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The Audit Committee and Government Enforcement: Where the Buck Stops

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Individuals in the Cross Hairs? What This Means for Directors

Following the 2008 financial crisis, government regulators and prosecutors have been under tremendous public pressure to prosecute individuals.¹ Senior government officials have responded by speaking forcefully about their desires to sue or prosecute more individuals.² What does the government's heated rhetoric and renewed focus on individual liability mean for corporate directors? As the chairman of the Securities and Exchange Commission ("SEC") recently noted, "[s]ervice as a director is not for the faint of heart...."³ But the good news is that directors who perform their role with even a modicum of reasonableness are highly unlikely to be held personally liable in carrying out their responsibilities.⁴ Of course, most directors aspire to more than staying out of trouble. As a former SEC chairman put it: "It is not an adequate ethical standard to aspire to get through the day without being indicted."⁵

This *Commentary* will discuss the landscape of director liability in the SEC context and provide some suggestions that may help directors minimize the risks of regulatory scrutiny.

A "New" Focus on Individuals

The current chairman of the SEC noted in her confirmation hearing that enforcement would be a top

priority, emphasizing an intent to pursue "all wrongdoers—individual and institutional, of whatever position or size."⁶ But the SEC's focus on individuals has actually been quite commonplace over the years. Corporations act only through the individuals who run them, and thus any investigations of corporate misconduct necessarily require an investigation of individual conduct. The SEC's enforcement statistics bear this out. Since the beginning of the 2011 fiscal year, the SEC charged individuals in 83 percent of its actions.⁷ And since 2000, the SEC has charged individuals in 93 percent of its fraud and financial reporting cases.⁸ These numbers include a small number of directors, although it is a relatively rare event relative to the hundreds of cases the SEC brings each year.

A criminal prosecution against a director, on the other hand, is an almost unheard-of event in the securities context.⁹ And while the DOJ has sued individuals for securities fraud, it hasn't been enough to appease critics of the department. So, the DOJ recently announced six changes to its policies governing investigations of corporate misconduct that are aimed at increasing prosecutions against individuals.¹⁰ The so-called "Yates Memo" directs prosecutors to "focus on individual wrongdoing from the very beginning of any investigation" and directs companies seeking to cooperate to "identify all

individuals involved or responsible for the misconduct at issue, regardless of their position, status, or seniority.”¹¹ The clear goal is to force line prosecutors *and* companies seeking cooperation to more aggressively gather and produce evidence of individual wrongdoing. The Yates Memo has the potential to affect many aspects of corporate investigations and prosecutions, but it does not change the standards for proving criminal conduct beyond a reasonable doubt, which is a serious hurdle to proving individual liability. Nevertheless, the government’s focus on individual liability creates additional risks.

SEC Enforcement Against Directors

A review of recent SEC enforcement allegations against directors provides insight into what this risk means in practice.¹²

The SEC entered into a settlement with four defendants, including a former outside director and member of the audit committee,¹³ who failed to exercise oversight when he “recklessly signed a number of financial statements that were materially misleading and took no care to ensure their accuracy.”¹⁴

The SEC settled claims against two audit committee members for failure to make timely 10-K filings and concealing information.¹⁵ The SEC alleged that the directors “directly and indirectly, aided and abetted” the company’s reporting violations by authorizing management to not timely file the company’s Form 10-K and a Form 10-Q to prevent the release of a going concern opinion, despite being presented with evidence that doing so could be unlawful. In addition, the two directors allegedly ignored red flags from their auditors, outside counsel, and internal memoranda. The directors received “an interoffice memorandum [...] entitled ‘Pros/Cons to Filing the Form 10-K.’ The ‘Cons’ included the fact that not filing ‘[i]ncreases the chances of an SEC enforcement action.’”

The SEC alleged that an audit committee chair “failed to respond appropriately to various red flags” and failed to investigate and take meaningful action to address improprieties, even when directed to do so by the company’s board.¹⁶ The director allegedly “failed to take appropriate action regarding the concerns expressed to him” by two internal auditors regarding reimbursements for personal expenses, and after failing to investigate, “omitted critical facts in his report to the board.”

The SEC alleged that three independent directors were “willfully blind to numerous red flags signaling accounting fraud, reporting violations, and misappropriating” that allowed senior management to manipulate reports and filings.¹⁷ The SEC alleged that “[i]n addition to a close personal relationship, [the directors] each had business relationships with [the CEO] that influenced their impartiality and independence” and that they “willfully ignored [a] controller’s concerns about [the company’s] inventory valuation.” In addition, the directors allegedly remained blindly deferential to management, “ma[king] little or no effort even to understand their Audit Committee responsibilities” and being financially rewarded with “lucrative perks” for doing so.

The SEC charged an audit committee chair with failure to appropriately investigate and disclose accounting fraud.¹⁸ The director ignored the advice of a former director to hire professional investigators and outside counsel despite the warning that there was “not just smoke but fire” and that “the company appeared to have engaged in fraud and maintained two sets of books.” The director also allegedly failed to properly oversee the filing of accurate financial statements.

The SEC settled with two outside directors who allegedly misled investors when they “improperly extended, renewed, and rolled over bad loans to avoid impairment and the need to report ever-increasing allowances for loan and lease losses ... in its financial accounting.”¹⁹

The SEC settled claims against an audit committee chair for knowingly signing a falsely certified Sarbanes-Oxley compliance report stating that the company had an active CFO.²⁰ The SEC alleged the director signed the company’s 10-K as “Audit Committee Chair and a Director, when she knew or should have known that any fraud, whether or not material, involving management had not been disclosed to the company’s auditors and the company’s Audit Committee.” The director’s settlement permanently banned her from signing any public filing with the SEC that contains any certification required by the Sarbanes-Oxley Act.

The SEC charged the chairman of the board and majority shareholder of a small staffing solutions company with misleading by the auditors and investors about the misuse of company funds.²¹ The director “secretly held the controlling

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