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REPORT

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Enforcement

The Securities and Exchange Commission Raises the Cost of Non-Cooperation

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In a largely unheralded development, the Securities and Exchange Commission has moved from a policy of rewarding cooperation with its investigations to one of also punishing failures to cooperate. In a series of recent cases, the Commission has responded to perceived failures to cooperate by adding or raising charges, imposing record-setting monetary penalties and publicly excoriating offenders in filings and press releases.

With the SEC's move to a "carrot and stick" approach, now is a good time to review the benefits and risks of cooperating with the SEC, what companies can hope to gain or avoid by cooperating, and what the SEC expects in the way of cooperation. Now also is a good time for practitioners to pay close attention to the types of conduct that have prompted the Commission to impose harsher sanctions, since much of it involves conduct by practitioners themselves.

A. The Beginning of the Policy: The Seaboard Report. On October 23, 2001, the SEC issued a "Commission Statement on the Relationship of Cooperation to Agency En-

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forcement Decisions" announcing a policy of rewarding companies for taking measures to deter, uncover, self-report, and remediate misconduct and for fully cooperating with SEC investigations.¹ This policy statement, referred to as the "Seaboard Report," grew out of the SEC's investigation of the Chestnut Hill Farms division of Seaboard Corporation. In a settled administrative proceeding against the former controller of Chestnut Hill Farms,² the Commission found that she had overstated deferred costs assets and understated related expenses.³ While sanctioning the former controller, the Commission took no action against Seaboard.⁴

The Commission attributed its decision not to take enforcement action against Seaboard to the company's prompt and comprehensive response to the fraud. Within days of discovering the problem, its internal auditors conducted a review and reported their findings to management who advised the audit committee and then the full board. The company promptly dismissed the

¹ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, Accounting and Auditing Enforcement Release No. 1470 (October 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm> ("Seaboard Report").

² *In re Gisela de Leon-Meredith*, Exchange Act Release No. 44970, Administrative Proceeding File No. 3-10626 (October 23, 2001), available at <http://www.sec.gov/litigation/admin/34-44970.htm>.

³ *Id.* at 2-3.

⁴ Seaboard Report at 1.

controller and her supervisors and disclosed the problem to the SEC and to the public. Seaboard also gave “complete cooperation” to the SEC staff conducting the investigation. Notably, the cooperation included production of notes and transcripts of interviews from the company’s internal investigation, as well as its decision not to assert attorney-client or work product privilege as to the documents. The SEC also credited Seaboard for its remediation efforts, including improving its financial reporting and staffing.

The Commission used the *Seaboard* case to unveil its renewed efforts to use its enforcement powers to promote good corporate governance and citizenship.⁵ As the Seaboard Report explained, “When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more directly.”⁶ The initiative was followed by similar efforts by the Justice Department to reward companies for self-policing and self-remediation.⁷

B. The New Regime: Self-Policing, Self-Disclosure, Remediation, and Cooperation. In deciding whether to take “the extraordinary step of taking no enforcement action,” or whether to agree to reduced charges, lighter sanctions, or the inclusion of mitigating language in the charging documents, the SEC said that it will focus on four broad measures: (1) self-policing prior to discovery of misconduct, (2) self-reporting of the misconduct once it has been discovered, (3) remediation, and (4) cooperation with regulatory authorities and law enforcement.⁸

The evaluation and weighting of these factors is inherently subjective, and the Seaboard Report contains caveats that make the results of cooperation difficult to predict with certainty. Each case, of course, turns on its own facts and circumstances as well as the SEC’s judgment as to what best protects investors, for which there is “no single, or constant, answer.”⁹ The Seaboard Report pointedly confers no rights on anyone, is non-exclusive, and does not limit the SEC’s very broad discretion.¹⁰ That said, these are the factors that the SEC will consider:

1. Self-Policing

⁵ In the 1970s, the SEC adopted a voluntary disclosure program to encourage corporations to disclose illegal payments to foreign officials. It has subsequently encouraged self-reporting in subsequent decisions and has maintained an informal practice of sometimes rewarding cooperation with lesser sanctions. See *SEC v. Dresser Industries, Inc.*, 628 F.2d 1368, 1368 (D.C. Cir. 1980) (en banc), cert. denied, 449 U.S. 993 (1980).

⁶ Seaboard Report at 2.

⁷ The Seaboard Report was later mirrored in a Justice Department policy set forth in Federal Prosecutions of Business Organizations, Memorandum from Deputy Attorney General Larry Thompson (January 20, 2003), http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00162.htm, (“Thompson Memorandum”); see also U.S. Attorney’s Manual § 9-27.230.

⁸ Seaboard Report at 2.

⁹ *Id.*

¹⁰ *Id.* While the Report asserts that it conveys no rights, one decision suggests otherwise. In *F.X.C. Investors Corp.*, the company persuaded an SEC administrative law judge that it was entitled to credit for its cooperation with state regulators, even though the SEC’s Enforcement Division believed that no credit was warranted. See *In re F.X.C. Investors Corp.*, Admin-

The Commission will focus on the corporate background against which the misconduct occurred, *i.e.*, whether the company had a commitment to obeying the law or had a “tone of lawlessness.”¹¹ Involvement of senior management in the misconduct or pressuring subordinates to achieve specific financial results will increase the likelihood that the corporation will be named. The Commission, in essence, will ask whether the misconduct was isolated or symptomatic of the way the company does business.

The Commission also will focus on whether the company had a compliance program in place and the reasons why the procedures failed. As SEC Enforcement Director Stephen Cutler put it, “If you start thinking about the [Seaboard] report only after you receive a subpoena, you’re too late.”¹²

In *Seaboard*, the problems were limited to misconduct by one mid-level manager and a failure to supervise by two supervisors. Once the problems were discovered, management moved in quickly to halt the misconduct.

2. Self-Reporting

The Commission placed great emphasis on how quickly and effectively the company responded to the misconduct. The response should include a prompt and thorough investigation into the nature, extent, origin, and consequences of the misconduct (preferably conducted by outside counsel with no ties to the company), and overseen by a committee of outside directors.¹³ The Commission also will take note of whether management promptly informed the Audit Committee and Board of Directors. The response also should include prompt, complete, and effective public disclosure of all material facts.

The Commission also will focus on whether the company disclosed the wrongdoing on its own initiative to the SEC and the public, or whether it waited until the misconduct was brought to its attention by someone else.

In *Seaboard*, the Commission went out of its way to commend the company for commencing its investigation within a week of discovery of the fraud, reporting the misconduct to the audit committee and the full board, and disclosing the misconduct promptly.

3. Remediation

The Commission will want to know what steps the corporation has taken to ensure that the conduct is unlikely to reoccur. The SEC will look favorably on terminating or disciplining wrongdoers, strengthening internal controls to prevent a reoccurrence, and identifying the extent of damage to investors and compensating those affected. For Seaboard, this meant new procedures and hiring additional internal accounting staff.

4. Cooperation

In dealing with the Commission’s own investigation, the SEC expects that a corporation will be prompt and complete in providing documents, information and assistance. Particular items the Commission will want

Administrative Proceeding File No. 3-10625, 2002 SEC Lexis 3168 (December 9, 2002).

¹¹ *Id.*

¹² Stephen M. Cutler, Remarks Before the Investment Company Institute, Securities Law Developments Conference (December 6, 2001), available at <http://www.sec.gov/news/speech/spch527.html> at 8.

¹³ Seaboard Report at 3.

produced include the corporation's written report of its internal investigation, as well as notes and transactions of interviews during the investigation. The Commission's statement appears to encourage privilege waiver without explicitly requiring it.

The Commission will likewise want the corporation to encourage its employees to cooperate with the Commission's investigation. The corporation will get credit for disclosing information not directly required that the staff otherwise might not have discovered. The Commission also will want to see reporting of any "additional related misconduct."¹⁴

C. The Results of Seaboard: Rewarding Good Corporate Citizenship. In the wake of *Seaboard*, the Commission followed through in rewarding cooperation in its investigations in at least some cases. But the individualized nature of the SEC's decision-making has yielded a range of results in which some companies have fared considerably better than others, and the SEC has discussed cooperation in only a handful of its settlements.

1. No Charges

Notwithstanding a serious and sizeable financial fraud at *Homestore.com*, the Commission declined to bring any enforcement action against the company, because of "its swift, extensive and extraordinary cooperation in the Commission's investigation."¹⁵ At *Homestore.com*, three senior executives artificially inflated the company's online advertising revenue and exercised stock options at prices that reflected the overstated revenue. The individuals settled the Commission's charges, pleaded guilty to felonies in a parallel criminal case, and agreed to cooperate with the government's ongoing investigation. *Homestore.com* remains the only case after *Seaboard* in which the SEC has explicitly stated that it did not bring charges because of the company's cooperation.

However, without explaining its decisions, the SEC exercised its discretion not to charge companies in a number of high-profile financial frauds. For example, the Commission charged Tyco International's chief executive Dennis Kozlowski, chief financial officer Mark Swartz and general counsel Mark Belnick—but not the company—with failing to disclose low-interest and interest-free loans that they took from the company.¹⁶ Tyco's outside directors retained a law firm not previously associated with the company to conduct an internal investigation. They terminated Kozlowski and Swartz; Belnick ultimately was permitted to resign.

2. Reduced Charges

¹⁴ *Id.*

¹⁵ *SEC v. John Giesecke, Jr.*, Litigation Release No. 17745, 2002 SEC LEXIS 2423 (September 25, 2002), available at <http://www.sec.gov/litigation/litreleases/lr17745.htm>.

¹⁶ *SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud*, SEC Press Release 2002-135 (September 22, 2002), available at <http://www.sec.gov/news/press/2002-135.htm>. The SEC separately charged an outside director with failing to disclose an investment banking fee he received from Tyco. See *SEC v. Frank Walsh, Jr.*, Litigation Release No. 17896 (December 17, 2002). In a related criminal investigation, Kozlowski, Swartz and Belnick were indicted by the New York County District Attorney's Office on similar theories. News Release, New York County District Attorney's Office (September 12, 2002), available at <http://www.manhattanda.org/whatsnew/press/2002-09-12.htm>. The first Kozlowski and Swartz trial ended in a hung jury. Belnick was tried separately and acquitted.

The Commission has rewarded cooperation by allowing companies to settle for reduced charges, specifically, by settling for recordkeeping violations instead of fraud-based charges and for administrative cease-and-desist orders instead of federal court injunctions.¹⁷

Rite-Aid Corp. In *Rite-Aid Corp.*,¹⁸ for example, Rite-Aid agreed to an order requiring it to cease and desist from violating the periodic reporting and books-and-records provisions of the Exchange Act in a financial fraud involving two-plus years of overstated income.¹⁹ Notably, the SEC did not impose a monetary penalty on Rite-Aid. Instead, the company agreed to undertake to cooperate with the Commission staff in connection with this investigation.

IGI, Inc. In *IGI Inc.*,²⁰ the former president, chief financial officer, and vice president of operations inflated revenue, income, and assets over a three-year period. The Commission entered a settled cease-and-desist order against IGI for violating the recordkeeping and periodic reporting requirements of the Exchange Act. The SEC did not seek to impose a monetary penalty against the company, noting that its audit committee promptly investigated allegations of wrongdoing and terminated senior officers found to be responsible for fraudulent accounting practices.

Boston Scientific Corp. Similarly, in *Boston Scientific Corp.*,²¹ the SEC ordered the company to cease and desist from violating the internal controls and recordkeeping provisions of the federal securities laws. In determining not to seek fraud-based charges, the Commission noted that Boston Scientific itself discovered the problem, initiated an investigation headed by its outside directors and publicly disclosed accounting irregularities that led to the improper recognition of \$75 million in revenue.

3. No Monetary Penalty

On October 13, 2004, the SEC filed settled enforcement actions against Royal Ahold, N.V., its former chief executive, former chief financial officer, and former executive vice president, alleging that the company overstated net sales by \$30 billion in fiscal 2000 through 2002.²² The SEC alleged that the company's U.S. sub-

¹⁷ Barry W. Rashkover, *Reforming Corporations Through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 *Cornell L. Rev.* 535, 538 (January 2004).

¹⁸ *In re Rite-Aid Corp.*, Exchange Act Release No. 46099, Administrative Proceeding File No. 03-10808, 2002 SEC LEXIS 1595 (June 21, 2002), available at <http://www.sec.gov/litigation/admin/34-46099.htm>.

¹⁹ *Id.* at 2. In the administrative order, the SEC noted that "Rite Aid cooperated with the Commission's investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the investigation and voluntarily providing the Commission's staff with full access to an internal investigation conducted by Rite-Aid's counsel." and "The Commission has considered the value of this cooperation in determining the appropriate resolution of this matter." *Id.*

²⁰ *In re IGI, Inc.*, Exchange Act Release No. 45553, Administrative Proceeding File No. 3-10722, (March 12, 2002), available at <http://www.sec.gov/litigation/admin/34-45553.htm>.

²¹ *In re Boston Scientific Corp.*, Exchange Act Release No. 43183, Administrative Proceeding File No. 3-10272 (August 21, 2000), available at <http://www.sec.gov/litigation/admin/34-431983.htm>.

²² SEC Charges Royal Ahold and Three Top Executives with Fraud; Former Audit Committee Member Charged with Causing Violations of the Securities Laws (October 13, 2004),

subsidiary, U.S. Foodservice, inflated vendor payments known as promotional allowances, then persuaded vendors to falsely confirm the overstated allowances to Royal Ahold's auditors during the year-end audit. Royal Ahold also consolidated joint ventures in its financial statements despite owning 50 percent or less of the stock. To justify consolidation, Royal Ahold gave its independent auditors letters stating that Ahold controlled the joint ventures. At the same time, the company and joint venture executed side letters rescinding the control letters.

Despite the magnitude of the fraud and involvement of senior management, the SEC did not seek a monetary penalty from Royal Ahold because of what the SEC described as its "extensive" cooperation with the government. Royal Ahold began an internal investigation on its own initiative; expanded the internal investigation beyond its original focus on financial fraud at its U.S. subsidiary, U.S. Foodservice, to include accounting practices and internal control at seventeen operating companies; provided the internal investigation report and supporting documents to the SEC, waived the attorney-client and work-product privileges; and took remedial measures including revising its internal controls and terminating employees responsible for the wrongdoing. The SEC took special note that Royal Ahold not only made current employees available to the SEC, but also assisted the SEC staff in arranging interviews or testimony from former personnel located outside the United States. Because of the difficulty of obtaining testimony outside the United States, the SEC described Royal Ahold's efforts as of "great[] importance."²³

"This case is . . . an example of the clear corporate advantage to conducting a comprehensive internal investigation and fully cooperating with the SEC," said Thomas C. Newkirk, an associate director of the SEC's Enforcement Division.

In *Rite-Aid* and *IGI*, the SEC did not seek a monetary penalty from the companies, citing their cooperation. Similarly, in *Waste Management*,²⁴ while obtaining a settled cease-and-desist order against the company to the anti-fraud provisions, the Commission did not impose a monetary penalty, citing the company's cooperation with the SEC's investigation.²⁵ Within a week of announcing an earnings shortfall, the Board of Directors appointed a three-member Executive Committee of independent members to oversee the management of the company. The directors also initiated an investigation and, within a month, terminated the chief executive, chief operating officer, chief financial officer, and general counsel.

D. Punishing Companies for Non-Cooperation. Recently, however, the SEC's policy has evolved from encouraging self-reporting and cooperation to one that, in addition,

affirmatively punishes the failure to cooperate. "Any effort to impede an SEC investigation may itself become the subject of an enforcement proceeding," said SEC Enforcement Director Stephen M. Cutler.²⁶ Added Associate Director Paul Berger, "Stiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interest of investors."²⁷

In imposing higher charges and monetary sanctions, the Commission has focused on three broad categories of conduct that it deems unacceptable during staff investigations: (1) discovery abuse and gamesmanship, (2) false exculpatory statements combined with a failure to respond sufficiently promptly to misconduct, and (3) voluntary indemnification of defense costs of employees who did not settle charges with the SEC.

1. Discovery Abuse and Gamesmanship

Banc of America Securities, LLC. On March 10, 2004, the Commission took the extraordinary step of charging Banc of America Securities, LLC, in a settled cease-and-desist order, with violating the recordkeeping and access requirements of Section 17(a) and (b) of the Exchange Act and Rule 17a-4(j) for discovery abuse. The SEC also insisted on a \$10 million penalty for the violations.²⁸ In a sharply worded order, the SEC alleged that Banc of America Securities impeded the staff's investigation by repeatedly failing to promptly produce documents; providing the staff with misinformation about the availability and production status of documents; and engaging in dilatory tactics that delayed the investigation.²⁹

The investigation arose out of an anonymous letter sent to the staff alleging that Banc of America Securities bought and sold securities in its proprietary accounts based on information about forthcoming upgrades, downgrades, and other market-moving research reports by its research department. The staff initiated an investigation with a document request to Banc of America about the allegations. In responding to the document requests, Banc of America missed deadlines set by the staff; failed to contact the staff to request extensions of time; failed to alert the staff that it would be providing

²⁶ Kathleen Day, *SEC Gets Tough on Hindering Investigations*, The Washington Post, at E1 (March 19, 2004).

²⁷ Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud, SEC Press Release 2004-67, available at <http://www.sec.gov/news/press/2004-67.htm> (May 17, 2004) ("Lucent press release").

²⁸ *In re Banc of America Securities LLC*, Exchange Act Release No. 49386, Administrative Proceeding File No. 3-11425 (March 10, 2004), available at <http://www.sec.gov/litigation/admin/34-49386.htm>. Rule 17a-4(b)(4) requires broker-dealers to "preserve for a period of not less than 3 years, the first two years in an accessible place . . . [o]riginals of all communications received and copies of all communications sent by such member, broker or dealer . . . relating to his business as such." Rule 17a-4(j) states that "[e]very member, broker, or dealer subject to this rule shall furnish promptly to a representative of the Commission such legible, true and complete copies of those records of the member, broker or dealer, which are required to be preserved under this Rule, as are required by the representative of the Commission." The Commission has brought cases on two prior occasions against broker-dealers for failing to promptly produce to documents to the staff during investigations. See *SEC v. J.W. Korth & Co.*, 991 F. Supp. 1468 (S.D.Fla. 1998); *In re Dominick & Dominick, Inc.*, Exchange Act Release No. 29243 (May 29, 1991).

²⁹ *Id.* at 2.

available at <http://www/sec.gov/news/2004-144.htm>. The Commission also charged a former member of Ahold's supervisory board and audit committee with causing the violations of the reporting, books, and records, and internal controls provisions of the securities laws. *Id.*

²³ *Id.*

²⁴ *In re Waste Management, Inc.*, Exchange Act Release No. 42968, Administrative Proceeding File No. 3-10238 (June 21, 2000), available at <http://www.sec.gov/litigation/admin/34-42968.htm>.

²⁵ *Id.* at 10.

partial responses to pending requests; failed to explain the reasons for production delays; and failed to promptly disclose that responsive documents had been destroyed or rendered unavailable.³⁰ The staff repeatedly admonished Banc of America about the inadequacy of its responses to the documents requests. The problems nevertheless persisted and, in some cases, worsened.

In one instance, Banc of America told the staff that it could not produce certain e-mails because restoration of the back-up tapes would require an unreasonable amount of time, labor and expense. However, Banc of America restored the tape, recovered the e-mail and then deleted it from the firm's computer system. On other occasions, Banc of America failed to disclose promptly that compliance reviews had been destroyed after the staff had requested them.³¹

American International Group, Inc. (AIG). The Banc of America settlement followed another \$10 million penalty that the Commission imposed on AIG because of "the gravity of the misconduct," and because it allegedly "did not come clean" with the SEC and instead "withheld documents and committed other abuses."³² The Commission alleged that AIG custom-designed an "insurance policy" that allowed Brightpoint, Inc. to overstate its earnings by 61 percent.³³ The SEC described the transaction as a "round-tripping" of cash from Brightpoint to AIG and back.³⁴ By disguising the transaction as "insurance," AIG allegedly enabled Brightpoint to spread losses over several years that should have been recognized immediately.

During the investigation, AIG provided the staff with a sworn certification that it had complied fully with the subpoenas.³⁵ Later, the staff made further inquiries, which led to the production of documents the Commission believed should have been part of the original production. The SEC also faulted the original search as not thorough enough.

Areas allegedly not searched included the files of the leaders of the business unit that designed the policy. In addition, AIG allegedly did not conduct an adequate search of the business unit's computer drive.³⁶ As a result, the Commission concluded that the certification was "substantially erroneous."³⁷

The Commission further faulted AIG for failing to produce a White Paper that undercut AIG's position in a Wells meeting that the misconduct resulted from a lack of training rather than corporate policy.³⁸ AIG asserted that it had no obligation to produce the White Pa-

per because it was not called for by subpoena.³⁹ The Commission argued in the alternative that it had been called for, but that if it had not, AIG still had an obligation to produce it because it undercut AIG's position in a Wells meeting.⁴⁰

The lesson of this case is that large organizations now bear the risk that even innocent failures to identify documents, or decisions to withhold arguably relevant records *not* covered by an SEC document request could lead to "failure to cooperate" sanctions.

Lucent Technologies, Inc. In a settled injunctive action, the Commission charged Lucent Technologies, Inc. with violations of the fraud, recordkeeping, and internal control provisions of securities law, but imposed a \$25 million fine.⁴¹ In announcing the settlement, the Commission went out of its way to emphasize that the fine was a punishment not for the underlying fraud but for the company's failure to cooperate with the staff's investigation. Throughout the investigation, the SEC said, Lucent provided incomplete document production, producing key documents after the testimony of relevant witnesses, and failed to ensure that a relevant document was preserved and produced pursuant to the subpoena, thus impeding the staff's investigation.⁴²

Xerox Corporation. The Commission obtained settled injunctive relief against Xerox Corporation for violating the antifraud provisions and a \$10 million fine—then the largest ever obtained against a public company in a financial fraud case—partly as a sanction for the company's "lack of full cooperation during the investigation."⁴³

2. False Exculpatory Statements and Failure to Respond to Allegations of Misconduct

Lucent Technologies. In an interview with Fortune magazine, Lucent Technologies' outside counsel characterized Lucent's fraudulent booking of the \$125 million software pool agreement between Lucent and another company as "a failure of communication," implicitly denying that a fraud had occurred.⁴⁴ Lucent had previously reached an agreement in principle to settle the SEC investigation without admitting or denying the allegations. In the SEC's eyes, the outside counsel's dismissal of the misconduct as a miscommunication and implicit denial of wrongdoing "undermined both the spirit and letter of its agreement in principle with the staff."⁴⁵ The SEC cited the outside counsel's statements as one of the reasons for imposing a \$25 million fine on Lucent.

Dynegy, Inc. In *Dynegy*, after the staff expressed concern about the company's use of special purpose entities (SPEs) to improve the appearance of its financial statements, Dynegy failed to self-disclose the problem.⁴⁶ Instead, its chief financial officer allegedly issued a false press release claiming the special purpose enti-

³⁰ *Id.*

³¹ *Id.* at 5.

³² SEC Charges American International Group and Others in Brightpoint Securities Fraud, SEC Press Release 2003-111 (September 11, 2003), available at <http://www.sec.gov/news/news/2003-111.htm>, at 1 ("AIG press release").

³³ *Id.* at 2.

³⁴ *Id.* at 1.

³⁵ *In re American International Group, Inc.*, Exchange Act Release No. 48477, Administrative Proceeding File No. 03-11254 (September 11, 2003), available at <http://www.sec.gov/litigation/admin/34-48477.htm>, at 12 ("AIG order").

³⁶ AIG press release at 3.

³⁷ AIG order at 12.

³⁸ The White Paper was a guide distributed to AIG managers on how to treat accounting and regulatory issues related to the insurance products at issue in the case. AIG order at 4.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Lucent press release at 1.

⁴² *Id.*

⁴³ Xerox Settles SEC Enforcement Action Charging Company with Fraud, SEC Press Release 2002-52 (April 11, 2002), available at <http://www.sec.gov/headlines/xeroxsettles.htm>.

⁴⁴ Lucent press release at 2.

⁴⁵ *Id.*

⁴⁶ *In re Dynegy, Inc.*, Exchange Act Release No. 46537, Litigation Release No. 17744, 2002 SEC Lexis 2415 (September 25, 2002), available at <http://www.sec.gov/litigation/litreleases/lr17744.htm>.

ties' primary purpose was to secure a long-term supply of natural gas. Only later did the company acknowledge in a Form 8-K that the special purpose entities' true purpose was to minimize the gap between Dynegy's reported net income and reported operating cash flow and to realize an associated tax benefit. In settling the case, the SEC obtained an injunction and issued a cease-and-desist order for violating the antifraud provisions. In addition, the SEC required Dynegy to pay a \$3 million penalty. The monetary sanction reflected "the Commission's dissatisfaction with Dynegy's lack of full cooperation in the early stages of the Commission's investigation."⁴⁷

3. Voluntary Indemnification of Wrongdoers

In settling Lucent, the Commission cited the company's indemnification of non-settling employees for defense costs in the absence of a legal obligation to do so.⁴⁸ The SEC sanctioned Lucent because it changed its indemnification policies after agreeing in principle with the SEC to settle the case. Lucent did not have pre-existing indemnification agreements requiring it to advance such costs and state law did not require it to do so. In the Commission's eyes, the company went out of its way to indemnify employees "against the consequences of th[e] SEC enforcement action."⁴⁹ That, the SEC said, "is contrary to the public interest."⁵⁰

Lucent also did not keep the SEC informed about its indemnification issues, which the Commission characterized as a "[f]ailure to provide accurate and complete disclosure" that "undermine[d] the integrity of SEC investigations."

The SEC's extraordinarily negative reaction to voluntary indemnification raises interesting issues of the right to counsel and whether giving an individual a lawyer is a proper basis for the SEC to assert that a company has not cooperated with an investigation. Current practice is now to run potential indemnity decisions past regulators to avoid a Lucent-type sanction.

E. State Regulators' Response to Non-Cooperation. On October 14, 2004, New York Attorney General Eliot Spitzer took efforts to punish non-cooperation to a whole new level. He filed suit against Marsh & McLennan Companies, charging that the insurance broker engaged in bid-rigging and collected fees from insurance carriers for steering business their way.⁵¹ In announcing the lawsuit, Spitzer said that he had been misled "at the highest levels of the company," urged Marsh's directors to "think long and hard, very long and very hard about the leadership of your company" and vowed "the leadership of that company is not a leadership that I will talk to."⁵² The rebuke was seen as an effort by Spitzer to force the company's chief executive, Jeffrey W.

Greenberg, to step down. On October 25, 2004, in fact, Greenberg resigned as chief executive.

In the wake of Spitzer's efforts, several insurance companies, including AIG, announced that they voluntarily were suspending the practice of "contingent commissions," in which an insurer paid a broker for routing business its way.⁵³ AIG has announced that it would fully cooperate with the Attorney General's investigation.⁵⁴

F. The Cost of Cooperation: Waiver of the Privilege. The principal downside to cooperation with the SEC is the risk that voluntary production of privileged documents to the staff, even when produced under a confidentiality agreement, will waive the privilege and that plaintiffs in class actions or other civil actions as well as defendants in criminal cases will seek copies of the documents. By and large, federal courts have held that voluntary disclosure of privileged documents waives the privilege.⁵⁵

To alleviate concerns that production may waive the privilege, the Commission has entered confidentiality agreements, so as to give companies grounds to argue that the privilege remains intact. These agreements have met with mixed success, as illustrated by the experience of McKesson HBOC, Inc. After McKesson acquired HBOC, it found evidence of account irregularities at HBOC; conducted an internal investigation; and, as part of its cooperation produced the results of the investigation to the SEC and U.S. Attorney's Office under a confidentiality agreement. The efficacy of the agreement has been litigated in three courts, and each one reached a different result. In *United States v. Bergonzi*, a federal court held that disclosure to the government waived the privilege.⁵⁶ In *Saito v. McKesson*, the Dela-

⁵³ *Id.*

⁵⁴ Press Release, AIG, AIG Issues Statement Regarding the Action Announced Today By New York State Attorney General Spitzer (Oct. 14, 2004), available at <http://ir.aigcorporate.com/phoenix.zhtml?c=76115&p=irol-news>.

⁵⁵ See *United States v. Massachusetts Inst. of Technology*, 129 F.3d 681, 686 (1st Cir. 1997); *In re Steinhart Partners, LP*, 9 F.3d 230, 236 (2d Cir. 1993); *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1431 (3d Cir. 1991); *In re Martin Marietta Corp.*, 856 F.2d 619, 623-24 (4th Cir. 1988); *In re Grand Jury Proceedings*, 78 F.3d 251, 254-55 (6th Cir. 1996); *McMorgan & Co. v. First California Mortgage Co.*, 931 F. Supp. 703, 711 (N.D. Cal. 1996). The Eighth Circuit is the only circuit to hold that disclosure of confidential information to the government does not waive the privilege. See *Diversified Industries, Inc., v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (en banc).

⁵⁶ *United States v. Bergonzi*, 216 F.R.D. 487 (N.D. Cal. 2003).

⁴⁷ Dynegy Settles Securities Fraud Charges Involving SPEs and Round Trip Energy Trades, SEC Press Release 2002-140 (September 24, 2002), available at <http://www.sec.gov/news/press/2002-140.htm>.

⁴⁸ Lucent press release at 2.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ Investigation Reveals Widespread Corruption in Insurance Industry, NYAG Press Release (October 14, 2004, available at http://www.oag.state.ny.us/press/2004/oct/oct14_04.html).

⁵² In Wake of Spitzer Probe, Company to Suspend Controversial Commissions, *Newsday, Business & Technology*, at A18 (October 16, 2004).

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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ware Chancery Court reached the opposite conclusion, holding that the confidentiality agreement with the SEC preserved the privilege.⁵⁷ In *McKesson v. Adler* and *McKesson HBOC v. Green*, two class actions, an intermediate state court in Georgia remanded the cases to a trial court to determine whether McKesson maintained an expectation of confidentiality when it produced the documents to the SEC and U.S. Attorney's Office.⁵⁸

⁵⁷ *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. Ch. Nov. 13, 2002), *aff'd*, 818 A.2d 970 (Del. 2002).

⁵⁸ *McKesson HBOC, Inc. v. Adler*, 562 S.E.2d 809 (Ga. Ct. App. March 27, 2002); *McKesson Corp. v. Green*, 597 S.E.2d 447 (Ga. Ct. App. March 8, 2004), *cert. granted* 2004 GA Lexis 557 (Ga. June 29, 2004).

Conclusion. Attorneys representing companies should welcome the SEC's emphasis on cooperation as an avenue to lessen liability. But they also must be aware of the pitfalls in such cooperation. Risk of loss of the attorney-client and work product privilege is one such pitfall. In addition, companies must be careful not to engage in the sort of conduct during the course of investigations that has prompted the SEC to impose additional sanctions, including failure to promptly produce all relevant documents or even the provision of attorneys to non-officer or director employees. More and more, this new cooperation environment transforms the role of defense counsel to that of quasi-governmental agent to satisfy the SEC's expectations for "cooperation."