Trends In SEC Financial Fraud Actions: Part II

Law360, New York (May 6, 2011) -- This is the second installment of a two part series examining trends in recent U.S. Securities and Exchange Commission financial fraud actions. Part I considered the dividing line between civil and criminal financial fraud actions and cases against officers and directors centered on scienter-based charges. This concluding segment will analyze claims against corporate officers based on negligence or other charges, selected financial fraud cases and offer conclusions about trends in this key enforcement area.

Cases Involving Officers and Directors Based on Negligence or Other Charges

In recent enforcement actions the SEC has brought financial fraud actions alleging what appears to be intentional misconduct. Yet the legal charges and the resolution of the case are based on negligence and perhaps books and records charges rather than scienter-based fraud. These cases suggest that negligence-based fraud under Securities Act Sections 17(a)(2) and (3) may be evolving into a new “failure to monitor.” See generally, In re Caremark Int. Derivative Litg., 698 A. 2d 954 (Del. Ch. Ct. 1996) (corporate directors have a state law duty to monitor).

The commission’s financial fraud case against computer giant Dell Inc. and its founder, chairman and CEO Michael Dell is illustrative of this type of case. Dell had picture perfect results for years, according to the complaint, meeting street expectations quarter after quarter and year after year. The company told investors and the markets this came from superior products and management.

In fact from 2003 through 2007 a large portion of the company’s revenues came not from what the markets were told but from what they were not told — payments from chip maker Intel Corp. not to use the product of a competitor. When the payments were curtailed in 2007 investors were told that the sharp drop in income resulted from other causes, not a cut in Intel payments.
To resolve this case the company, Dell and other officers consented to the entry of a permanent injunction based in part on negligent fraud under Securities Act Section 17(a)(2)&(3). Penalties were of course paid and those who were accountants were suspended from practice before the commission. See also SEC v. Imhoff, Case No. 1:10 – cv -01464 (D.D.C. Filed Aug. 2, 2010) (settled financial fraud actions against two additional Dell officers on similar terms); SEC v. Abernathy, Civil Action No. CV 11-01308 (C.D. Cal. Filed Feb. Filed Feb. 11, 2011) (financial fraud action settled based on negligent fraud where the case arose out of the failure of lender IndyMac; the action was against the former chief financial officer who failed to update boilerplate disclosures about the loan portfolio to show serious loan origination difficulties as market crisis unfolded); but see SEC v. Perry, Case No. CV 11-01309 (C.D. Cal. Filed Feb. 11, 2011) (scienter-based fraud action against two other IndyMac officers which is in litigation).


These actions center on a claim that the bank misrepresented its exposure to the sub-prime market as the market crisis was unfolding. Citigroup told investors that its exposure was about $13 billion when in fact it was about $56 billion. The bank failed to disclose two groups of subprime loans valued at $43 billion. Repeated false disclosures were made despite the fact that the two officers named in the administrative proceeding were repeatedly informed about the true facts. All of the settlements were based on Securities Act Sections 17(a)(2) and (3). The settlements included penalties.

When presented with the settlement papers in Citigroup, the court initially postponed execution of the consent decrees and raised a number of questions. Following a hearing the judge ultimately, but reluctantly, deferred to the commission. It was perhaps the mismatch between the allegations of what appeared to be intentional misconduct with the resolution of the actions that at least in part triggered the court’s reluctance.

Other Selected Financial Fraud Actions

The commission also brought a number of other financial fraud actions during 2010 and early 2011. Those include:

Related Part Transactions:

• SEC v. Escala Group Inc., Case No. 09 CV 2646 (S.D.N.Y. March 23, 2009) is a settled action against the former chairman of Escala, an international company in the collectables business. The case centered on a series of related party transactions made by defendant Gregory Manning. Those transactions were disclosed as being at arm’s length and were used to improperly boost the value of the company just before a merger. Manning settled by consenting to an injunction based on the Exchange Act anti-fraud and books and records, and internal control provisions and an officer/director bar for 10 years. He also agreed to pay disgorgement, prejudgment interest and a penalty.
• SEC v. Priddy, Civil Action No. 1:10-cv-00739 (D. Md. filed Mar. 25, 2010) is a settled action against Richard Priddy, the former CEO and president of TVI Corp., Charles Sample, the former executive vice president of the company and their personal accountant J. Michael Broullire. The case alleged that Priddy and Sample sold products to the company through undisclosed related party transactions which netted them significant profits.

In another facet of the fraud Priddy increased the compensation of Sample which was then paid back to him in undisclosed kickbacks. Priddy and Sample settled, consenting to the entry of permanent injunctions prohibiting future violations of Exchange Act Sections 10(b) and 14(a) and from aiding and abetting violations of Section 13(a). Broullire consented to the entry of a similar injunction based only on Sections 10(b) and 13(a). A related criminal case is pending.

Revenue Recognition:

• SEC v. International Commercial Television Inc., Case No. 3:10-cv-05555 (W.D. Wash. Filed Aug. 9, 2010) is a settled action against the company centered on premature revenue recognition. International Commercial Television is alleged to have recognized revenue on sales of its primary product made through Home Shopping Network prior to the actual sale. It also carried receivables on its books from the claimed sale of product prior to the actual sale and improperly recognized revenue on sales with a right of return. The company settled, consenting to the entry of a permanent injunction prohibiting future violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). See also SEC v. Redekopp, Case No. 3:10-cv-05557 (W.D. Wash. Filed Aug. 9, 2010) (pending action against the former CFO of the company); In the Matter of Dohan + Company CPAs, Adm. Proc File No. 3-13997 (Aug. 9, 2010) (pending proceeding against outside auditors, founding partner, engagement partner and audit manager).

• SEC v. Lapine, Case No. 10 Civ. 1842 (N.D. Ca. Filed Sept. 27, 2001) is a settled action against Jay Lapine, former general counsel to HBOC and, after its merger with McKesson, to the HBOC division of McKesson HBOC. The complaint claimed that after learning the company was improperly falsifying its books by inflating revenue he participated in the scheme rather than halting it. The case was settled with the consent to the entry of a permanent injunction based on the anti-fraud and reporting provisions, a five-year officer/director bar and the payment of a $60,000 fine.

Finally, the SEC has brought actions under the clawback provision of the Sarbanes-Oxley Act against certain officers to recover incentive compensation when there is a restatement of the company financial statements. SEC v. Jenkins, Case No. CV 09-01510 (D. Ariz. Filed July 22, 2009); SEC v. O’Del, Civil Action No 1:10-CV-00909 (D.D.C. Filed June 2, 2010). Section 304 applies regardless of whether the CEO or CFO was involved in the underlying conduct according to the commission.

That view, reflected in actions like Jenkins where the commission’s complaint acknowledges that Jenkins was not involved in the underlying fraud, has been upheld by the Second Circuit. Cohen v. Viray, Case No. 3860-cv (2nd Cir. Sept. 30, 2010). See generally The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 954 (requiring the SEC to issue regulation directing exchanges to include similar but some what broader clawback provisions in their listing standards).
Analysis and Conclusions

Financial fraud actions have long been a staple of SEC enforcement. Those cases may well become a priority in view of the new task forces. At the same time those task forces can be expected to work closely together, contributing to a further blurring of the line between civil and criminal financial fraud cases. An examination of recent cases suggests that in fact the dividing line is now one of degree — the more egregious the fact pattern, the more likely the case will be charged criminal.

SEC actions naming directors as defendants tend to be based on extreme fact patterns such as those in the action against the Point Blank directors. Other actions such as Dell and Citigroup suggest another trend however. The juxtaposition of factual allegations demonstrating intentional conduct with charges and settlements keyed to negligence suggest a failure of the company and its officers to properly marshal the available information to ensure correct statements and filings. Viewed in this context the cases represent a kind of failure to properly monitor using Securities Act Sections 17(a)(2) & (3).

Finally, it is clear that the commission is continuing to bring its traditional financial fraud actions. Those cases involve improper revenue, cookie jar reserves and other types of accounting manipulations. The SEC can also be expected to continue bringing SOX Section 304 actions. Overall it seems apparent that going forward financial fraud cases will be an SEC enforcement priority, frequently on a parallel track with the U.S. Department of Justice and perhaps other agencies. In view of cases like Dell and Citigroup the SEC can be expected to continue developing a kind of Caremark duty to monitor under the Securities Act fraud sections.

--By Thomas O. Gorman, Dorsey & Whitney LLP

Tom Gorman is a partner in Dorsey & Whitney’s Washington, D.C., office. He is co-chairman of the American Bar Association’s White Collar, Securities Fraud Subcommittee. He is also the author of a blog which analyzes trends in SEC enforcement.

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