N. Sukenik, CPA, Philip J. Ryan III, Constantine L. Hampers, A. Miles Nogelo, and Robert W. Armstrong III, CPA. The Commission's order alleges that all respondents except Ryan committed or caused violations of the antifraud, reporting, and books and records provisions of the Exchange Act. The order alleges that Ryan caused violations of the books and records provisions of the Exchange Act. In addition, the order alleges that Smith, Sukenik and Armstrong willfully violated the antifraud and books and records provisions of the Exchange Act and engaged in improper professional conduct. This case is pending.

H. SEC v. Sony Corp. and Sumio Sano, Lit. Rel. No. 15832; In the Matter of Sony Corp. and Sumio Sano, SEA Rel. No. 40305, AAE Rel. No. 1061 (Aug. 5, 1998).

On August 5, 1998, the Commission issued a settled cease-and-desist order against Sony Corporation and Sumio Sano and filed a related settled complaint against Sony in the federal district court, for violations of the federal securities laws based on Sony's inadequate disclosures concerning the performance of its subsidiary, Sony Pictures.

Without admitting or denying the Commission's findings, Sony consented to the issuance of a cease-and-desist order in which the Commission found that Sony violated the periodic reporting provisions applicable to foreign private issuers in Section 13(a) of the Exchange Act and Rules 13a-1, 13a-16, and 12b-20 thereunder. The order also found that Sano, who was a director of Sony and the General Manager of its Capital Market and Investor Relations Division during the relevant period, was a cause of Sony's violations. Specifically, the Commission found that during the four months preceding Sony's November 1994 writedown of approximately $2.7 billion of goodwill associated with the acquisition of its Sony Pictures subsidiary, Sony made inadequate disclosures about the nature and extent of Sony Pictures' net losses and their impact on the consolidated results Sony was reporting. Those inadequate disclosures were contained in several filings submitted to the Commission. The Commission also noted that during the relevant period, Sony did not report the results of Sony Pictures as a separate industry segment, but instead reported the combined results of Sony Pictures and

Sony's profitable music business as a single "entertainment" segment, which had the effect of obscuring the losses sustained by Sony Pictures.

The Commission ordered Sony to cease and desist from committing or causing violations of the periodic reporting provisions of the Exchange Act, and ordered Sano to cease and desist from causing such violations. The Commission also ordered Sony to comply with three undertakings. In the federal court action, Sony consented to the entry of a final judgment imposing a $1 million civil penalty.

I. In the Matter of Sensormatic Electronics Corporation, SA Rel. No. 7518, SEA Rel. No. 39791, AAE Rel. No. 1017 (Mar. 25, 1998); SEC v. Ronald G. Assaf, Michael E. Pardue and Lawrence J. Simmons, Lit. Rel. No. 16580 (Mar. 25, 1998); In the Matter of Joy Lynn Schneider Green, CPA, SEA Rel. No. 39792, AAE Rel. No. 1018 (Mar. 25, 1998); In the Matter of Thomas H. Pike, SEA Rel. No. 39793, AAE Rel. No. 1019 (Mar. 25, 1998); In the Matter of Albert Glenn Yesner, CPA, SA Rel. No. 7528, SEA Rel. No. 39916, AAE Rel. No. 1027 (Apr. 27, 1998).

On March 25, 1998, the Commission instituted and settled administrative proceedings against Sensormatic Electronics Corporation, a manufacturer and marketer of electronic security systems. In addition, the Commission filed a civil action seeking permanent injunctions and civil penalties against Ronald G. Assaf, formerly Sensormatic's President and CEO; Michael E. Pardue, formerly Sensormatic's Chief Operating Officer, CFO and Executive Vice President and a member of its Board of Directors; and Lawrence J. Simmons, Sensormatic's former Vice President of Finance. The Commission also instituted and settled administrative proceedings against Joy Lynn Schneider Green, Sensormatic's former Controller of U.S. Operations, and Thomas H. Pike, Sensormatic's former Director of Management Information Systems.

Without admitting or denying any of the findings in the order, Sensormatic consented to the issuance of an order that found that Sensormatic violated the antifraud, reporting, internal controls, and books and records provisions of the federal securities laws (Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, and 13a-13), and required Sensormatic to cease and desist from violating these provisions. The Commission order found, among other things, that from at least the start of its 1994 fiscal year through July 10, 1995, Sensormatic manipulated its quarterly revenue and earnings to reach its budgeted earnings goals and thereby meet analysts' quarterly earnings projections. During the relevant period, Sensormatic consistently met, within one cent, the analysts' forecasts of quarterly earnings per share.

According to the order, Sensormatic carried out this fraudulent scheme by improperly recognizing revenue through the following practices: (1) recognizing revenue in one quarter, when products were shipped to warehouses leased by Sensormatic, instead of in the next quarter, when the products were shipped to the customers; (2) slow shipments, whereby revenue was recognized on shipments which were made during the last days of a quarter but which were not scheduled to arrive at the customers' location until well into the next quarter; and (3) recognizing revenue on goods at the time that they were shipped to customers even though the customers' contracts with Sensormatic contained an FOB destination provision. The amount of out-of-period revenue that Sensormatic recognized in quarters ranged from $4.6 million to $30.2 million.

The order also found that Sensormatic filed materially false and misleading periodic reports as well as registration statements for the sale of securities that incorporated these periodic reports by reference and issued false and misleading press releases. During the relevant period, Sensormatic's misstatements of its quarterly net income ranged from an understatement of about $1.9 million (9.1%) in the second quarter of fiscal year 1994 to an overstatement of about $5.2 million (40.5%) in the fourth quarter of fiscal year 1995.

The Commission's complaint filed in federal district court against Assaf, Pardue and Simmons alleged that Pardue and Simmons violated provisions of the federal securities laws that prohibit fraud, falsifying accounting records, and making misrepresentations to auditors; and Assaf aided and abetted Sensormatic's reporting violations and caused the falsification of accounting records. Assaf, Pardue and Simmons, without admitting or denying the allegations of the complaint, each consented to a court order enjoining them from violating the relevant provisions of the federal securities laws and ordering Assaf to pay a penalty of $50,000, Pardue to pay a penalty of $40,000, and Simmons to pay a penalty of $50,000. As part of his settlement, Simmons also agreed to settle Rule 102(e) administrative proceedings, which deny him the privilege of appearing or practicing before the Commission as an accountant, with the right to reapply after five years.

The Commission also instituted and settled administrative and Rule 102(e) proceedings against Joy Lynn Schneider Green, Sensormatic's Controller of U.S. Operations during the relevant period of time. Without admitting or denying the findings contained in the order, Schneider consented to the order which found, among other things, that she was aware that shipping documents had been backdated and that revenue was improperly and prematurely recorded based on the documents. The Commission ordered Schneider to cease and desist from committing or causing any violation of the relevant provisions of the federal securities laws and denied her the privilege of appearing or practicing before the Commission as an accountant, with the right to reapply after three years.

The Commission issued a cease-and-desist order against Thomas H. Pike, Sensormatic's former Director of Management Information Systems, based upon his conduct that allegedly violated Rule 13b2-1 and caused Sensormatic's above described violations. Without admitting or denying the findings contained therein, Pike consented to a cease-and-desist order.

Finally, on April 27, 1998, the Commission issued an order instituting administrative and cease-and-desist proceedings against Albert Glenn Yesner, a CPA and Sensormatic's former Controller and Director of Business Controls. The order alleges that Yesner violated certain provisions of the federal securities laws, aided and abetted and caused Sensormatic's violations, and engaged in improper professional conduct. This case is pending.

J. In the Matter of Presstek, Inc., SEA Rel. No. 39472 (Dec. 22, 1997); SEC v. Robert Howard and Robert E. Verrando, Lit. Rel. No. 15599 (Dec. 22, 1997).

The Commission filed and settled a civil injunctive action against the Chairman and President of Presstek, Inc., for causing Presstek to disseminate, through its own and third-party statements, materially false and misleading information about its sales and business prospects. The Commission also instituted and settled cease-and-desist proceedings against Presstek arising out of the same conduct alleged in the civil injunctive action.

The complaint alleged and the Commission's order found that Robert Howard and Robert E. Verrando knowingly caused Presstek to: (1) disseminate a financial newsletter aggressively touting Presstek and containing excessive earnings projections that were significantly inconsistent with Presstek's nonpublic earnings projections; (2) issue a press release that misrepresented Presstek's sales of its key product and failed to disclose materially adverse information about that product; and (3) distribute, for six months, an analyst's report that substantially overstated Presstek's sales and earnings expectations, without disclaimer.

The Commission's order found Presstek liable for an inaccurate analyst's report because Howard edited the report by making some corrections but leaving other information which he knew was erroneous uncorrected. By editing the report, Presstek entangled itself with the analyst's report. In addition, by distributing, without disclaimer, another analyst's report that contained information that Presstek knew was inaccurate Presstek adopted the report and became liable for the misstatements in it.

Without admitting or denying its allegations, Howard and Verrando consented to a final judgment enjoining them from violating Sections 10(b) and 13(a) of the Exchange Act and Exchange Act Rules 10b-5, 13a-1, 13a-13, and 12b-20 thereunder. In the settled cease-and-desist proceedings, Presstek, without admitting or denying the Commission's findings, consented to a cease-and-desist order.

The Commission's investigation in this matter is continuing.

K. SEC v. John Logan, Lit. Rel. No. 15562, AAE Rel. No. 988 (Nov. 17, 1997); In the Matter of Bausch & Lomb, Inc., Harold O. Johnson, Ermin Ianacone, and Kurt Matsumoto, SEA Rel. No. 39329, AAE Act Rel. No. 987 (Nov. 17, 1997).

The Commission filed a civil injunctive action against John Logan, former Regional Sales Director in the Contact Lens Division of Bausch & Lomb, Inc. ("B&L") based on B&L's material overstatement of its net income in financial statements filed with the Commission for fiscal years ending December 1993 and 1994. Specifically, the complaint alleged that B&L improperly recognized $22 million in revenue through a sales promotion program involving huge consignment sales of contact lenses -- which are not bona fide sales -- to B&L distributors two weeks before the end of the fiscal year. The improper revenue recognition from both the consignment sales and fictitious sales of sunglasses in B&L's Asia-Pacific Division, resulted in B&L materially overstating its 1993 revenue by $42.1 million and its 1993 net income by at least $17.6 million or 11 percent with the Commission for fiscal years ended December 1993 and 1994.

The complaint alleged that as an incentive for reluctant distributors to participate in this sales promotion program, Logan granted, and instructed others to grant, to certain B&L distributors the right to return unsold contact lenses. According to the complaint, Logan knew, or was reckless in not knowing that B&L would incorrectly record these transactions as sales. The complaint charged Logan with aiding and abetting B&L's violation of the antifraud, reporting, recordkeeping, and internal controls provisions of the federal securities laws and with directly violating the internal controls provisions.

Logan consented to the entry of a proposed final judgment which enjoined him from violating, or aiding and abetting the violation of, Sections 10(b), 13(a), 13(b)(2)(A) and (B), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-1 thereunder. Logan also agreed to pay a $10,000 civil penalty.

The Commission also instituted and settled administrative proceedings against B&L and four senior executives based on their involvement in B&L's misrepresentation of earnings and improper recognition of revenue, as alleged in the injunctive action. The Commission found that B&L violated Sections 10(b), 13(a), and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, and 13a-1 thereunder. The Commission found various violations of the antifraud, reporting, recordkeeping, and internal controls provisions by the individual respondents. Without admitting or denying the Commission's findings, each of the individual respondents consented to the entry of a cease-and-desist order.

L. In the Matter of W.R. Grace & Co., SEA Rel. No. 39156 (Sept. 30, 1997).

The Commission instituted and settled cease-and-desist proceedings against W.R. Grace & Co. ("WRG"), finding that WRG failed to disclose fully the substantial retirement benefits it had agreed to provide to CEO J. Peter Grace, Jr. ("Grace, Jr.") and omitted to disclose from its 1993 Form 10-K a proposed related-party transaction between WRG and Grace, Jr.'s son, J. Peter Grace III ("Grace III"). As a result, the Commission found that WRG violated the proxy solicitation and periodic reporting provisions of the Exchange Act and ordered WRG to cease and desist from further violations of these provisions. Without admitting or denying the Commission's findings, WRG consented to cease and desist from violating Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1, 14a-3, and 14a-9 thereunder.

Failure to Disclose Fully Grace, Jr.'s Retirement Benefits

Grace, Jr. was the CEO of WRG from 1945 until his retirement in 1992. WRG's Retirement Agreement with Grace, Jr. provided that upon Grace, Jr.'s retirement, WRG would continue to provide to him "all other benefits and arrangements" that had been provided to him as CEO. Pursuant to that Agreement, WRG provided to Grace, Jr. in 1993 use of a $3 million WRG-owned and maintained apartment, a cook employed by WRG, a WRG limousine and driver, a secretary and administrative assistant, corporate aircraft for personal and business travel, and home nursing and security services. The Commission's order found that Grace, Jr., Pyne, and J.P. Bolduc, then a member of WRG's Board of Directors had knowledge of the benefits that WRG had agreed to provide to Grace, Jr.

The Commission found that WRG did not disclose in any of its proxy statements or periodic reports filed with the Commission before 1995 the cost of providing Grace, Jr.'s retirement benefits. According to the Commission's order, Pyne and Bolduc reviewed the executive compensation section of WRG's draft 1993 proxy statement, and Bolduc and Grace, Jr. signed WRG's 1992 Form 10-K, which incorporated the executive compensation section by reference. The order found that neither Pyne, Bolduc, nor Grace questioned the absence of information about Grace, Jr.'s "other benefits" in WRG's disclosure of Grace, Jr.'s retirement benefits.

Failure to Disclose the Proposed Related-Party Transaction

Grace III was chairman of the board of directors of Grace Hotel Services Corporation ("GHSC"), a wholly owned subsidiary of WRG in the business of providing food and beverages to hotels. In February 1993, WRG decided to dispose of GHSC, and Grace III proposed to WRG that he acquire GHSC from WRG. WRG failed to disclose its proposed related-party transaction with Grace III. The Commission found that Grace Jr., Bolduc, and Charles H. Erhart, Jr., a WRG board member, reviewed WRG's 1993 Form 10-K and 1994 proxy statement but did not question the absence of disclosure about the proposed related-party transaction.

The Commission's Section 21(a) Report

The Commission issued a Section 21(a) Report of Investigation that found that WRG's violations of disclosure statutes and regulations resulted from the failure of Bolduc, Pyne, Erhart, and Grace, Jr. to take steps which they should have taken to ensure full and proper disclosure. The Commission issued the Report "to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the securities laws." The Commission stated that Bolduc, Pyne, and Erhart should have discussed the issues of Grace, Jr.'s "other benefits" and the proposed related-party transaction with disclosure counsel and asked whether the securities laws required disclosure of these matters.

Commissioner Wallman dissented from the Report, taking issue with the Commission's interpretation of the legal standard as requiring officers and directors to ensure the accuracy and completeness of company disclosures.

M. SEC v. Ferrofluidics Corporation, et al., Lit. Rel. No. 15508, AAE Rel. No. 966 (Sept. 25, 1997); In the Matter of Stephen P. Morin, CPA, SEA Rel. No. 39376, AAE Rel. No. 991 (Dec. 1, 1997).

The Commission filed a civil injunctive action against Ferrofluidics Corporation, five individual defendants, and the 1991 RPM Irrevocable Trust (the "RPM Trust"), alleging that from July 1991 through April 1993, Ferrofluidics, a Nasdaq-listed company, materially inflated its revenues and earnings in financial statements filed with the Commission and in other disclosures made to the investing public. The complaint also alleged that defendants prepared and disseminated materially false and misleading statements concerning a sham private placement of stock by Ferrofluidics, sales of the company's products, and equity investments made by the company. Defendants also allegedly disseminated favorable projections about Ferrofluidics' future business prospects and profitability without a reasonable basis. Defendants' activities, the complaint alleged, led Ferrofluidics investors to believe that the company was prosperous, had marketable products, and had potential for rapid growth and earnings. In fact, Ferrofluidics was, at the time, experiencing significant losses and encountering problems in product development and manufacture.

The complaint also alleged that Ronald Moskowitz, Ferrofluidics former CEO, and another defendant sold Ferrofluidics stock worth millions of dollars in private placements and open market transactions while in possession of material, nonpublic information about the company. The complaint also alleged antifraud, reporting and recordkeeping, and disclosure violations, as well as allegations that one defendant violated Section 17(b) of the Securities Act by publishing and circulating a newsletter that ran numerous articles recommending the securities of Ferrofluidics without disclosing that it had been compensated by the company.

The complaint alleged violations of antifraud, reporting, internal controls, and recordkeeping violations. The Commission is seeking injunctive relief, disgorgement, prejudgment interest, civil penalties against the individual defendants and the RPM Trust, and officer and director bars against three of the individuals. Without admitting or denying the Commission's allegations, Ferrofluidics and Stephen P. Morin, a CPA, agreed to the entry of permanent injunctions. Morin consented to pay a $25,000 civil penalty and to the entry of a five year officer and director bar. Morin also consented to a Rule 102(e) administrative proceeding that barred him from practicing or appearing before the Commission as an accountant, with a right to reapply in five years. The case is pending against the other defendants.

Moskowitz was indicted for his role in the fraud. That case is pending.

N. SEC v. Policy Management Systems Corporation, George Larry Wilson, Robert L. Gresham, James P. Brown, David T. Bailey and Bernard C. Mazon, Lit. Rel. No. 15417, AAE Rel. No. 939 (July 23, 1997).

The Commission brought a settled civil injunctive action against Policy Management Systems Corporation ("PMSC") and five of its current and former officers. The complaint alleged that the CEO, CFO and general counsel controlled PMSC's revenue recognition policies and knew or should have known that in certain instances revenue was recognized from contracts which had not been finalized and were not executed until after the end of the period. The complaint further alleged that the executive vice presidents each negotiated contracts with customers where material terms were not agreed until after the close of the period, and each gave customers undisclosed side letters to conclude contracts, although each was aware of PMSC's revenue recognition policies. According to the complaint, these practices, which did not comply with GAAP or PMSC's own publicly stated accounting policies, caused the revenues in PMSC's quarterly and annual financial statements for 1991, 1992 and the first quarter of 1993 to be misstated by amounts ranging up to $3.9 million.

PMSC and the five individual defendants consented, without admitting or denying the allegations in the complaint, to the entry of final judgments ordering PMSC to pay a $1 million civil penalty and each individual defendant to pay a $20,000 civil penalty. The judgments also enjoin PMSC, Wilson, Gresham and Brown from violating the periodic reporting, books and records, and internal controls provisions of the Exchange Act and enjoin Bailey and Mazon from violating the internal control provisions.

O. SEC v. Emanuel Pinez, Lit. Rel. No. 15258, AAE Rel. No. 891, (Feb. 14, 1997); Lit. Rel. No. 15295, (Mar. 14, 1997), Lit. Rel. No. 15605 (Dec. 23, 1997), Lit. Rel. No. 16170 (June 2, 1999); SEC v. Bond D. Fletcher and Mediajet, Inc., Lit. Rel. No. 15548 (Oct. 31, 1997); Lit. Rel. No. 15818 (July 21, 1998).

On February 14, 1997, the Commission filed a complaint seeking emergency action against Emanuel Pinez, the former chief executive officer of Centennial Technologies, Inc. for violations of the antifraud provisions of the federal securities law. On the same day, the court granted the Commission's request for an *ex parte* temporary restraining order, and an order for the freezing of assets, requiring an accounting of assets, and other relief.

The complaint alleged that, on the afternoon of February 7, 1997, while in possession of material nonpublic information regarding Centennial's true financial condition, Pinez purchased approximately 1955 "put" option contracts, and sold approximately 2400 "call" option contracts on Centennial stock. On Monday, February 10, 1997, Pinez allegedly purchased and additional unknown number of put option contracts, at a time when he was aware that Centennial's true financial condition was substantially worse than had been reported.

The complaint further alleged that, while at Centennial, Pinez caused the company to record fictitious sales by arranging for the purchase of Centennial products and secretly paying for those products with his own funds. In some such instances, Pinez allegedly funded these transactions through margin loans on his personal holdings of Centennial stock. Pinez also allegedly altered inventory tags which resulted in an overstatement of inventory. According to the complaint, Pinez's motive for these transactions was to ensure that Centennial's reported results met analysts' expectations.

On March 12, 1997, the U.S. Attorney's Office indicted Pinez, charging him with five counts of securities fraud. On March 14, 1997, the Commission filed an amended complaint in its civil action against Pinez, adding Lehman Brothers, Inc. as a relief defendant. The amended complaint alleges that Lehman is currently holding the proceeds of Pinez's ill-gotten gains from his sale and purchase of put and call options contracts on February 7, 1997.

On December 24, 1997, the court granted the Commission's motion to freeze Pinez' assets and for a preliminary injunction prohibiting Lehman from taking over $4.69 million in profits from Pinez' alleged insider trading. Lehman asserted a claim against the proceeds, seeking repayment for margin loans that Lehman made to Pinez under a margin agreement. The court found that Lehman had knowledge of "highly suspicious circumstances" relating to Pinez' trades and, thus, was not a "bona fide" purchaser entitled to the proceeds of those transactions. The case against Pinez and Lehman is pending.

On October 31, 1997, the Commission filed a separate injunctive action against Bond D. Fletcher and Mediajet, Inc. of which Fletcher is owner and president, for aiding and abetting the financial fraud committed by Pinez and Centennial. The Commission's complaint alleged that at Pinez' request, Fletcher caused Mediajet to create false records and engage in several acts calculated to enable Centennial to include more than $3 million in phony revenue in its reported financial results. According to the complaint, Pinez gave Fletcher at least 260,000 shares of Centennial common stock and made $190,000 in loans to Fletcher and Mediajet in exchange for their participation in the fraud. The complaint further alleged that Fletcher sold the Centennial shares for $6.8 million.

On July 21, 1998, without admitting or denying the allegations in the complaint, Fletcher and Mediajet consented to a final judgment that enjoined them from violating Sections 10(b), 13(a), and 13(b)(2)(A) of the Exchange Act and Rules 10b-5, 13a-1, 13a-13, 13b2-1, and 12b-20 thereunder. The final judgment also ordered Fletcher to pay disgorgement of $7,024,184, plus prejudgment interest but provides that Fletcher will pay approximately $3 million and the remainder will be waived based on Fletcher's demonstrated inability to pay. Mediajet was not ordered to pay a civil penalty based on its demonstrated inability to pay.

P. SEC v. Comparator Systems Corp. et al., Lit. Rel. No. 14927, AAE Rel. No. 786 (May 31, 1996); Lit. Rel. No. 14979, AAE Rel. No. 801 (July 11, 1996); Lit. Rel. No. 15056, AAE Rel. No. 819 (Sept. 19, 1996); Lit. Rel. No. 15855, AAE Rel. No. 1068 (Aug. 20, 1998).

On May 31, 1996, the Commission filed a civil action alleging violations of the antifraud, books and records, and reporting provisions of the federal securities laws by Comparator Systems Corp., company Chairman and CEO Robert Reed Rogers, director and vice president Gregory Armijo, and former executive vice president Scott Hitt.[4] The complaint alleged that the defendants sold tens of millions of Comparator stock to investors while making material misrepresentations concerning the financial status of the company, the company's purported proprietary interest in certain fingerprint identification technology, and the company's other business activities. Among other things, the complaint alleged that over a period of almost three years Comparator issued false and misleading financial statements that grossly inflated the company assets. The complaint further alleged that the defendants made materially false and misleading statements to investors and prospective investors concerning Comparator's technology, including claims that the company owned certain patents that in fact it did not own.

On the same day, the court entered a temporary restraining order prohibiting violations of the antifraud and other provisions of the federal securities laws and freezing the assets of the individual defendants. The Commission's complaint seeks permanent injunctions and civil penalties against all defendants, and, in addition, an order barring Rogers, Hitt, and Armijo from serving as an officer or director of any public corporation.

On September 16, 1996, the court entered a final judgment against Comparator and also entered judgments against Rogers and Armijo. The final judgment against Comparator permanently enjoins Comparator from violating the antifraud, reporting, and books and records provisions of the securities laws. The judgments against Rogers and Armijo permanently enjoin them from violating the same provisions; bar them from serving as an officer or director of any public corporation; and continue the freezes on their assets pending the determination, following further discovery, of the appropriate amount of disgorgement and penalties. The judgments permit Comparator's new management to employ Rogers and Armijo as consultants for a limited period, with restrictions on their compensation, and forbid Comparator from transferring any item of value to Hitt.

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4 On May 14, 1996, before it filed its complaint in this matter, the Commission ordered a ten-day suspension of trading in the securities of Comparator because of questions raised as to the adequacy and accuracy of publicly disseminated information about Comparator.

Comparator, Rogers, and Armijo consented to the entry of the foregoing judgments without admitting or denying the allegations of the Commission's complaint.

On May 18, 1998, the court entered a final judgment by default against Hitt that permanently enjoins Hitt from violating the antifraud, reporting, and books and records provisions of the federal securities laws; bars him from serving as an officer or director of any public corporation; orders him to disgorge $516,614.31, along with prejudgment interest of $87,635.35; orders him to pay a civil penalty in the amount of $516,614.31; and continues the freezes on his assets.

On August 20, 1998, the court entered supplemental judgments against Rogers and Armijo. The court ordered Rogers to disgorge $263,106 in salary from Comparator, $4,469.50 in profits from the sale of Comparator stock, and $29,921.17 in prejudgment interest. Rogers also was ordered to disgorge 30,536,575 shares of Comparator stock and to disavow all debts owed to him by Comparator and incurred during the period covered by the Commission's complaint. The supplemental judgment against Armijo orders him to disgorge $106,401 in salary from Comparator, $9,990 from the sale of Comparator stock, and $13,038.06 in prejudgment interest on those amounts. Armijo also was ordered to disgorge 3,579,816 shares of Comparator stock and to disavow all debts owed to him by Comparator and incurred during the period covered by the Commission's complaint.

Q. In the Matter of Sulcus Computer Corporation, Jeffrey S. Ratner, and John Picardi, SA Rel. No. 7286, SEA Rel. No. 37160, AAE Rel. No. 778 (May 2, 1996).

On May 2, 1996, the Commission instituted and settled administrative proceedings against Sulcus Computer Corporation, Jeffrey S. Ratner, and John Picardi, alleging violations of the antifraud, reporting, and books and records provisions of the federal securities laws.

According to the Commission's Order, during both 1991 and 1992, Sulcus filed with the Commission periodic reports that: (1) contained financial statements that were materially false and misleading and not presented in conformity with GAAP; and (2) failed to disclose that certain increases in revenue and decreases in expenses were non-recurring and not representative of Sulcus' ongoing operations. The misstatements resulted from improper accounting employed in connection with a series of acquisitions Sulcus completed during 1991 and 1992. They resulted in Sulcus filing false financial statements included in the Forms 10-K for 1991 and 1992 and in Forms 10-Q for the second and third quarters of 1991 and for all 1992 quarters. Certain of those false financial statements were incorporated in a registration statement on Form S-1 for an offering of shares of stock originally filed with the Commission on June 17, 1992.

According to the Order, Ratner, as CEO of Sulcus, had ultimate authority as to the accuracy of its financial statements. He signed all relevant periodic reports filed with the Commission, including the registration statement filed on June 17, 1992. As CFO of the Sulcus Hospitality Group, the largest component of Sulcus' operations, Picardi failed to maintain true and accurate books and records and adequate internal controls to assure that Sulcus complied with the recording, books and records, and internal controls provisions of the federal securities laws.

Without admitting or denying the Commission's findings, Sulcus, Ratner and Picardi agreed to cease and desist from committing or causing any violation and any future violation of the antifraud, reporting and books and records provisions. In addition, Ratner and Picardi agreed to cease and desist from causing violations of the reporting and books and records provisions. Furthermore, Picardi agreed to a thirty-month bar from appearing or practicing before the Commission as an accountant.

R. In the Matter of Micro Component Technology, Inc., SA Rel. No. 7639, SEA Rel. No. 41043, AAE Rel. No. 1109 (Feb. 11, 1999)

On February 11, 1999, the Commission instituted proceedings against Micro Component Technology, Inc. (MCT), Duane August Wille, CPA, Steven David Turner, Jeff Allen Stewart, and Daniel James Hill. The Commission alleged that MCT engaged in improper revenue recognition and other improper accounting practices that resulted in materially overstated financial results contained in its Form S-1 Registration Statement and two quarterly reports filed with the Commission. The improper accounting practices included: (a) the recording of sales revenue when, in fact, MCT products were shipped with rights of return or other terms that did not permit revenue recognition; (b) the recording of revenue upon shipment of MCT's product without customer authorization; and (c) the failure to record, and improper recording of, certain expenses. The Commission also alleged that MCT's internal controls were deficient because, among other things, no qualified person regularly reviewed purchase order documentation to determine whether the terms permitted the proper recording of revenue in conformity with GAAP. MCT's books and records were also deficient because certain transactions and expense entries were not properly recorded in conformity with GAAP.

The Commission found that MCT violated periodic reporting provisions and books and records provisions of the federal securities laws. The Commission also found that MCT violated internal controls provisions by failing to implement procedures designed to provide reasonable assurances that revenue and expenses were recognized in conformity with GAAP.

The Commission found that Duane Wille, the CFO, willfully committed violations of Section 17(a) of the Securities Act and Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5 and 13b2-1 thereunder. As CFO, he reviewed and signed MCT's Registration Statement and quarterly reports when he knew, or was reckless in not knowing, that those financial statements were materially misstated. As the CFO and signer of the Form S-1 Registration Statement and quarterly reports, Wille had a duty to take steps sufficient to satisfy himself that there was a reasonable basis for the entries recorded in MCT's periodic reports. He also had a responsibility to take sufficient steps to insure that MCT's books, records and accounts were accurate. Wille failed to exercise that duty in both respects. The Commission also found that by willfully, and at times recklessly, recording certain transactions in a manner that was inconsistent with GAAP when he knew the accounting treatment to be improper, Wille engaged in improper professional conduct.

The Commission found Steven David Turner committed antifraud and other violations based on his role in the fraud. Jeff Allen Stewart committed violations of Rule 13b2-1 and caused MCT's reporting and books and records violations because, as controller, he prepared one of the quarterly reports filed with the Commission when he knew or should have known that those financial statements were materially false and misleading. Daniel James Hill, a company director and officer, failed to remove Wille from any of his accounting responsibilities, and his failure to take corrective steps with regard to MCT's books and records and internal controls problems was a cause of MCT's books and records violations.

Without admitting or denying the Commission's findings, MCT and the individuals consented to the entry of the findings, cease-and-desist orders and remedial sanctions.

AUDITOR AND OTHER OUTSIDE ACCOUNTANT VIOLATIONS

S. In the Matter of PricewaterhouseCoopers, LLP, SEA Rel. No. 40945, AAE Rel. No. 1098 (Jan. 14, 1999)

On January 14, 1999, the Commission instituted and settled proceedings pursuant to Rule 102(e) of the Commission's Rules of Practice against PricewaterhouseCoopers LLP ("PwC"). The Commission's order found that in over 70 instances during the period 1996-1998, PwC or one of its predecessor firms, Coopers & Lybrand L.L.P. ("C&L"), engaged in improper professional conduct by not complying with Commission regulations and other applicable professional standards. Specifically, the Commission found that: (1) in four instances, certain professionals owned securities of publicly-held audit clients for which they provided professional services; (2) in 31 instances, individual partners and managers owned securities of publicly-held audit clients for which they provided no professional services; and (3) in 45 instances, C&L's retirement fund owned securities of publicly-held audit clients of C&L and PwC.

The order found that PwC failed to comply with the independence standards of Rule 2-01(b) of Regulation S-X and generally accepted accounting standards ("GAAS"), which require, among other things, that public accounting firms and their partners and certain professionals not have, or commit to acquire, any direct or material indirect financial interest in their audit clients.

Without admitting or denying the Commission's findings, PwC consented to the entry of the order and to a censure. In addition, PwC agreed to undertake to establish a fund of $2.5 million for programs to further awareness and education throughout the accounting profession relating to independence requirements for public accounting firms. PwC also agreed, among other things, to undertake to complete an internal review supervised by an independent person or firm appointed by the Commission and to report to the Commission staff any additional instances in which PwC partners or professionals owned securities of public audit clients of PwC in contravention of applicable rules and regulations concerning independence. PwC further agreed to undertake certain measures designed to assure future compliance with applicable regulations and professional standards.

T. In the Matter of Jeffrey M. Steinberg and John Geron, SEA Rel. No. 40025 (May 22, 1998).

On May 22, 1998, the Commission instituted administrative proceedings against Jeffrey M. Steinberg, a CPA, and John Geron, a CPA, for causing Spectrum Information Technology, Inc.'s violations of the reporting provisions of the federal securities laws. Spectrum, an Arthur Anderson & Co. auditing client, was a Nasdaq-listed company. Steinberg and Geron are partners in the accounting firm of Arthur Anderson & Co.

The Commission's order alleges that during 1992 and 1993, both Steinberg and Geron advised and concurred in accounting which wrongfully allowed Spectrum to recognize illusory revenues and profits. Beginning in late 1992, Spectrum launched an aggressive campaign to persuade various companies to pay "seven figure" licensing fees for the use of technology to which it claimed to hold the patent rights. When the users refused to pay the fees demanded, Spectrum proposed to three users that the parties enter into "advertising" agreements at the same time as the proposed licensing agreements. Pursuant to the "advertising" agreements, Spectrum would make quarterly payments to the users for purported advertising which matched, dollar for dollar and date for date, the quarterly payments the users would make to Spectrum under the licensing agreements, providing zero net cash to Spectrum, outside of certain initial payments.

The Commission further alleges that Spectrum management accounted for these transactions, after consulting with Steinberg and Geron, by recognizing as current revenue, the full amounts purported to be received and receivable from the users, while deferring the amount purportedly to be paid by Spectrum over the life of the advertising agreements, and creating an advertising asset with an offsetting payable. This accounting treatment created the illusion of revenues and profits in the current period, even though the underlying transactions had no economic substance, apart from the initial payments. Steinberg informed Spectrum orally and in writing that he and Geron concurred with the proposed accounting. The Commission alleges that they concurred even though they knew or should have known that the accounting was improper and that Spectrum management would use their concurrence to prepare the company's public filings.

In addition, the Commission alleges that Steinberg subsequently assisted in drafting financial statement footnotes included in Spectrum's Forms 10-Q which concealed the true substance of the license and advertising transactions. Spectrum then filed materially false and misleading Forms 10-Q with the Commission, violating, among other things, Section 13(a) of the Exchange Act.

The Commission alleges that, by their actions, Steinberg and Geron each was a cause of Spectrum's violations of Section 13(a) of the Exchange Act. This case is pending.

U. In the Matter of Richard Valade, CPA, SEA Rel. No. 40002 (May 19, 1998).

On May 19, 1998, the Commission instituted and settled Rule 102(e) administrative proceedings against Richard Valade, a CPA, based on his improper professional conduct as engagement partner on an audit for Perry Drug Stores, Inc. Valade, without admitting or denying the Commission's findings, was censured and required to remain a member of, and comply with the requirements of, the SEC Practice Section of the American Institute of Certified Public Accountants Division for CPA Firms as long as he appears or practices before the Commission as an independent accountant.

Valade, a partner with Arthur Andersen, LLP ("AA"), was engagement partner for the 1991, 1992, and 1993 audits of Perry, a chain of drugstores that operated primarily in Michigan. Before the fiscal year 1992 audit, Perry notified AA that it was experiencing a large discrepancy between physical counts of inventory and the amounts appearing on Perry's books. During the 1992 audit, Valade and the audit team conducted various analytical tests to verify Perry's inventory and the $20 million discrepancy. None of the tests or analyses conducted by Valade and the audit team explained the cause of the inventory discrepancies. Nevertheless, Valade agreed with Perry's decision to rely upon the results of the testing and analyses and include the $20 million as an asset, and signed an unqualified audit opinion. Without this $20 million asset, Perry would have reported a net loss of almost $6 million for the year; instead it reported a net income of $8.3 million.

The Commission's order held that Valade failed to identify an appropriate basis for selecting the recorded inventory over the physical inventory. He could not point to any error generated by either system of computing the inventory. Despite Valade's consultations with his partners and the additional audit procedures he performed, he nevertheless failed to obtain sufficient competent evidential matter to resolve the inventory discrepancy issue. Valade failed to: (a) require Perry to reconcile the recorded inventory and the physical inventory and record the proper adjustment to the books and records; (b) discredit either the recorded inventory or the physical inventory and require Perry to adjust the books and records accordingly; (c) issue a qualified opinion; or (d) refrain from issuing an audit opinion until the matter was resolved.

As a result, the Commission's order held that Valade failed to comply with GAAS and failed to require Perry to comply with GAAP when he signed an unqualified audit report despite the fact that he had not obtained sufficient competent evidential matter to verify the existence of the store inventory. Thus, Valade engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

V. <u>In the Matter of KPMG Peat Marwick LLP,</u> SEA Rel. No. 39400 (Dec. 4, 1997).

On December 4, 1997, the Commission instituted administrative proceedings against the public accounting firm KPMG Peat Marwick based on its alleged improper professional conduct and violations of the federal securities laws when it audited the financial statements of a client from which it lacked independence.

The Commission alleges that in early 1995, KPMG organized and capitalized KPMG BayMark ("BayMark") as a vehicle to engage in the "corporate turnaround" business. According to the Commission's order, BayMark, as part of a turnaround engagement later in 1995, installed one of its four principals as the President and Chief Operating Officer of Porta Systems Corp., a financially troubled KPMG audit client. The order alleges that when KPMG audited Porta's 1995 year-end financial statements, KPMG lacked independence from Porta because: (1) KPMG had loaned $100,000 to Porta's

President/COO; (2) KPMG had capitalized the separate business owned by Porta's President/COO; (3) KPMG had capitalized Porta's "affiliate"; (4) KPMG was entitled to a percentage of Porta's earnings, disposed inventory, and restructured debt; and (5) KPMG and BayMark should be considered a single entity by virtue of their contractual ties and interdependence.

The order alleges that by auditing and rendering an audit opinion on Porta's 1995 year-end financial statements, KPMG rendered Porta's annual report on Form 10-K materially false and misleading because it was not audited by independent accountants, thereby causing Porta to violate Section 13(a) of the Exchange Act and Rule 13a-1 thereunder. The order further alleges that KPMG violated Rule 2-02 of Commission Regulation S-X, which requires that auditors be independent of their audit clients, and engaged in improper professional conduct under Rule 102(e)(1)(ii) of the Commission's Rules of Practice. This case is pending.

W. In the Matter of Carroll A. Wallace, SEA Rel. No. 41240, AAE Rel. No. 1121 (Apr. 1, 1999)

On April 1, 1999, the Commission instituted proceedings pursuant to 102(e) of the Commission Rules of Practice against Carroll A. Wallace, CPA, audit engagement partner with KPMG Peat Marwick, LLP, in its Denver office, alleging that he recklessly violating professional auditing and accounting standards in connection with his audit of the 1994 and 1995 financial statements of the Rockies Fund, Inc. a business development company. The Order alleges that Wallace engaged in improper professional conduct by failing to assure that the Fund's financial statements complied with GAAP in that they materially overstated net assets due to the improper classification of securities issued directly to the Fund by Premier securities. The order also alleges that Wallace failed to plan the audits adequately; obtain sufficient competent evidential matter concerning the procedures and bases for the valuation of the Premier stock by the Fund's board of directors. He allegedly failed to maintain an attitude of professional skepticism by ignoring indications that the Fund's valuations of the Premier securities were inflated, by failing to appropriately question representations made to the auditors by the Fund's management. The matter is pending.

X. In the Matter of Michael, Adest & Blumenkrantz, P.C., David Michael, CPA and Paul Adest, CPA, SEA Rel. No. 41284, AAE Rel. No. 1125 (Apr. 14, 1999)

On April 14, 1999, the Commission instituted administrative proceedings pursuant to Rule 102(e) of its Rules of Practice against Michael, Adest & Blumenkrantz, P.C. (MA&B), David Michael, and Paul Adest. The Commission found that MA&B engaged in improper professional conduct in connection with their audit of the financial statements of Power Phone, Inc., for the fiscal year ended June 30, 1995. Power Phone's financial statements for that year improperly accounted for two assets, which comprised 95% of Power Phone's total assets: (i) certain artwork held for resale; and (ii) a software program. The respondents did not comply with GAAS because they failed to obtain sufficient competent evidential matter to afford a reasonable basis for their opinion that the art work and software had a total value of $4 million and were actually owned by Power Phone. The Commission also found that respondents failed to exercise due professional care and a proper degree of professional skepticism when evaluating documentation and representations related to these assets.

Specifically, respondents based their audit report principally on the unreasonable and uncorroborated representation of Power Phone's management regarding the value of Power Phone's preferred stock, which in turn was used to establish the value of the software and artwork. The auditors also permitted Power Phone to revise the contract for the artwork after the fiscal year had ended, to reflect a purchase rather than a consignment. In addition, they did not take sufficient audit steps to determine whether Power Phone actually owned the software.

Without admitting or denying the Commission's findings, the respondents consented to the issuance of an order denying them the privilege of appearing or practicing before the Commission as accountants.

FOREIGN CORRUPT PRACTICES ACT

Y. SEC v. Triton Energy Corporation, et al., Civ. Act. No. 1:97CV00401 (D.D.C.), Lit. Rel. No. 15266, AAE Rel. No. 890 (Feb. 27, 1997); Lit. Rel. No. 15396 (June 26, 1997); In the Matter of David Gore, et al., A.P. File No. 3-9262, SEA Rel. No. 38343, AAE Rel. No. 889 (Feb. 27, 1997).

On February 27, 1997, the Commission filed a civil injunctive action against Triton Energy Corporation ("Triton Energy"), and Philip W. Keever and Richard L. McAdoo, former senior officers of Triton Energy's subsidiary Triton Indonesia, Inc. ("Triton Indonesia"). The complaint alleged that in 1989 and 1990, McAdoo and Keever authorized numerous improper payments to Triton Indonesia's business agent, who was acting as an intermediary between Triton Indonesia and Indonesian government agencies, knowingly or recklessly disregarding the high probability that the agent either had or would pass the payments to Indonesian government employees for the purpose of influencing their decisions relating to the business of Triton Indonesia. The complaint alleged that these payments were made in violation of the Foreign Corrupt Practices Act ("FCPA"). The complaint also alleged that

Triton Indonesia recorded other false entries in its books and records. During the relevant time period, the complaint alleged that Triton Energy failed to devise and maintain an adequate system of internal accounting controls to detect and prevent improper payments by Triton Indonesia to government officials and to provide reasonable assurance that transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP.

Simultaneous with the filing of the complaint, Triton Energy consented, without admitting or denying the allegations, to the entry of a final judgment, permanently enjoining it from violating the books and records and internal control provisions of the Exchange Act, and ordering Triton Energy to pay a $300,000 penalty. In addition, Keever consented to be permanently enjoined from violating the foreign corrupt practices and books and records provisions of the Exchange Act, and to a penalty of $50,000.

On February 27, 1997, the Commission also instituted and settled administrative proceedings against former employees David Gore, Robert Puetz, William McClure, and Robert P. Murphy for their conduct in connection with the improper payments and misbookings. Without admitting or denying the Commission's findings, McClure and Murphy consented to cease-and-desist from violating the books and records provisions of the Exchange Act. At the same time, Gore and Puetz consented to cease an desist from violating the foreign payments provision of the Exchange Act. In addition, Gore, Puetz, McClure and Murphy consented to cease-and-desist from causing any violating of the recordkeeping provisions of the Exchange Act.

On June 26, 1997, McAdoo consented, without admitting or denying the allegations in the Commission's complaint, to the entry of a final judgment which permanently enjoins him from violating the antibribery provision and the internal control and books and records provision of the FCPA. The final judgment also orders McAdoo to pay a $35,000 penalty.

10.12 D&O Policies and the Year 2000 Problem.

In Section 2.06 of this book, we discussed the many liability issues raised for companies and their management by "Year Y2K" issues. An all too typical review of a company's D&O policy for Y2K coverage simply asks: "Does the policy contain an Y2K exclusion?" If the answer is "no", then coverage may be thought to exist. Unfortunately, the answer is not that simple. A proper inquiry as to the extent of Y2K coverage in a D&O policy will ask the following questions:

1. Is there a specific Y2K exclusion on the policy? (The answer is should almost always be "no"),
2. What are the advantages and disadvantages of "silence" (i.e. no specific provision one way or the other) with respect to Y2K in a D&O policy?
3. What arguments other than policy language will the insurer have that might affect Y2K coverage? (This may affect the answer to Question No. 2.);
4. What is the impact of the general terms, conditions and exclusions of the policy on potential Y2K claims; and
5. Does the policy include litigation management incentives or loss mitigation provisions that might assist the insured in avoiding or reducing the cost of D&O claims?

A correct answer to these questions involves fully understanding the approach of company to the management of Y2K as well as reviewing all potential causes of action and complainants and asking, in each case: "Would this claim be covered?"

The first inquiry – the presence of a Y2K exclusion – is the easiest. It is important that companies that are negotiating coverage thoroughly examine potential Y2K liabilities before accepting a full exclusion. More often the existence of an exclusion results from the failure to respond to the underwriter's Y2K inquiries, or perhaps a questionable desire to save premium, than a fully thought-out decision to accept an exclusion. If an exclusion is the only alternative being offered, evaluate whether the underwriter might negotiate coverage subject to a higher retention or sub-limit of liability.

Assuming that the policy does not contain an express exclusion, the next level of inquiry is what if the policy says *nothing*? Here we might be guided by an appropriate warning from the Securities & Exchange Commission: "We stress in this release the uncertainties related to remediation, third parties, litigation, *insurance coverage* and other contingencies in the Year 2000 context." (Emphasis added.)[1] As discussed in our next two levels of inquiry, there are good reasons for this advice. Both events and the application of the general D & O policy terms, conditions and exclusions can interfere with the extent of D&O coverage in the Y2K context. The goal of any contract is certainty of purpose and effect. Since a D&O policy has as one of its primary obligations the protection of a board member's personal assets, certainty is even more important than usual. "Policies which are silent on the [Y2K] issue will rarely (and poorly) serve the best interests of the board of directors"[2] In the context of a discussion of the materiality of Y2K issues, the SEC has again emphasized the value of specific Y2K policy

[1] Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisors, Investment Companies and Municipal Securities Issues (July 29, 1998) at http://www.sec.gov/rules/concept/33-7558.htm ("July 1998 SEC Release.") n 32
[2] July 1998 SEC Release at n 47.

provisions, saying: "[i]n considering whether potential Year 2000 consequences are material, companies may offset quantifiable dollar amounts of those consequences that would be covered by Year 2000–specific insurance policies, provided that the policies have a sufficiently broad coverage to cover all risks."[3] Thus, be wary of any insurer whose response to the question "Is Y2K covered under the policy?" is that "Y2K will be generally covered to the same extent as any other similar claim." This response does not answer the more important question: "Is covering Y2K *generally* to the same extent as any other *similar* claim, giving my board enough coverage?" That is our next level of inquiry.

Having concluded that negotiating specific grants of coverage with known parameters is usually a superior choice over silence, we now turn to issues outside the policy terms and their impact, if any, on the extent of coverage.

As discussed in Section 10.08[3][d], insurers have the right to ask underwriting questions and to rely generally on the truthfulness of the information that they are being given. Y2K is no exception to this rule. Today, to the best of the knowledge of the authors, all underwriters, as part of the application process, are asking questions regarding status and handling of the company's Y2K compliance. Whether these inquiries are made orally, or by way of "Y2K Questionnaires" or "Supplemental Applications," it will be difficult for an insured to argue that such inquiries were not part of the "application process" and, thus, made for the purposes of underwriting the policy. In the event these inquiries do not elicit a truthful response, the insurer will have a potential basis for rescission of the policy as to some or all insureds. While the

[3] July 1998 SEC Release at n 34

requirements for rescission vary from jurisdiction to jurisdiction, it is common for an insurer to be entitled to rescind the policy if, as part of the application process, a prospective insured withholds or misstates facts that are material to the risk insured.[4]

An insurer might also argue that, if an insured had knowledge at the beginning of the policy period of facts that would indicate a claim was likely (as opposed to being a mere contingency), coverage would be precluded as a "known loss." This doctrine has its origins in the notion that insurance does not serve the purpose of spreading risk when a loss is known before the insurance coverage begins.[5] Application of this concept to D&O is complicated by the express terms of the D & O contract which usually *permit* but do not require the insureds to submit to the carrier, prior to the expiration of a policy, "circumstances which might reasonably give rise to a claim."[6] The presence of this clause has been used by some insureds to argue that the insurance agreement between the parties specifically contemplated that the insureds would not be obliged to advise the carrier of pre-claim "known losses" unless asked.

Neverthess, it would be the unwise company that would rely upon such an argument in circumstances where it intentionally failed to take required action in the face of a wealth of public information and media coverage of the dangers of the Y2K problem and the responsibilities of the board to manage the issue.

[4] See generally, § 10.08[3][d] of this treatise; *see also* Allan D. Windt, Insurance Claims & Disputes, §2.26 (3d ed. 1995)
[5] See, for example, US Liab Ins Co v Selman, 70 F.3d 684, 690 (1st Cir. 1995) ("Where there is no risk of loss--as where a loss has already occurred before a policy takes effect--insurance ceases to serve its socially utile purpose of risk-spreading.")
[6] See, for example, National Union 1995 Policy at section 7(c), set forth in the Appendices at App. 10-1-21.

Closely related to the "known loss" defense is the general requirement of insureds to mitigate their losses. Traditionally, recovery from a policy may be limited in cases where the insured's failure to exercise "such care as a person of reasonably prudence would have used in the same or similar circumstances"[7] results in additional losses.

The above doctrines underscore that D&O insurers will expect companies and their management to be active, as most are, in their handling of their Y2K issues and will take whatever actions are reasonably required, and not simply rely on the possibility of an insurance recovery. It is also important to note that applying "known loss" and "loss mitigation" concepts to a policy which has *expressly* provided Y2K coverage on the basis of an underwriting review of the insured company, becomes more difficult for the carrier. This may be an additional reason for evaluating the purchase of a policy with specific Year 2000 coverage provisions.

Our next inquiry concerns the application of the general terms, conditions and exclusions[8] of a D&O policy to the Y2K context. Amazingly, some policy consultants overlook the fact that the "regular" terms of the policy must permit coverage of a Y2K. Even when those provisions are not overlooked, all too often policyholders assume mistakenly that they only type of claim for which they need coverage is shareholder actions.

[7] 22A J. Appelman, Insurance Law & Practice §14070 (West 1979); see also Industrial Sugars, Inc. v. Standard Accident Ins. Co., 338 F.2d 673, 676 (7th Cir. 1964).

As the analysis in earlier sections of this Chapter 10 shows, it is clear that the key terms to be evaluated in a D&O policy[9] include:

1. <u>The policy's definition of "Claim</u>" which should *expressly* include SEC investigation, including most importantly SEC subpoenas of individual directors and officers, grand jury investigations and other governmental proceedings at the "target letter" stage;

2. <u>The policy's definition of "Insured" (or the allocation between insured and non-insured parties)</u> which should contain express language, preferably a formula which is pre-agreed between the parties, representing a fair and equitable spilt between loss of the insured directors and officers and the non-insured corporation for non-securities claims. Without such a formula, insureds might expect no more than 10% of a joint settlement and 25% of joint defense costs to be covered in a non-securities claim naming both D&Os and the corporation.[10] Of course, with respect to securities claims, the policy's definition of Insured should expressly include the entity or insured corporation. The definition of "insured" should also expressly include the insured corporation as "debtor-in-possession" regardless of the financial health of the entity;

3. <u>The fraud exclusion</u>, which might include a waiver if, as discussed earlier, the securities disclosures that are the subject matter of the fraud allegation were

[8] See Section 10.06, supra.
[9] See generally, for example, National Union D&O Gold policy.
[10] Indeed, given some of the provisions of the Y2K Act with respect to proportionally liability, it can be expected that insurers will argue even more strongly for low loss allocations in non-securities claims.

written or approved by a specialist securities law firm consented to by the insurer;

4. The insured v. insured exclusion in the context of bankruptcy proceedings should specifically be inapplicable to claims brought by the bankruptcy trustee regardless of whether the insurer believes that the trustee is only "standing in the shoes" of the insured corporation.

5. Express coverage for employment claims should be provided to the directors and officers and perhaps to non-officer employees. While this is probably a good idea in all contexts, it also helps in any Y2K whistle-blower claim. Coverage in this regard should include the elimination of any libel, slander or emotional distress exclusion.

Our last inquiry might be called "icing on the cake". Here we are attempting to take what is otherwise a very good policy for Y2K coverage and add loss mitigation or prevention provisions. All of these provisions have been discussed elsewhere in the chapter but it is important to note their usefulness if expanded to include all Y2K claims. In addition to the waiver of the fraud exclusion mentioned above (which logically falls within the loss prevention philosophy), two additional provisions might be:

1. Waiver of the policy retention if a Y2K claim (whether or not a securities claim) is won, i.e. the defendants are found not liable; and

2. Year 2000 crisis communication coverage paying, preferably from first dollar, fees of public relations firms who assist companies in communicating bad Y2K news to the investment public.

§2.06 The Year 2000 Crisis

[1] Background

The origin of the Year 2000 or "Y2K" crisis is well known. In order to save expensive data storage space, computer programmers wrote mainframe applications that employed two digits instead of four to represent the year in each date field. Thus, "98" represented "1998." Although such programs were not designed to be in use at the turn of the century, they remain, three and a half decades later, a mainstay of many corporate software applications.[1] The programming inadequacy is incorporated in potentially millions of embedded chips in everything from elevators to airplanes.[2] When the clocks turn to the year 2000, many of these programs and embedded chips will malfunction or cease to function altogether.

While the problem is simple to understand, its scope and cost are mind-shattering. President Clinton stated in 1999 that "all told, the worldwide cost will run into the tens, perhaps the hundreds of billions of dollars, and that's the cost of fixing the problem, not the cost if something actually goes wrong".[3] Gartner Group, Inc., an information technology research firm, has estimated that it will cost up to $600 billion to correct the Year 2000 problem worldwide.[4] Some estimates have run even higher. Technology

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[1] Compounding this design deficiency are two additional problems: (1) certain software programs will not be able to calculate for the fact that the year 2000 is a leap year because the year 1900 was not and (2) many such programs make use of what are known as "semantic" or "magic" dates that employ the digits "99" in the year portion of the date field to represent a non-expiring or unknown value. The effect of this second problem is that many programs will not be able to interpret and calculate for the year 1999.

2. The Gartner Group estimates that there will be 50 billion embedded systems in use worldwide and that from 1 to 3 percent of these will have Year-2000 (Y2K) related failures leading to shutdowns, incorrect results or other chaotic behavior. See, http://www.gartner.com "The Year 2000 Crisis: A FRAMEWORK for Embedded Systems" by Andrew Kyte, private report 00054348, 5 December 1997

[3] Speech of July 14, 1998 to National Academy of Science.

[4] See "Year 2000 Problem' Gains National Attention" at *http://www.gartner.com/aboutgg/pressrel/pry2000.html*

Management Reports, a San Diego based research firm, projects that the overall, worldwide economic impact of dealing with computer-related Year 2000 problems will exceed two *trillion* dollars.[5] The Office of Management and Budget has estimated that it will take $4.7 billion to debug federal computers – a figure that is up 100 percent from a year ago[6]. The Gartner Group, on the other hand, predicts that this estimate is wildly too low and that the funds necessary to overhaul all of the federal government's computers would be closer to 7 times that amount.[7] A Rubin Systems survey conducted in March of 1998 indicated that a majority of those corporations surveyed expect to spend over $100 million on their Y2K remediation plans.[8]

More frightening is the fact that there is a substantial reason to believe that some companies will not make it. The Rubin survey also found that 78% of the IT directors and managers reported that their companies' rate of missing remediation milestones was increasing and that 37% of the companies already experienced a Y2K-related systems failure.[9] The Gartner Group has estimated that approximately 50% of companies with Year 2000 problems may not become "Year 2000 compliant" in time.[10] This statement is consistent with a survey conducted a year earlier by Arthur Anderson, which predicted that only 50% of companies will be fully compliant by the year 2000.[11]

[5] *See Dealing With the Year 2000 Problem; Community Impact of the Year 2000 Problem* (visited Sept. 3, 1998) http://www.erols.com/steve451/economy.htm.
[6] *See* Douglas Stanglin, *Year 2000 Time Bomb*, U.S. News and World Report, (June 8, 1998).
[7] Id.
[8] See Rubin Systems, Inc. at *http://www.hrubin.com/2000/results.html*
[9] Id.
[10] See N. Weil, "Gartner's Year 2000 Survey Finds Widespread Disruptions Likely", InfoWorld Electric, August 5, 1998
[11] See, "Year 2000—The Impact on Business" in the European Commission Directorate General III-Industry Report, Workshop on the Business Impact of the Year 2000 Computer Problem, Brussels, 22 October and 12 November 1997, draft 2.0 dated 25 November 1997.

These predictions may be the result of a lack of planning by certain companies, especially smaller companies. As late of August 1998, a survey conducted by ZD Computer Intelligence of 75,000 technology decision-makers found that over 1/3 of companies with less than 100 employees and 18 percent of medium sized companies (100-499 employees) do not have a plan for testing their computers' Year 2000 compliance. Large companies reported that while the percentage of those having a Y2K plan is much higher, only 15.1 percent of them had actually completed their plan.[12]

All this apparent lack of follow-through has and will continue to lead to litigation. Estimates of the total costs of litigation arising out of the Year 2000 problem frequently cite amounts of up to $1 *trillion* dollars.[13] To understand exactly how big $1 trillion in legal costs would be, recall that the *combined* estimated annual cost of Superfund environmental litigation ($1 billion), asbestos litigation ($1 billion) and _all_ U.S. tort litigation ($29 - $36 billion) is still much lower than this figure.[14] Indeed, at $1 trillion, the cost of Y2K is several times the cost of all civil litigation in the United States on an annual basis (estimated at between $200 billion and $300 billion).[15]

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[12] *See* Mitch Ratcliffe, *The Importance of Being Compliant*, (August 25, 1998) *http://www.zdnet.com/icom/e-business/1998/08/980825compliant/index.html*.

[13] See, e.g., "The Legal Nightmare that is Y2K; Millenium Bug Litigation Costs Could Top $1 Trillion," Zachary Coil, San Francisco Examiner (June 22, 1997); Alison Rea, *Does Your Computer Need Millennium Coverage?* Business Week, March 10, 1997; Testimony of Ann Coffou, Managing Director of Giga Information Group before the U.S. House of Representatives Science Committee et al., on March 20, 1997 at http://www.itpolicy.gsa.gov/mks/yr2000/hearing.htm; Rex Nutting, *Y2K Cost Cost $1 Trillion in Legal Costs,* TechWire, March 20, 1997 at *http://www.techweb.com/se/directlink*.

[14] See: Craig Skaggs, *15 Years Later: Superfund Demands Reform,* The Charleston Gazette, May 10, 1996, at p. 5A; Angela Wenihan, *Comment: Let's Put the Contingency Back in the Contingency Fee,* 49 S.M.U. L.Rev. 1639, 1655 (1966); Harold Moskowitz and Robert Wallace, *Loser Pays: A Deterrent to Frivolous Claims,* The New York Law Journal, March 7, 1996, at p.2 (citing an American Tort Reform Association estimate of the cost of civil litigation as between $200 billion and $300 billion).

[15] See, Moskowitz and Wallace, *infra.* at n 8; Also see, Jack Kemp, *Common Good Above Profits,* The National Law Journal, November 4, 1996 at p.20.

[2] Foundations of D&O Liability

Senator Robert F. Bennett (R-UT), Chairman of the United States Senate Special Committee on the Year 2000 Technology Problem correctly remarked that "[a]s we approach this problem, one thing is very clear. Not only do we have a limited amount of time, we have a limited amount of resources in the number of people who can work on a solution to this problem. More than a technological challenge, we face a management challenge." And at the heart of the management challenged is the companies' board of directors. Surveys have estimated that the D & O insurance industry might be compelled to pay between $2 billion and $5 billion dollars of losses as a result of claims against directors and officers.[16] Whether this estimate proves to be accurate is speculative. What is not speculative, however, is that directors and officers will face substantial legal obligations arising out of the Year 2000 problem from many fronts. Among these are:

- Shareholder derivative actions alleging mismanagement;
- Shareholder class actions alleging improper conduct, or even deliberate fraud, in connection with disclosure of Y2K events;
- Governmental and regulatory investigations, including service of personal subpoenas by the Securities & Exchange Commission;
- Other third party claims such as breach of contract suits by customers, suppliers or others, claims brought by bankruptcy trustees or corporate creditors should Y2K force a company into bankruptcy and whistle-blower suits by employees.

We will briefly discuss each of these in turn.

[16] J. Russ, W. Murphy, R. Bhagavatula, *Putting a Price Tag On the Millenium*, Bus. & Management Practices, Best's Review Property/Casualty Edition, Vol. 100, No. 2, pp.77-93 (June 1999)

[a] Shareholder Derivative Claims: Breach of Fiduciary Duty

As discussed in Chapter One of this treatise, directors and officers generally must act with the care that a ordinarily prudent person in a like position would use under similar circumstances.[17] They must perform their duties in good faith and in a manner they reasonably believe to be in, or, by some standards, at least not opposed to the best interests of the corporation.[18] Prior to making a decision, directors and officers must inform themselves of all material information reasonably available to them.[19] Recently, the Supreme Court commented that it is an "elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervising and monitoring role."[20] The court explained that the directors' duty of care includes the obligation to assure themselves that information reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board to reach informed judgments concerning both the corporation's compliance with law and its business performance. Directors and Officers who run afoul of this obligation are subject to an action by shareholders suing "on the behalf" of the company. The so-called shareholder derivative action has been described by the Supreme Court of Delaware as a "potent tool to redress the conduct of a torpid or unfaithful management."[21]

Directors historical main protection against shareholder derivative type actions is the protection they enjoy under the business judgment rule. The business judgment rule is designed to protect good faith decisions by management so long as management

[17] See, e.g., Model Business Corporation Act §8.30.
[18] Model Business Corporation Act §8.30; Del. Gen. Corp. L. §145(a).
[19] See, e.g., Smith v. van Gorkom, 488 A2d 858 (Del 1985)
[20] In re Caremark International Derivative Litigation, 1996 WL 549894 (Del. Ch. Sept. 25, 1996)

intended to serve a business purpose, was made in good faith, and did not involve fraud or a conflict of interest. Under the business judgment rule, it has been said that director liability is predicated upon the concepts of gross negligence.[22] The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interest of the company."[23] An important ingredient is that the directors keep themselves informed. In this regard, it is important to note that directors are generally permitted to rely upon the reports of the company's officers, counsel and third party experts in the course of their decision making. This aspect of the business judgment rule has been codified in Delaware as follows:

> "A member of the board of directors…shall in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."[24]

- In order to gain the protection of the business judgment rule, directors must *act*.[25] Courts have held that, where directors have abdicated their responsibilities and failed

[21] Aronson v. Lewis, 473 A.2d 805, 811 (Del 1984).
[22] Aronson v. Lewis, 473 A.2d 805, 811 (Del 1984).
[23] Aronson v. Lewis, 473 A.2d 805, 812 (Del 1984).
[24] Del Gen Corp L, § 141(e)
[25] See § 1.03, supra; see also E. Brodsky and M. Adamski, "Law of Corporate Officers and Directors" (Clark Boardman Callaghan 1995), section 2.12, p. 2-51 through 2-56.

to act, the business judgment rule does not apply, and such directors could be held liable by a showing of mere negligence.[26]

The passage of the Y2K Act[27] signed by President Clinton on July 20, 1999, may have a major impact on the applicability of the business judgment rule in the context of Y2K management decisions. While the Act general does not apply to any action in which the underlying claim "arises out of the securities laws",[28] an exception is section 13(b) of the Act, which, in relevant part, imposes on plaintiffs making certain types of claims the burden of proving that "the defendant actually knew, or recklessly disregarded a known and substantial risk, that such [Y2K] failure would occur."[29] The section expressly applies to "claims such as fraud, constructive fraud, breach of fiduciary duty, negligent misrepresentation, and interference with contract or economic advantage." The intent of the legislatures to raise the plaintiff's burden for shareholder actions arising out of Y2K is clear. The conference report accompanying the law states "the conferees want to ensure that the Act applies to those cases involving questions as to the determination of liability to shareholders…"

It is too early to speculate how the Y2K Act will affect director liability in derivative actions after the statute has been interpreted by the federal courts. At a minimum, however, it seems likely that a board that fails to take any action with respect to Y2K, or concludes that Y2K is not a matter requiring its attention, may be found to have acted with "reckless disregard of a known and substantial risk", thus losing the protection of both the Y2K Act as well as the business judgment rule.

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[26] See, e.g. Rabkin v. Philip A. Hunt Chemical Corp., 13 Del. J. Corp. L. 1210, 1217 (Del. Ch. Dec. 17, 1987).

[27] H.R. 775, Pub. L. No. 106-37, 113 Stat L 185 (eff July 20, 1999).

[b] Shareholder Class Action Claims: Failure to Disclose

As discussed in other chapters of this book, corporations issuing securities to the public have continuing disclosure obligations under the federal and state securities laws; corporate officials also may be subject to state law duties of candor in their dealings with stockholders. Failure to adhere to the statutory provisions and rules governing disclosure subject the issuing company and its directors and officers to administrative proceedings, lawsuits by shareholders and even criminal penalties. Moreover, as discussed above, the protections of the Y2K Act specifically do not apply to claims "under the securities laws".

As early of May of 1997 divisions of the Securities & Exchange Commission ("SEC") updated its rulemaking guidelines to include guidance on Y2K disclosure.[30] On October 8, 1997, the SEC issued Staff Legal Bulletin No. 5 (CF/IM) reminding companies that Y2K issues must be disclosed "just like any other significant issue". On January 12, 1998, the SEC revised and strengthen this bulletin to provide more specific guidance.

Remarkably, nobody seemed to be listening, or at least, the SEC's Year 2000 Task Force concluded, not enough companies were listening hard enough. The Task Force found that while 70 percent of annual reports filed after the revisions to Staff Bulletin No. 5 in January 1998 contained the phrase "Year 2000" (as compared with only 10 percent filed during the first four months of 1997), "many companies are not

[28] Y2K Act, section 4(i).
[29] Y2K Act, section 13(b).
[30] Division of Corporation Finance, Current Issues and Rulemaking Projects (May 1997)

providing the quality of detailed disclosure that we believe that investors would expect".[31] For example, the SEC found[32] that:

- 43 percent of the company filings did not discuss the company's plans to remedy the Year 2000 problem;
- 64 percent included no information about the timetable for completing their assessment and remediation;
- 51 percent included no disclosure regarding evaluation of material relationships with other entities that could be affected by Y2K;
- 92 percent included no information about historical costs; and
- 78 percent included no information about estimated future costs related to Y2K.

What might have angered the SEC just as much was the findings that only 9 percent of filing companies indicated that the Y2K issue "could be material" to their operations while a full 67 percent represented that it was not material. Almost a quarter of companies indicated that either they had no information on whether Y2K was material and that "materiality was unknown at this time"!

Accordingly, effective August 8, 1998, the SEC released a 22-page Commission Interpretation with 77 footnotes, providing detailed guidelines for Y2K disclosures.[33] The Interpretation made it clear that the Commission expected disclosure if either: (a) the

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[31] Report of the Year 2000 Task Force at http://www/sec/gov/news/extra/y2kefty.htm

[32] See Testimony of Laura S. Unger, SEC Commissioner, Concerning Disclosure of Year 2000 Readiness before the Senate Subcommittee on Financial Services and Technology, Committee on Banking, Housing and Urban Affairs (June 10, 1998) at http://www.sec.gov/news/testimony/tsty0798.htm.

company's assessment of its Year 2000 issues was not complete (including a determination whether third parties with whom the company has material relationships are Year 2000-compliant); or (b) management determined that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition.[34] The rub in the second prong – which alone might allow many companies to conclude that disclosure is not required – is that in determining "materiality", the company cannot take into account any of "the company's efforts to avoid those consequences."[35] In other words, according to the SEC, "in the absence of clear evidence of readiness" a company must assume that all of its efforts to avoid a Y2K problem will fail. Plus, in making the assessment, a company is required to assume that all material third parties will not be ready "unless these third parties have delivered written assurances to the company that they expect to be Year 2000 compliant in time".[36] Based on these rules, it is little wonder that the SEC concluded that "[b]ecause of the prevalence of computers and embedded technology in virtually all businesses and the potential consequences of not adequately addressing the Year 2000 problem, we believe that *almost every company* will need to address this issue." (emphasis added)[37]

Assuming disclosure must be made, the SEC has indicated four general categories of disclosure[38].

[33] Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisors, Investment Companies and Municipal Securities Issues (July 29, 1998) at http://www.sec.gov/rules/concept/33-7558.htm ("July 1998 SEC Release.")
[34] Id. At 6-7
[35] Id.
[36] Id.
[37] Id.
[38] Id. At 8

1. The Company's State of Readiness, including a discussion of information technology ("IT") systems, non-IT systems (such as embedded chips); a discussion of the Company's progress and timetable, and a discussion of the status of material third parties (including their nature and level of relationship with the company);

2. The Cost of Addressing the Company's Year 2000 Issues, including both material historical costs and estimated remaining costs of remediation;

3. The Risks of the Company's Year 2000 Issues, including a "reasonable description of [a company's] most reasonably likely worst case Year 2000 scenarios."[39] If no such forecast can be made, then "this uncertainty must be disclosed" as well as all efforts made to analyze the uncertainty.[40]

4. The Company's Contingency Plans, including a description on how the company is going to "handle the most reasonably likely worst case scenarios".[41] If the company does not have a contingency plan, then, of course, the SEC requires that "disclosure of this fact, whether [the company] plans to create one, and the timetable for doing so".[42]

Within of the above categories and descriptions, there are yet more specific issues which go beyond the purpose of this chapter. The authors strongly recommend seeking counsel from law firms with specific expertise in this area. Indeed, it is interesting to note that at least one insurance company believes that such expertise is so important that

[39] Id. At 9
[40] Id.
[41] Id.
[42] Id.

it conditionally deletes the disclosure fraud exclusion[43] from its policy with respect to any Y2K disclosure reviewed by an approved securities law firm.[44]

Perhaps the only good news in the SEC release is the Commission's support for the applicability of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 to the Year 2000 issue.[45] The SEC seems to go out of its way to explain (and some might argue broaden) the applicability of the safe harbor provisions to the Y2K disclosures that it now requires. Projections of future costs, the likely success of remediation efforts and contingency planning all seem to be treated as "forward looking" statements deserving protection under the safe harbor. Somewhat remarkably, the SEC has stated that even statements of present condition, if based on third party assessments, are "forward looking" in nature.[46] Of course, to have the benefit of the safe harbor, forward looking statements must be accompanied by "meaningful cautionary statements" and other requirements. Again, expert counsel is advised.

[c] Regulatory and governmental investigations

Shareholder lawsuits are not the only possible adverse consequence for management that fails properly to disclose its company's Y2K issues. The Securities & Exchange Commission has stated that "[w]e intend to intensify our efforts to elicit meaningful disclosure from companies about their Year 2000 issues…incentives [to provide such disclosure] include…possible referrals to our Division of Enforcement".[47]

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[43] See § 10.06[5] of this Treatise.
[44] See National Union D&O Gold form, exclusion (b).
[45] The Reform Act is discussed more fully in §3.05[__].
[46] July 1998 SEC Release at footnote 31
[47] July 1998 SEC Release at 4

Such referrals, of course, can result in the service of personal subpoenas on corporate directors and officers.

Along with the SEC, banking regulators were among the first agencies to promulgate detailed guidelines respecting Y2K.[48] The FDIC reported on June 1, 1988 that 88 percent of the 6,034 financial institutions it supervises were making "satisfactory progress" in "all key phrases of the Year 2000 project management process".[49] On the other side of the spectrum, the FDIC reported that the progress of 43 institutions was deemed "unsatisfactory" and would be closely reviewed every quarter.[50] As early as 1997, the Federal Financial Institutions Examination Council issued a series of cease and desist orders to at least one group of financial institutions who failed to satisfy the regulators Y2K concerns.[51] Under federal regulations, the FDIC is empowered to assume the control of a financial institution whose financial health or operation is endangered by failure to take Y2K precautions. Standing in the shoes of the bank, regulators could pursue claims against directors and officers for mismanagement in much the same way bank regulators did against the saving and loan industry in the 1980s and early 90s.[52]

The protections of the Y2K Act are specifically inapplicable to claims brought by regulatory agencies. Beyond the banking and securities areas, management in virtually every regulated industry is subject to possible claims brought by the relevant agencies for

[48] See Federal Financial Institutions Examination Council ("FFEIC") Interagency Statement, "Year 2000 Project Awareness" (May 5, 1997) at http://www.ffiec.gov.y2k/yr2000.htm and "Guidance Concerning Testing for Year 2000 Readiness" (April 10, 1998) at http://www.ffiec.gov/y2k/guidance.htm
[49] See Financial Institutions Letter, "Year 2000 Readiness Assessments" at http://www.fdic.gov/banknews/fils/1988/fil9857.htm
[50] Id.
[51] See In re Farmers & Merchants Bank FDIC No. 97-0846 (Nov. 17, 1997); In re First Bank of Coastal Georgia, FDIC No. 97-0856 (Nov. 17, 1997); In re Farmers Bank, FDIC No. 97-0866 (Nov. 17, 1997) Insureds could argue that the cease and desist order, in itself, is a claim. However, it is more logical to regard this as a circumstance which could reasonably give rise to a claim if it is reported to the insurer along with the other required details of the policy.

mismanagement of the Y2K problem. In extreme cases, criminal jury investigations are conceivable if life, limb or extreme financial hardship has resulted from such mismanagement.

[d] The Ripple Effect: Other Third-Party Claims

Even before January 1, 2000, suits against vendors and manufactures of non-Y2K compliant products have become a big business.[53] The most frequent remedy sought is free Y2K compliant upgrades for class purchasers. While the class receives no monetary settlement in such cases, the plaintiffs' attorneys can receive sizable fees from the defendants as part of the "non-cash" settlement. Not surprisingly, one of the largest plaintiff firms in this business also happens to be the largest plaintiff securities class action firm, which now styles itself "the leading plaintiffs firm in the rapidly emerging field of Year 2000 litigation."[54] Professionals providing services, whether Y2K-related services, such as computer or management consulting, or more mainstream accounting, legal, investment advisory, banking or insurance services, can be sued in the event that: (a) a Y2K failure in their own systems (or those of a third party on whom they rely) prevents them from providing their services properly or (b) their professional advice is faulty due to their inability to evaluate the impact of Y2K on their client. For example, insurance brokers could be negligent in telling their client that they have Y2K coverage when they do not, investment advisors could make or recommend investments in companies that turn out not be Y2K compliant, adversely impacting the value of their clients' portfolios, accountants could fail to discover Y2K related accounting

[52] See §3.10[3] *infra.*
[53] There are numerous web sites devoted to tracking Y2K litigation such as http://legalY2K.com

deficiencies, lawyers could fail to advise their M&A clients of Y2K deficiencies in the target or acquiror. Directors and officers, however, may not bear the brunt of these types of claims, which generally arise out of corporate legal responsibilities. Indeed, as of the date of publication, no vendor-related Y2K claim has named a director or officer as a defendant. However, that is not to say that directors and officers who are thought to have acted grossly negligently in permitting their professional group to incur such Y2K-related liabilities could not later be sued derivatively by their stockholders. Moreover, as discussed further in this chapter, D&O insurance issues can become complicated in the event that such a corporate claim happens also to name a director or officer, perhaps on the basis of misrepresentation, fraud or other type of tort.

In the event that Y2K leads to bankruptcy, claims may be commenced against the debtor corporation's directors and officers by creditors, or in the case of a chapter 7 filing, by the bankruptcy trustee. Finally, Y2K related third party claims can arise out of employment decisions, if the claimant alleges that an adverse employment action was taken because employee threatened to "blow the whistle" on corporate misconduct or inadequacies in addressing the Y2K problem.

[54] See http://www.milberg.com (Milberg Weiss Bershad Hynes & Lerach LLP). This website also contains the firm's current Y2K case load and selected settlement information.

[2] Ten Steps To Reduce Management Exposure

As outlined above, corporate boards are expected to take an active role in managing the Y2K problem. Eleven steps[55] (many of which should already have been completed by the publication date of this chapter) have been recommended as a means of addressing board responsibilities with respect to Y2K:

1. Examine the company's own systems (and those of third parties upon whom the company relies).
2. Formulate, implement, track and test a remediation plan.
3. Stay active in Year 2000 efforts and create a proper "paper trail."
4. Investigate potential claims against third parties.
5. Identify exposure to third parties.
6. Evaluate securities disclosures.
7. Implement securities loss prevention.
8. Monitor responses by competition.
9. Control future transactions.
10. Review liability limitation and indemnification provisions.[56]
11. Review insurance policies.

The final step involves an examination of insurance policies including, most importantly from a personal liability point of view, the company's directors and officers

[55] Taken from "The Year 2000 Crisis as a Management Liability Issue: A Practical Guide for Directors and Officers" by Milbank, Tweed, Hadley & McCloy, Coopers & Lybrand, L.L.P., Arter & Hadden, L.L.P., John V. Guttagh (Professor of Computer Science and Engineering, MIT) with additional assistance provided by Cahill, Gordon & Reindel and Cravath, Swaine & Moore (© 1988 American International Group, Inc.). Copies are available by contacting managementliability@aig.com or calling 212-458-1716.
[56] See Section 1.07, *supra*, and Chapters 5, 7 and 8 of this treatise.

insurance policy. For a discussion of the implications of Year 2000 claims for the beneficiaries of D & O insurance policies, please turn to Section 10.12 of this treatise.

ACCOUNTING IRREGULARITIES AND THE D&O INSURER

Ty R. Sagalow
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Chapter 8
Dealing with the D&O Insurer

Ty R. Sagalow and Michael R. Young

The commencement of class action litigation will bring to the fore a document whose principal function to that point will have been to sit quietly in a filing cabinet. That document is the director and officer or "D&O" insurance policy. Among other things, defendant officers and directors, and perhaps the company itself, will seek to call upon the D&O policy to pay lawyers, to finance "damages" experts and, they hope, to finance all or a portion of any settlement. When an accounting irregularity first surfaces, the newly-named defendants will no doubt be comforted by their general understanding that D&O insurance generally provides coverage for conventional securities class actions and that, assuming compliance with the notice provisions and other prerequisites of the policy, reputable D&O carriers are fairly straightforward in abiding by the policy requirements.

Unfortunately, a situation involving accounting irregularities does not necessarily give rise to a "conventional" securities class action of the sort that D&O policies are specifically designed to address. The reason is that, in a conventional class action, the defendants will normally have available the defense that they told, or at least tried to tell, the truth. In an accounting irregularities class action, in contrast, that defense will not necessarily be available. At least one person within the organization, and frequently more than one, will have deliberately lied. The company, moreover, will have already admitted that it got the numbers wrong.

In a situation where accounting irregularities have surfaced, therefore, the insurance posture changes somewhat. And the defendant officers, directors, and company will likely find themselves facing, among other things, a policy exclusion that explicitly disclaims coverage for deliberate fraud. When accounting irregularities have surfaced, accordingly, officers, directors, and the company itself soon find themselves encountering significant issues as to coverage under the policy.

This chapter explores those issues. First, it provides an overview of the typical D&O policy with the focus on important policy provisions relevant to securities class action litigation. Then it zeroes in on those provisions that can be troublesome where accounting irregularities have surfaced.

The Structure of the Typical Policy

The typical D&O policy is an elaborate system of parts, each with a separate function. However, the traditional policy is typically built around two central promises, reflecting the dual purposes of this type of insurance. In older policy forms, the separate promises were treated as separate policies. Most modern policies, however, treat the two promises as two insuring clauses in one policy form. One promise, typically called Coverage A or the "individual side" coverage, promises to pay or reimburse officers and directors for losses they have suffered as a result of wrongful acts for which they are not indemnified by the company. The second promise, frequently called Coverage B or "Company Reimbursement" coverage, promises to reimburse the corporation for amounts that it has had to pay as indemnification of officers and directors for losses they have suffered as a result of wrongful acts within the meaning of the policy. Today, many policies also contain a third promise, entity coverage, which provides direct coverage for certain claims against the corporation itself.

The front page of a typical D&O policy is a "declarations page," which functions as something of a specification sheet for the policy. The declarations usually state:

- *The policy period:* Since the mid-eighties the policy term is most often a year, but beginning in 1996, two or three-year terms became increasingly available;
- *The name of the parent or "Named Corporation":* The typical policy will cover the directors and officers of the Named Corporation and its subsidiaries, as defined;
- *The limit of liability of the insurer:* That is, the maximum combined amount that the insurer is liable to pay with respect to all claims, in the aggregate, made during the policy period or any extended reported period;

- *The "retention" or deductible amounts:* The amounts by which the company and the individual insured are agreeing to "self insure" each of their losses;
- *Coinsurance:* The amounts, expressed as a percentage, of every loss by which the company and the individual insured are agreeing to "self insure."
- *The premium and any surcharges or installment terms.*

For purposes of analysis, it may be helpful to think of the body of the policy as divided into several principal parts, whether or not the policy writer has set these off from one another in the text. The insuring clauses, as discussed above, form the initial principal part of the policy. These are the promises that form the heart of the bargain between the insureds and the carrier. Second, there are the defining terms, which must be reviewed with particular attention, as they materially affect the extent of coverage offered by the policy. Third, an exclusion section describes broadly those areas of liability to which the bargain does not extend. Next, general terms and conditions of the policy establish important procedures, presumptions, and conditions to coverage, including: provisions relating to notice of claims to the insurer, the insured's and insurer's rights with respect to the defense of a claim and subrogation of losses, circumstances in which the policy may be canceled, the right of the insured to elect an extended reporting period or discovery period, and sometimes an agreed mechanism for alternative dispute resolution. A particularly important provision in this section of the policy is one that describes the circumstances in which the insurer will advance costs to the insured. Finally, there are the endorsements—a series of side agreements between the insureds and the carrier reflecting points of negotiation and adjustments to the premium; this "customized" section of the policy has enormous practical impact, as it can either diminish or enhance the value of the policy to the company and insured officials.

Analysis of D&O Policy Provisions

Because of the complexity of the policies, and the huge impact on coverage of the exceptions and conditions imposed in them, the best way to understand what D&O insurance offers may be to go through the policy as an insurer would when faced with a claim. Three preliminary tests must be satisfied before a claim can be considered for coverage under the policy. These tests arise, logically enough, under the policy's "insuring" clause. If these preliminary tests are satisfied, then a review of the policy's exclusions and other conditions must be made in order to make a final determination of coverage.

To satisfy these preliminary tests, the following must be true: (1) a "claim" must have been made against the insureds during the policy period; (2) the claim must be for a "wrongful act" committed by the insureds; and (3) the insureds must have experienced a "loss." Each of these is examined in turn.

(1) A "Claim" Must Have Been Made During the Policy Period.

D&O policies, like professional malpractice and other similar liability policies, are "claims-made" policies. That is, they provide coverage only for "claims" that have been made first against an insured during the policy period.

Some policy holders may confuse the "claim" on which a claims-made policy is predicated with the "claim" that must be made by an insured when it gives the insurer notice of an insured loss. The "claim" referred to in the term "claims-made" does not refer to the notice by the insured to the insurer, but to a demand by a third party against the insured seeking to hold the insured responsible for the consequences of some alleged wrongful act.

The first inquiry, therefore, focuses on what constitutes a "claim." Surprisingly, in the past it was not uncommon for a D&O insurance policy not to contain a definition of the word. In the absence of a defining term in the contract, though, as the years progressed the meaning of "claim" became subject to conflicting judicial interpretations. Because of the potential ambiguity and expense associated with judicial interpretations of undefined terms, policy holders increasingly grew to demand that important terms be defined. Accordingly, almost all modern D&O policies contain a definition of the term "claim."

Under some policies, especially those written years ago for higher-risk coverage, the term "claim" is fairly restrictive. Given prior judicial determinations, a basic definition of claim for most risks would generally contain four types of coverage:

- Civil proceedings, such as lawsuits;
- Criminal proceedings (post-indictment);
- Administrative proceedings (post notice of charges);
- Monetary or nonmonetary damages or relief for all of the above.

A typical definition of "claim" that fulfills all these requirements would be the following:

1. a written demand for monetary or nonmonetary relief, or
2. a civil, criminal, or administrative proceeding for monetary or nonmonetary relief that is commenced by:

   (a) service of a complaint or similar pleading; or

   (b) return of an indictment (in the case of a criminal proceeding); or

   (c) receipt or filing of a notice of charges.

Recently, the definition of claim has been the beneficiary of several additional, and significant, enhancements. These include civil, criminal, administrative or regulatory investigations, as well as grand jury proceedings. D&O policies are "claims-made" policies and cover only "claims" that are first made during the policy period.

Closely related to the "claims-made" concept is the establishment of a retroactive date. A "retroactive date" or "prior acts date" is a starting point for coverage under the policy¾ the first date in which covered wrongful acts may occur. For both the insureds and the insurer, the placement of the retroactive date can be of great significance to the amount of risk covered under the policy. For example, a retroactive date that is concurrent with the inception date of the D&O policy would limit coverage severely. In such a case, in order for a claim to be covered, both the wrongful acts as well as the claim arising out of those wrongful acts would have to occur during the policy period. This concept is so central to many D&O policies that some policies actually have a reference to the retroactive date in the insuring clauses. On the other hand, sometimes policies can be negotiated with no retroactive date. In that case, wrongful acts occurring at any time in the past or during the policy period would be covered.

(2) The Claim Must Be Made Against an Insured.

The definition of "insured" obviously plays an important role in a coverage determination. Until recently, the term insured usually meant those directors and officers whose acts were protected. However, recent policies have greatly expanded the definition to include the company for certain designated claims, in particular securities claims. Modern D&O policies, therefore, will include as "insureds" officers, directors, and the company itself.

As a general matter, the term "director" is meant to describe those individuals who are elected by the shareholders of the corporation. Similarly, the term "officer" is meant to describe corporate officers appointed by the board of directors.

In the past, directors and officers had to be listed individually to be insured, and persons who thereafter became directors and officers during the policy period had to be submitted to the insurance company for approval. However, today almost all policies provide blanket coverage for all directors and officers and automatically include all directors and officers elected or appointed after the inception date.

But it should not ever be assumed without checking the terms of the policy that individuals hired by management and given generic titles such as "vice president" are automatically covered. Most insurers have the ability to add by endorsement divisional officers or other types of managers or supervisors as insureds to the policy upon request of the parent corporation. In addition, policies may contain endorsements automatically adding all employees as insureds in the cases of employment practices coverage or securities claims coverage.

(3) The Claim Must Be for A Wrongful Act.

Assuming that one has a "claim" against an "insured" made during the policy period, the next question is whether the claim alleges a "wrongful act." The wording of "wrongful act" will vary somewhat from policy to policy. A typical definition would read as follows:

> "Wrongful Act" means any breach of duty, neglect, error, misstatement, misleading statement, omission or act by the directors and officers of the company in their respective capacities as such, or any matter claimed against them solely by reason of their status as directors and officers of the company.

Definitions of "wrongful act" generally require, as a predicate for coverage, that the directors or officers be acting in "their respective capacities as such." A number of issues arise out of this "capacity requirement." The most common example of a claim that could run afoul of this requirement is a claim made against a director or officer because of his service at the request of the insured corporation on the board of another corporation that is not a subsidiary. While the director in question might view his service on the other corporation's board as a mere extension of his capacity as a director or officer of the insured corporation, no insurer is likely to agree with him. Claims arising out of such "outside directorships" are normally excluded from the policy unless such coverage is specifically provided. This restriction in coverage may take the form of an "outside directorship" exclusion or may be inferred from or made explicit in the definition of wrongful act. However, outside directorship coverage is commonly available by endorsement.

An interesting question arises with respect to the "capacity requirement" when the director or officer is also rendering professional services to the corporation. Carriers take markedly different views as to whether, for example, an officer-attorney rendering legal services to the corporation was acting in a covered capacity if he or she is sued as a result of those professional services. Other allegations that may fall outside the insured capacity are those that involve conduct by directors and officers that concern acts that are self-interested, such as ventures involving corporate officials, but not corporations, or other acts that are not within directors' and officers' official sphere of responsibility. The position of virtually every insurer will be that at least some, and possibly all, such acts would not be covered by the policy even if such coverage were not already barred by public policy or standard policy exclusions, which they generally are. Outside directors who provide legal, consulting or other services to the corporation not directly related to their service as directors also may find that those activities are not covered.

(4) The Insured Must Have Incurred a Loss.

D&O policies require that, in order to qualify for coverage, the insured must have incurred a "loss." A "loss" with respect to an individual insured is generally defined as any amount for which the insured is legally liable and that arises out of a claim made against him for wrongful acts. With respect to the corporate reimbursement side of the policy, a "loss" may encompass any amount for which the corporation indemnifies its directors and officers for covered wrongful acts by such directors and officers. Further, in the event that the policy provides entity coverage, the corporation may also recover for losses it incurs arising out of securities claims made against the corporation itself.

A typical definition of "loss" includes all "damages, judgments, settlements and defense costs" incurred in the defense and investigation of a claim. Losses covered by the policy thus do not include losses incurred by the corporation unless entity coverage is bargained for separately.

It almost goes without saying that the directors or officers must have suffered real legal liability for there to be a loss under the policy terms. In the past, some defendants have attempted to settle a claim without the consent of the insurer, with the proviso that the plaintiff could not look to them for payment, but must proceed directly against the D&O insurance policy. Carriers have resisted such attempts to create what they perceive to be an inchoate or artificial loss and courts have upheld the insurers' position.

It is usual for a D&O policy's definition of "loss" to be limited by specific exceptions. One illustrative exception, mentioned above, prevents payments made pursuant to settlements without legal recourse to the insured. Other typical exceptions include: punitive and exemplary damages, fines and penalties, taxes, and "matters uninsurable under the law pursuant to which the policy is construed." The historic logic behind these limitations is that fines, penalties, and punitive damages are really designed to be punishment to wrongdoers, not compensation to wronged plaintiffs, and they are, or should be, uninsurable as a matter of public policy.

Another issue affecting the scope of covered "losses" is the treatment of interrelated or causally connected wrongful acts. D&O policies typically provide that all claims arising out of interrelated wrongful acts are deemed to arise out of the first such claim. Arguably, this provision has benefits for both the insurer and the insured. For the insurer, it ensures that all risks associated with claims arising out of the same or related wrongful acts will be captured within one policy period and thus will be subject to one liability limit. The danger to the insurer of omitting such a requirement is that insurers who fail to include such language may be found liable under separate policy limits for multiple related claims filed over a several-year period. On the other hand, such a provision may also contain benefits for the insured. First, it may permit the insured to move coverage to another carrier, reserving the argument that any future claims arising out of the interrelated wrongful acts of a previously submitted claim will be covered by the former policy. In addition, most policy forms also indicate that all claims that are interrelated for the purpose of imposing a single limit also obtain the benefit of applying a single retention.

(5) The Claim Must Not Be Excluded.

If a "claim" occurs during the policy period against an "insured" and alleges "wrongful acts" creating "losses" for the insureds or for the corporate policy holder that indemnifies them, then the next avenue of inquiry is whether the claim has been excluded either by the "exclusion" section of the policy or by "endorsement."

Exclusions in a typical D&O policy fall generally under three categories:

- Exclusions relating to specific conduct of an insured;
- Exclusions of coverage provided under other policies;
- Exclusions relating to issues of public policy or areas of difficult exposure.

Most exclusions are found in the basic policy form, but many are often added by endorsement. There are also various fairly standard exclusions that (for historical reasons) are always added by endorsement. It should be noted that, because exclusions block coverage under the policy, it is the insurer that bears the burden, in the event of any coverage dispute, of demonstrating that the exclusion applies and that the language of the exclusion is clearly stated. Typical exclusions are as follows.

a. Conduct Exclusions. "Conduct" exclusions preclude coverage of acts that the carriers deem to be uninsurable or inappropriate for coverage. Typical conduct exclusions concern claims based on¾

- Illegal remuneration;
- Short-swing profits; and
- Criminal or deliberately fraudulent acts; or the gaining of any personal profit or advantage to which the insured is not legally entitled.

As discussed in detail below, the third of these—the exclusion for "criminal or deliberately fraudulent acts"—can play an important role in determining D&O coverage where accounting irregularities have surfaced. For the moment, the important point is to recognize not only the exclusion but the fact that a policy may provide that the exclusion is triggered not merely by allegations, but by a final adjudication or other finding of fact. The reason is obvious. Virtually all class action complaints allege deliberate fraudulent acts. If the exclusion were triggered by a mere allegation, the exclusion would swallow the policy.

b. Exclusions Due to Other Policies. A number of exclusions in the D&O policy are meant to protect the policy from being used to cover claims that are, or should be, covered under another type of policy. Such exclusions include:

- Claims to which an earlier D&O policy was applicable;
- Claims arising out of litigation pending as of or completed prior to the continuity date (the "pending and prior litigation exclusion");
- Claims based on wrongful acts of a director or officer of a subsidiary corporation occurring either before it became a subsidiary or after it was spun off;
- Claims based upon or attributable to any failure or omission to effect or maintain insurance;
- Claims that are insured against by any other policy or policies, except presumably for D&O policies written specifically to provide excess coverage in addition to the coverage provided by the primary policy.

While these exclusions are rather straightforward in intent, there are nevertheless issues of interpretation of which a corporation should be wary. For example, exclusions preceded by the word "for" are typically interpreted narrowly to exclude only those items specifically stated. For the insureds, such a narrowing of the exclusions is a benefit. In contrast, older policy forms may begin with the broader introductory phrase, "based upon, arising out of or attributable to" which is "catch-all" introductory language that broadens the scope of the exclusions.

One exclusion that is subject to significantly varying interpretations is the seemingly-innocent exclusion for "pending and prior litigation." In its most acceptable form, the exclusion precludes coverage for "claims arising from any pending or prior litigation as of the continuity date, as well as all future claims or litigation based upon the pending or prior litigation or derived from the same or essentially the same facts that gave rise to the pending or prior litigation." Other broader, and therefore less preferable, versions of the exclusion might also exclude any "demand, suit or other proceeding . . . decree or judgment entered against any" director, officer, or the insured corporation.

c. The "Insured v. Insured" Exclusion. The purpose of the "insured v. insured" exclusion, now standard in almost all D&O policies, is easy to understand. The underwriting philosophy behind a D&O policy is to provide coverage for claims brought by third parties against an insured corporation's management. There are two reasons classically given for the insured v. insured exclusion. First, providing coverage for a claim brought by an insured against another insured, or brought by the company against an insured, would support potentially collusive arrangements between insiders. Second, even in the absence of collusion, the insured v. insured exclusion is needed to prevent coverage for "boardroom in fighting."

While the reasons for the exclusion are understandable, some of the original phraseology used in older policies was overly broad and gave rise to considerable confusion. For example, an early broad form of this "insured v. insured" exclusion read as follows:

> The Insurer shall not be liable to make any payment for Loss in connection with any claim or claims made against the Insureds . . . which are brought by, or on behalf of,

> any other Insureds including but not limited to shareholders' derivative suits and/or representative class action suits, brought by one or more past, present or future Directors and/or Officers including their estates, beneficiaries, heirs, legal representatives, assigns and/or the Company against one or more past, present or future Directors or Officers.

Because the broad language of such early forms of exclusion might be deemed to exclude even judgments paid in shareholder derivative actions (coverage of which is one of the principal advantages of insurance over indemnification), policies subsequently came to be modified to clarify the exclusion. Newer forms of the exclusion create significant exceptions for shareholder claims that can be shown not to have been made in collusion with an insured or the company and for wrongful discharge complaints against management by former officers. For example, a modern "insured v. insured" exclusion might read:

> The Insurer shall not be liable to make any payment for Loss in connection with any claim or claims made against the Directors or Officers . . . which are brought by any Insured or the Company; or which are brought by any security holder of the Company, whether directly or derivatively, unless such claim(s) is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any Insured or the Company; provided, however, this exclusion shall not apply to wrongful termination of employment claims brought by a former employee other than a former employee who is or was a Director of the Company.

This form of the exclusion is intended to screen out the possibility of suits by the company, or by individuals acting as proxies for the board or the company, while at the same time permitting most non-collusive shareholder class or derivative actions to be covered.

d. Endorsements. Most of the exclusions listed above are so generally applied that they have become part of the preprinted policy form. Sometimes, however, exclusions that are more fitted to the particular circumstances and risks of an individual company are added by "endorsement." Endorsements, in fact, unlike exclusions, may be either restrictive or expansive, and thus may best be viewed as the result of bargaining and customization of the basic policy form.

A sample of some of the restrictive endorsements that might be found in a typical policy include:

- Deletions from coverage of specific directors or officers against whom actions or investigations or known claims are pending when the policy is written; and
- "Reorganization of business" exclusions, which provide for termination of coverage in the event of a takeover or insolvency.

Endorsements, of course, are also frequently used to expand coverage under the policy. Examples of such expansive endorsements include:

- Endorsements amending the term "insured" to include divisional officers, employees, or other non-officers;
- Endorsements expanding the definition of the insured company to include foundations, trusts, partnerships or other noncorporate affiliates;
- Endorsements obligating the insurer to advance defense costs, if such advancement is not already provided in the boilerplate of the policy;
- Endorsements expanding or clarifying the worldwide applicability of the policy;

- Endorsements providing multi-year discovery or run-off periods or making the policy applicable to a particular acquisition that the company is contemplating; and

- "State amendatory endorsements" required by state law, which typically expand coverage by providing longer advance notification of cancellation, the ability to elect discovery periods, and sometimes other benefits to policy holders mandated by state law.

(6) The Insurer Must Be Timely Notified.

Assuming that a "claim" has been made against an "insured" during the policy period alleging a "wrongful act" creating a "loss" and that the claim is not excluded by any of the "exclusions," the policy will require that the claim be submitted on a timely basis to the insurer. As mentioned earlier, the D&O policy is a "claims-made" contract. A necessary part of the claims-made concept is that both the insured and the insurer know with reasonable certainty at the time of policy creation or renewal whether coverage under the expiring policy has been triggered by a claim. Notification requirements are taken extremely seriously in the claims-made context, and the failure to give timely notice may jeopardize coverage. D&O policies usually require that insureds notify the insurer "as soon as practicable" of any claims made against them during the policy period (or discovery period, if elected). Higher-quality policies might add a small "window" after the end of the policy to facilitate the submission of claims made against the insured late in the policy period. A typical provision of that type might read as follows:

> The Company or the Insureds shall, as a condition precedent to the obligations of the Insurer under this policy, give written notice to the Insurer of a Claim made against an Insured as soon as practicable and either:
>
> (1) anytime during the Policy Period or during the Discovery Period (if applicable); or
>
> (2) within 30 days after the end of the Policy Period or the Discovery Period (if applicable), as long as such Claim(s) is reported no later than 30 days after the date such Claim was first made against an Insured.

Some more restrictive policies may require notice to be given within a certain period¾such as 30 days¾after the claim is first made.

In addition to the notice-of-claim provisions, most D&O policies also permit insureds to notify the insurer of circumstances that may give rise to a claim in the future. If such notice is given prior to the expiration of the policy, the insurer will treat any subsequent claims arising out of those circumstances as claims first made within the policy period. A typical provision would read like this:

> If during the Policy Period or Extended Reporting Period (if exercised) an Insured becomes aware of any circumstances which could give rise to a Claim and gives written notice of such circumstance(s) to the Company, then any Claims subsequently arising from such circumstances shall be considered to have been made during the Policy Period or the Extended Reporting Period in which the circumstances were first reported to the Company.
>
> The Insureds shall, as a condition precedent to exercising their rights under this coverage section, give to the Company such information and cooperation as it may reasonably require, including but not limited to a description of the Claim or circumstances, the nature of the alleged Wrongful Act, the nature of the alleged or potential damages, the names of actual or potential claimants, and the manner in which the Insured first became aware of the Claim or circumstances.

The advantage to the insured of submitting such a notice of circumstances is that it preserves the insured's rights under the existing policy. If a claim arises out of such circumstances after the expiration of the policy period, the policy will treat the claim as if it were made during the policy period and therefore covered. Of course, such a claim likely would be excluded from coverage under a subsequent policy due to that subsequent policy's "prior notice" exclusion. As a practical matter, therefore, giving notice of circumstances is something that should be approached with caution.

(7) Loss Must Be in Excess of the Retention Amount and Not Within Any Applicable Coinsurance Percentage.

Having properly submitted to the insurer a claim which falls within the scope of the insuring clause, and which meets the essential definitions of the policy and is not excluded by the exclusion section, the policy holder finally gets to ask the key question. How much of the loss will be paid by the policy?

This avenue of inquiry relates, in major part, to the retention and coinsurance sections of the policy. Typically, the insurer is liable to pay only that loss which is in excess of the applicable retention or deductible amount and, in the event of coinsurance, in excess of the applicable coinsurance percentage. Both retentions and coinsurance percentages are forms of self-insurance; their effect is generally to lower the amount of premium that the insurer otherwise would require, in exchange for some or all of the insureds' assumption of a portion of the risk.

The D&O Policy & Accounting Irregularities

That's basically how a standard D&O policy works. Where accounting irregularities enter the picture, though, particularly difficult issues of interpretation emerge. The reason, as mentioned at the outset, is that a typical D&O policy is primarily intended to address a conventional securities class action—that is, a class action in which the defendant officers, directors, and company do not admit they've deliberately said anything wrong. Where accounting irregularities have surfaced, that is by definition not the case. If the company has issued a press release admitting to "irregularities," it has already gone a long way to conceding the existence of fraud. Even absent the admission of "irregularities," the mere acknowledgment of need for an earnings "restatement" concedes that earlier numbers were incorrect.

Where accounting irregularities have surfaced, therefore, a series of difficult issues needs to be faced. These might be divided into five categories. They are:

- The "deliberate fraudulent act" exclusion
- Imputation from one insured to another
- The problem of "loose cannons on the deck"
- The need for a factual adjudication
- The application process

Each is discussed in turn.

The "Deliberate Fraudulent Act" Exclusion.

The starting point in assessing coverage in the wake of accounting irregularities is ordinarily the "deliberate fraudulent act" exclusion. To reiterate briefly, this exclusion typically provides:

> The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured:
>
> * * *

> (c) Arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act; . . . .

Interpreted in accordance with its plain meaning (which the insurer will be wont to do), this means that the D&O policy expressly excludes coverage for "deliberate fraudulent acts." That is, the policy excludes coverage for claims arising out of fraudulent acts that the perpetrator intentionally undertook. If the exclusion does not contain the restrictive adjective "deliberate" (and many policies do not), the breadth of the exclusion may be even broader, potentially excluding *all* fraudulent acts. The policy will also exclude coverage for "criminal" acts, which accounting irregularities may very well involve. If the coverage analysis were to end there, it would seem a fairly straightforward proposition that coverage would be denied.

Fortunately for the officers, directors and company, the analysis does not end there. The reason stems from the fact that, while some within the organization may have deliberately misstated financial results, it is not necessarily true that everyone named as a defendant will have knowingly participated—or perhaps participated at all. In particular, among those who were not participants in the irregularity, but who still may nonetheless be named as defendants in the class actions, will frequently be additional officers and directors of the company. Will the insurer deny coverage as to them? Here, the policy provisions may suggest a different outcome. While an enlightened D&O policy excludes coverage for "deliberate" fraud, it *provides* coverage for fraud that arises out of recklessness.

One interpretation of the policy, therefore, would have the defendants falling into one of two groups. One group would include those who were deliberate participants in the fraud. The other would include those who were not deliberate participants in the fraud and who, at worst, were only "reckless." One possible outcome, therefore, is that the insurance carrier will deny coverage to the former but provide it for the latter.

Imputation from One Insured to Another

If only life were that simple. First, it is not always entirely clear who acted with a deliberately-fraudulent intent—particularly when one is focusing upon potential participation in the fraud by a corporation. Second, in determining who possessed the requisite intent and who did not, another important provision comes into play. That is a provision providing for "imputation" from one insured to another—be the insured a natural person or an entity.

As a general matter, imputation works like this. If one person knows of the fraud, but another does not, then (in the absence of imputation) the insurance consequences should follow the separate knowledge of each. The "innocent" defendant gets coverage; the knowing defendant does not. However, this result can be unfair to the insurance company who, after all, has accepted a risk in good faith reliance on an understanding that it was not being misled. The doctrine of "imputation," therefore, will in some instances "impute" the knowledge of a deliberate wrongdoer into the state of mind of another. For example, under many circumstances, a senior executive's knowledge of wrongdoing might be imputed to the company, thereby making the company, as a matter of law, a deliberate wrongdoer as well. Similarly, knowledge of one officer or director may potentially be imputed to another. This approach, while perhaps understandable from the perspective of the insurance carrier, may nonetheless have harsh consequences for innocent insureds. The issue thus arises as to the extent of imputation for purpose of determining insurance applicability.

Here, too, different insurance carriers approach the issue differently. Fortunately, most quality insurance policies will contain an express "imputation" provision to address precisely this dilemma. For example, on the issue of imputation from an officer or director to their company, a policy might provide as follows:

> For the purposes of determining the applicability of the foregoing exclusions . . . only facts pertaining to and knowledge possessed by any past, present or future chairman of the board, president, chief executive officer, chief operating officer or chief financial officer of the Company shall be imputed to the Company.

Similarly, on the issue of imputation from one officer or director to another, the policy might read like this:

> The Wrongful Act of any Director or Officer shall not be imputed to any other Director or Officer for the purpose of determining the applicability of the [deliberate wrongful act exclusion].

Or the policy might contain a provision that reads:

> For the purpose of determining the applicability of [certain] exclusions, the facts pertaining to and the knowledge possessed by any Insured shall not be imputed to any Natural Person Insured . . .

On the issue of imputation, the provisions among various insurance carriers are far from standardized. As a general proposition, though, the extent of imputation from one defendant to another will be determined according to the policy's terms. In the absence of an imputation provision (these days a rarity), the extent of imputation from one defendant to another will be determined in accordance with the applicable state law.

The Need for a Factual Determination

The coverage analysis, though, is still not over. Yet another provision now comes into play. It is the provision, found in many policies, which premises an exclusion of coverage based on deliberate fraudulent acts to instances where there has been a final adjudication or other finding of fact. A typical provision may, for example, exclude coverage for deliberate fraudulent acts "if a judgment or final adjudication adverse to the Insured(s) or an alternative dispute resolution proceeding establishes that such criminal or deliberate fraudulent act occurred." Or a provision might indicate that the exclusion is premised upon a "finding in fact". Where such a provision exists, the insurance carrier may not, therefore, simply premise an exclusion of coverage based upon the mere allegation of the existence of accounting irregularities. Rather, it must first find or obtain a determination to that effect.

The ease or difficulty with which an insurer might obtain such a determination will largely be driven by the facts. Indeed, factual disputes can exist even where the company has conceded that accounting "irregularities" have taken place. For example, while the company may be more than willing to blame a particular executive as a perpetrator of the fraud, that executive may not be disposed to agree. He may, rather, point the finger at someone else or deny the existence of irregularities completely. It is not the case, therefore, that a determination of the facts will necessarily be swift or that the outcome is always sure. Rather, the parties may be in store for years of document productions, depositions, and perhaps even a trial before the underlying facts can be known and determined.

Making the process still more complicated is the fact that precisely what constitutes a "final adjudication" (on those policies that use that particular phrase) may not itself be entirely clear. The defendants can be expected to argue that the policy thereby requires a judgment in the class action litigation. Such an interpretation can operate to the singular advantage of the defendants insofar as virtually no class action litigation goes through trial to a final judgment. On the other hand, such a position may have the undesirable consequence of motivating the insurer to withhold consent to a settlement based upon an expectation that a subsequent trial will result in a finding of fraud thus triggering the exclusion. Even if the insurance carrier prefers not to proceed to a trial in the underlying claim, it may also argue that a final adjudication permits (and needs to permit) any judicial determination of deliberate wrongdoing. Accordingly, the insurance carrier may assert that a judicial declaration in, say, a separate declaratory judgment action brought by the carrier would suffice under the policy. As in most contract disputes, the actual meaning may largely turn on the understanding of the parties at the time the policy was signed. A definitive resolution of such issues may require a separate judicial determination—and therefore still more litigation—before the issue can be finally resolved.

The Problem of "Loose Cannons on the Deck"

Let's take a moment to recap. Accounting irregularities by definition involve deliberate false statements and therefore potentially trigger the "deliberate fraudulent act" exclusion of a normal D&O policy. Each defendant will fall into one of two categories: those who were knowing participants and those who were not. Due to the rule of imputation, though, the knowledge of those who were knowing participants may be imputed to some or all of those who were not. However, first a factual determination will be required.

The further one gets into the analysis, therefore, the messier it becomes. Now it will get even worse. Because strategic and practical concerns may cause the insurer to think twice about a denial of coverage even to those individuals as to whom it has a legal right to do so. The explanation lies in what might be referred to as the problem of "loose cannons on the deck."

The problem comes about as follows. At first blush, it might seem to make all the sense in the world for the carrier to deny coverage where it has a legal right to do so. Given the fractured interests of the defendants in typical accounting irregularity litigation, each defendant or similarly-situated group of defendants will frequently need their own law firms as well as their own entourage of experts, forensic accountants, and others. All of these can be exceedingly expensive. It would seem entirely logical, therefore, for the insurance carrier to seize upon the policy's exclusions and limit coverage to the full extent possible.

Except for one thing. That is whether it really makes sense for the insurance carrier to do so. The reason it may *not* make sense is that an outright denial of coverage to the deliberate wrongdoers may mean they will lack the financial resources to retain counsel at all. A foreseeable consequence, therefore, may be that the wrongdoers will end up completely unrepresented by counsel in the class actions. That may operate to no one's interest. Certainly it is bad for the deliberate wrongdoers. But more to the point, it can be exceedingly unfortunate for the other defendants—not to mention the carrier insuring them—insofar as those without lawyers may behave like "loose canons on the deck," careening back and forth through the swells and troughs of the litigation and wreaking havoc in the process. It is not without precedent, therefore, for some insurance carriers to recognize the legal right to deny coverage to some, but to go ahead and provide coverage for them nonetheless. The deliberate wrongdoers become the beneficiaries of their own lack of resources and their ability, through the inadequacy of their own representation, to compromise the defense of others.

The Application Process

We're getting to the end, but still not there yet. One final hurdle need be overcome. That is the injection of uncertainty into the insurance coverage arising out of representations and information given to the insurance carrier as a result of the insurance application process itself.

Here is the context. As part of the application process, an insurance carrier will normally seek submission of an application form to be accompanied by financial information on the company. The application will seek background information on the company and will normally be signed by a senior executive, such as the CFO. It may include a representation that the individual executing the application, as well as others in the company, are not aware of any circumstances that would give rise to a "claim." The financial information sought by the carrier, in turn, will typically include the company's most recent Form 10-K and, perhaps, more recent quarterly information.

The problem is that, where accounting irregularities have surfaced, the information given to the insurance carrier may in fact be false. The insurance application may be false, for example, insofar as it disclaims knowledge by any officer of circumstances that would give rise to a claim. Correspondingly, the financial information may be false insofar as, to the extent the fraud goes back into prior reporting periods (as it probably does), the financial information is infected by—and, for that matter, may be the same as—the false financial information that is giving rise to the class action litigation. Making matters worse, it is possible, if not likely, that among those signing (or deemed to be signing) the insurance application on the part of the company was the CFO, who will frequently himself be implicated in the underlying fraud.

On top of all of the other coverage issues, therefore, is heaped the problem that the insurance carrier itself may be a victim of the fraud. To the extent it can prove the misrepresentations were material and that the policy was issued in justifiable reliance upon them, the carrier may potentially have still another basis to deny coverage and, now, to rescind the policy.

That is not to suggest by any means that an attempt to deny coverage or rescind the policy will necessarily follow. Among the issues the carrier would want to consider would be, as mentioned above, materiality and justifiable reliance, and the carrier may have the uphill burden of proving those requirements. Here, too, the issue of imputation may arise. If the carrier acts too aggressively, moreover, there is the potential for a fairly severe downside. Beyond the possibility of harm to the insurer's reputation, the newly-uninsured officers, directors, and company may themselves commence "bad faith" litigation against the carrier premised upon the contention that the denial of coverage was made in bad faith. Historically, in front of a jury, insurance carriers have not always seemed to stand an even chance. On the other hand, neither the insurance industry nor the public welfare will necessarily be well served by a system of insurance which allows defrauders to obtain insurance coverage based on deliberately-fraudulent applications.

So issues arising out of the insurance application process create yet another level of problems for the defendant officers, directors, and company. As if they didn't have enough problems already.

So How Does All This End Up?

When all is said and done, how does the coverage issue end up? Unfortunately, there is no single answer. The answer, rather, turns on the specific terms of the insurance policy and, frequently just as important, the attitude, size, and reputability of the insurance carrier.

At one end of the spectrum, some carriers will recognize the perils of an outright denial of coverage, be openly disdainful of litigation as a mechanism to resolve insurance coverage disputes, and therefore be a willing participant with the class action defendants in an attempt to mutually define the precise contours of the policy. Among the considerations taken into account may be the carrier's own reputation and its desire to be perceived in the market as a supporter, rather than an adversary, of those it has elected to insure. This is particularly so given the likely innocence of many of those officers and directors named as class action defendants. More than that, an experienced and quality carrier will recognize the value of working as a partner to the insureds in devising a litigation strategy that is assisted by its own deep reservoir of experience in analogous situations—experience that the insureds themselves will typically lack.

But not all insurance carriers approach the issue in that way. At the other end of the spectrum, at least one of the smaller carriers has responded to the detection of accounting irregularities with a complete denial of coverage and the commencement of separate litigation by the carrier against the officers, directors, and company. The ostensible purpose of this separate litigation is a judicial declaration that the carrier may walk away from the policy completely.

For the officers, directors and company, an outright denial of coverage by the insurance carrier can be catastrophic. The reason has little to do with the need to fund a class action settlement, and everything to do with the more immediate problem of up front cash. Frequently, as the class action litigation proceeds through the early stages, the cash position of the company will be getting more and more dire. In all likelihood, the company will be in default on lending agreements; lenders may be seeking to withdraw from the relationship; and lines of credit may have suddenly dried up. At the same time, the company will likely be undergoing significant drains on its cash resources—stemming from the need to obtain a re-audit of its financial statements, the need to hire a new law firm to commence a special investigation, and particular needs of operations to sustain the enterprise in a time of crisis.

Of the utmost importance to those named as defendants in the class actions, therefore, will be the immediate availability of up-front cash with which to finance their defense. Making the need all the more pronounced will the reluctance of outside professionals to become involved absent assurance that their fees can be paid. Putting aside the insurance carrier's ultimate position as to coverage, therefore, the critical issue at the outset is the carrier's willingness to begin financing the defense. Absent up front cash, the defendants may end up tottering on the brink of default.

The Best Approach

All in all, D&O insurance thus becomes another potential headache for the board of directors and senior executives where accounting irregularities have surfaced. The issues can be difficult, the frustrations many, and the availability of coverage—at least during the early stages—not completely certain. Ideally, both the insureds and the insurance carrier will share a common appreciation for the desirability of an agreed-upon approach to the potential coverage issues. A preferred approach, for example, may be one that permits the parties to settle the underlying class action litigation and then, if necessary, resolve any disputes between themselves through some alternative dispute resolution mechanism, such as arbitration. At the end of the day, some sort of compromise on coverage is almost always in everyone's best interest. Looking into the future, it may be that sophisticated carriers will find "blended risk" solutions to the insurance problem.

The overriding objective on the part of both the insurer and the insureds, though, is the minimization of disputes between themselves. In that way, they may effectively cooperate to obtain an optimum result for the company and the other insureds in the underlying litigation.

Defending against Securities Fraud and Related Claims

AIG

What to Expect From Your D&O Insurer: Partner or Obstructionist?

Presented By
Ty R. Sagalow
Senior Vice-President and Chief Legal Officer
National Union

November 4, 1999

AMERICAN INTERNATIONAL COMPANIES

Topics

- Overview of Litigation Environment
- D&O Insurance and accounting fraud cases: managing the minefields of coverage
- Coverage Negotiation Part 1: Making Your Policy "litigation friendly"
- Coverage Negotation Part 2: Maximizing coverage for potential Y2k claims against management

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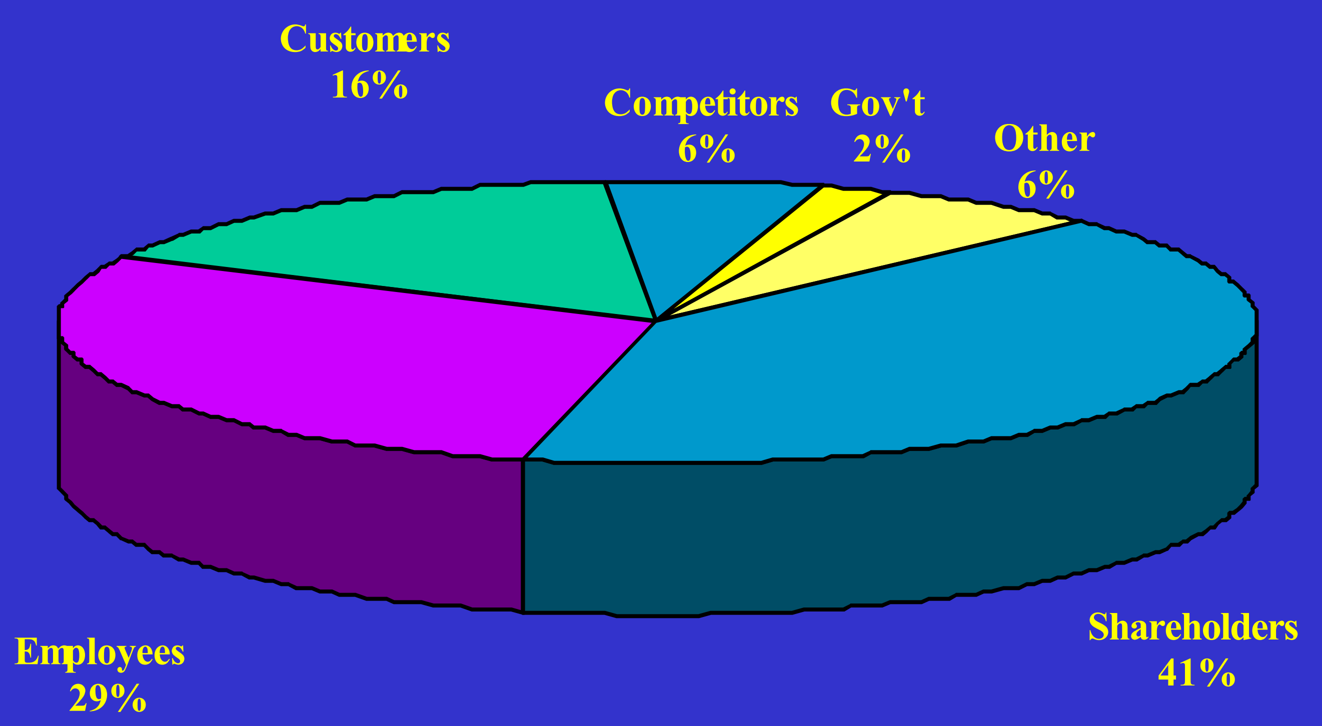
A M E R I C A N I N T E R N A T I O N A L C O M P A N I E S

Frequency by Claimant

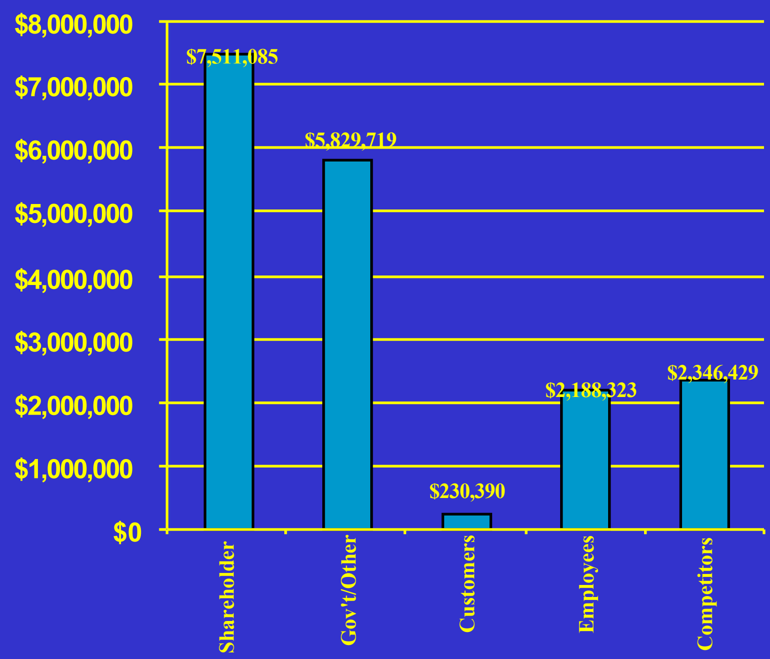
(Wyatt Survey 1997)



Severity by Claimant

(Wyatt Survey 1997)

(avg - $4.2M indemnity + (22%)
$.9 Def = $5.1M total)



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Litigation Environment

- Types of claimants
- Frequency of claims against management
- Severity of claims against management
- Impact of the Private Securities Litigation Reform Act on:
  - frequency, severity and settlements
  - types of allegations
  - policy coverage
  - insurance industry

Accounting Irregularities and D&O Insurance

- Managing the Minefields of Coverage
  - Fraud exclusion
  - Application issues
  - common law recession issues
  - Factors which underwriters consider in weighing the above
- Reality Check
- Potential solutions

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Negotiating Your D&O Policy

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Primary goals in purchasing D&O Insurance

- Protect individual assets of directors and officers
- Protect corporate assets
  - Arising from indemnification obligations
  - Arising from direct securities actions
- Obtain access to best defense litigates if company does not have direct relationships
- Access insurer "large buyer" relationship with plaintiff firms
- Access insurer information and expertise in D&O matters (without losing control)

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A M E R I C A N I N T E R N A T I O N A L C O M P A N I E S

Lesson 1: Litigation Friendly Policy provisions to seek

- Purchase Entity Coverage for Securities Claims
  - eliminates major allocation issue
  - removes financial incentive to bring D&Os in litigation
- Pre-approve all defense counsel BEFORE binding policy
- Retention waiver upon no liability in securities claim
- SEC retention does not apply to settlement/judgment
- Coverage for public relations fees in D&O related crisis both BEFORE (and after) a claim comes in
- Advancement of defense costs excess of retention
- No "hammer clause" (I.e. penalty for refusing to accept insurer recommended settlement)

Lesson 2: Does a D&O Policy cover Y2k claims?

- The Good
  - There is no specific Y2k exclusion in a D&O policy, therefore "Y2k claims will generally be covered to the same extent as other similar claims", most underwriters will confirm.
  - The Bad
  - The typical underwriter will NOT tell you whether treating Y2k claims the same as any "other similar claim" provides you with ENOUGH coverage.
  - The Ugly
  - It probably doesn't.

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D&O Policy Y2k Check-list

- Express Year 2000 Coverage with broad definition of Y2k Claim
- Year 2000 Crisis Management Public or investors Relations coverage is a nice bonus;
- No "dishonesty" or "willful violation" exclusion;
- Removal of the fraud exclusion if a company's disclosure statements are written or approved by an approved securities law firm;
- Coverage for SEC investigations against individuals at the early subpoena stage;
- Coverage for other governmental investigations against individuals at the "target letter" stage (including grand jury investigations)

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D&O Policy Y2k Check-list

- **Retention is waived if the insureds are found not liable in a Y2k claim (both for securities matters and non-securities cases);**
- **Coverage for claims brought by the bankruptcy trustee ("insured v. insured" exclusion does not apply);**
- **Coverage for the "debtor-in-possession" equal to the corporate insured coverage**
- **Coverage for third-party "prosecution" costs if brought in same lawsuit;**
- **Pre-set allocations: 25-50% (defense costs) and 10-25% (indemnity) for non-securities Y2k claims *with* 100% coverage for both corporate and individual defendants at trial and, expressed 100% coverage for any individual's non-indemnifiable loss.**
- **Assistance in providing Year 2000 Loss Prevention/Mitigation Services**

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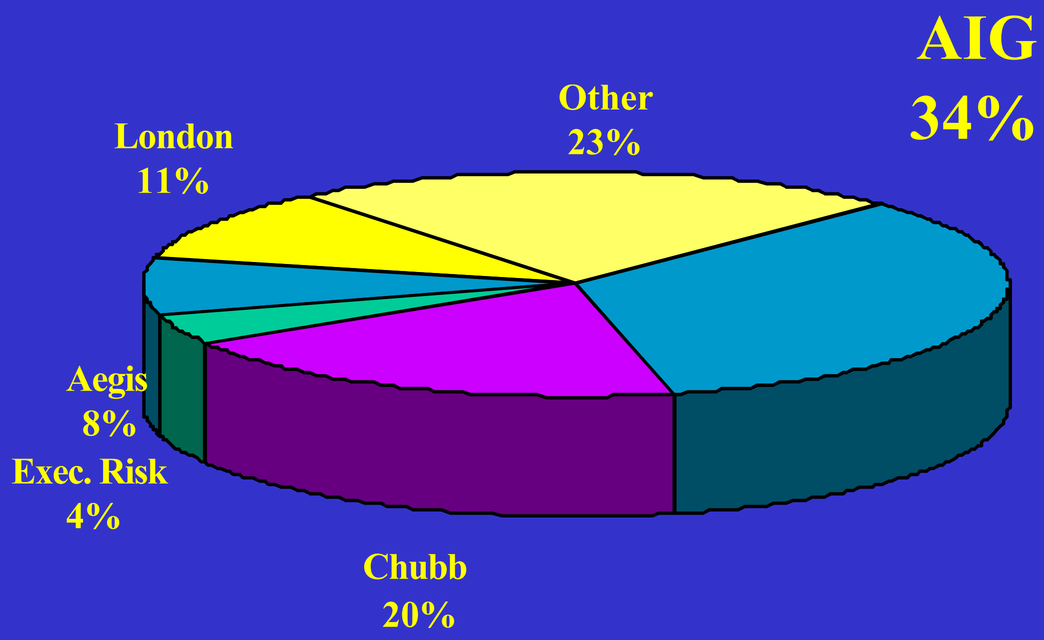
Primary D&O Insurers Market Share (Wyatt Survey, 1998)



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