

**ATTORNEYS AS GATEKEEPERS:**

**SEC ACTIONS AGAINST LAWYERS IN THE AGE OF SARBANES-OXLEY**

**By Lewis D. Lowenfels, Alan R. Bromberg  
and Michael J. Sullivan\***

**I. INTRODUCTION**

Following the enactment of the Sarbanes-Oxley Act on July 30, 2002,<sup>1</sup> the SEC has substantially increased the number of actions it has initiated against lawyers. In a speech at UCLA Law School on September 20, 2004, Stephen M. Cutler, the then Director of the SEC's Division of Enforcement, stated:

Consistent with Sarbanes-Oxley's focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate. We have named lawyers as respondents or

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<sup>1</sup> PL 107-204, 116 Stat. 745

defendants in more than 30 of our enforcement actions in the past two years.<sup>2</sup>

Since the date of Mr. Cutler's speech, the intensity of the SEC's actions against lawyers has continued unabated. One legal note stated that according to the SEC staff there were 76 actions initiated against lawyers in the 3½ years leading up to April 7, 2005, including 18 in the first 3 months of 2005 alone. The same note emphasized forcefully:

A substantial number of SEC enforcement actions in recent years against counsel to public companies (both internal and external) have highlighted the SEC's resolve to hold lawyers liable for not performing adequately their SEC-conceived role as "gatekeepers" to prevent fraud and other securities law violations.<sup>3</sup>

The SEC's actions have embraced a wide variety of alleged transgressions in a wide diversity of factual settings. These SEC actions have been prosecuted as civil injunctive actions in the federal district courts under §20(b) of the Securities Act of 1933 and §21(d) of the Securities Exchange Act of 1934, as administrative proceedings under Rule 102(e) of the SEC's Rules of

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<sup>2</sup> Speech by Stephen M. Cutler, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, UCLA School of Law, Los Angeles, CA, (Sep. 20, 2004)

<sup>3</sup> Board Member, SEC Enforcement Actions Target Internal Counsel, from Hogan & Hartson LLP (Apr. 7, 2005)

Practice, and as administrative cease-and-desist proceedings.

The ushering in of what appears to be a new era of the SEC as active and enthusiastic proponent of the "gatekeeping" role of attorneys, raises serious questions. While academicians and practitioners have debated the consequences of this shift, a detailed examination of what the SEC is actually doing in fact has been lacking. This Note seeks to focus on a compendium of real-life post-Sarbanes SEC enforcement actions, and to evaluate trends and consider conclusions. Some of the questions that arise are as follows:

What is the nature of the activity that the SEC considers volative of the "gatekeeper" function and worthy of sanctions?

What is the tone and tenor of the SEC's charging rhetoric when pursuing lawyers for perceived lapses?

What are the practical effects for the practicing bar of trying to balance the attorney's deeply engrained obligation to represent a client zealously and the newly-minted "gatekeeper" duties that presumably run in favor of the more diffuse and abstract "public interest"?

Finally, is aggressive enforcement by a quasi-prosecutorial agency such as the SEC the right vehicle to reconcile the tension between the often contradictory and competing interests that the practicing attorney must grapple with in guiding a

client through often murky and gray areas between the client's self-interest and the outer limits of what law and regulation will tolerate?

## **II. NATURE OF THE SEC ACTIONS EXAMINED HEREIN**

A substantial number of SEC actions against lawyers post Sarbanes-Oxley have been cases directly linking the lawyer to financial or accounting fraud through his/her omitting to furnish material information or providing false information to a company's independent auditors. The SEC justifies these actions as consistent with Sarbanes-Oxley's policy of improving the quality, transparency and integrity of corporate financial reporting as well as fitting comfortably within the SEC's view of the securities lawyer as gatekeeper. Thus, as we discuss in detail in Section III below, the SEC initiated civil injunctive and administrative proceedings against the inside general counsel of a public company for his alleged "failure to fulfill his gatekeeper role" to provide material information regarding the legality of a key accounting transaction to the company's audit committee, board of directors and independent auditors thereby allegedly enabling the company to file a materially false quarterly financial report. The SEC charged violations of Exchange Act §13(a) and Rules 12b-20, 13b2-2 and 13a-13.<sup>4</sup>

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<sup>4</sup>SEC v. John E. Isselmann, Jr., SEC Litigation Release No. 18896 (Sept. 24, 2004)

Similarly, the SEC initiated a 102(e) proceeding against the inside general counsel of a public company for allegedly facilitating the company's fraudulent revenue enhancement scheme by making false representations to the company's outside auditors in violation of §10(b) and Rule 10b-5 as well as certain Exchange Act §13 reporting provisions.<sup>5</sup> See Section III below. For a full discussion of post Sarbanes-Oxley SEC actions against lawyers directly linking the lawyer to financial or accounting fraud through his/her omitting to furnish material information or providing false information to a company's independent auditors see Section III below.

There have also been a substantial number of SEC actions against lawyers post Sarbanes-Oxley that address a wide variety of alleged violations of the federal securities laws in a wide diversity of factual settings that link the lawyer less directly or not at all to financial or accounting fraud.

In January, 2005, the SEC brought a cease-and-desist action against Silicon Valley search-engine Google and its inside general counsel in connection with the company's alleged failure to register more than \$80 million in stock option grants and related stock issuances to employees and consultants from 2002 to 2004 in violation of §5 of the Securities Act. The SEC

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<sup>5</sup>In the Matter of Jonathan B. Orlick, Esq., Securities Exchange Act Release No. 51081 (Jan. 26, 2005)

contended that the general counsel knew, but did not advise Google's board of directors, that significant questions existed with respect to the availability of exemptions from registration for the option grants and stock issuances, and therefore the board was unaware of the resulting risks of potential illegality and related liabilities.<sup>6</sup> See Section V below. In July, 2004, the SEC sued bond counsel in federal court for allegedly issuing favorable legal opinions with respect to a series of municipal bond underwritings despite his knowledge that the bond proceeds were being wrongfully commingled and diverted.<sup>7</sup> See Section VII below. In August, 2003 the SEC charged in an administrative proceeding that inside counsel of an investment adviser was aware of material disciplinary actions against the chairman and controlling person of his firm but failed to file amendments to Forms B-D and ADV disclosing these actions.<sup>8</sup> In June 2004, the SEC alleged that inside general counsel of a public company manipulated stock option exercise dates without regard to the stated terms of the company's stock option plans to enable certain senior executives, including himself, to profit unfairly at the company's expense. Capitalizing on the extended time period in effect before the enactment of Sarbanes-Oxley for

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<sup>6</sup> In the Matter of Google, Inc. and David C. Drummond, Esq., Securities Act Release No. 8523 (Jan. 13, 2005)

<sup>7</sup> SEC v. Kasirer, et al, 04 Civ. No. 4340 (N.D.Ill., Jul. 1, 2004)

<sup>8</sup> In the Matter of Steven L. Hunt, Esq., Securities Exchange Act Release No. 48330 (Aug. 13, 2003)

filing the forms on which executives were required to report stock purchases, the general counsel allegedly "cherry picked" the exercise dates during this period so as to reduce the cost of the exercise to the executive. The SEC charged violations of the anti-fraud provisions of the federal securities laws.<sup>9</sup> In November, 2004, the SEC filed a complaint in Florida federal court charging that a company's outside securities lawyer deceived the company's stock transfer agent into removing certain restrictive legends from company stock certificates.<sup>10</sup>

We have included only a very few brief examples of SEC actions against lawyers in this Introduction. A wide variety of post Sarbanes-Oxley SEC actions against lawyers in diverse factual settings are discussed at Sections III-VII below. These SEC actions target lawyers involved in one or more of the following activities:

1. Lawyers directly involved in financial or accounting fraud through omitting to furnish material information or providing false information to a company's independent auditors. See Section III below.
2. Lawyers preparing and filing false and misleading Forms 12b-25. See Section IV below.

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<sup>9</sup> SEC v. Symbol Technologies, Inc., et al, 04 Civ. No. 2276 (S.D.N.Y., Jun. 3, 2004)

<sup>10</sup> SEC v. Simmons, et al, 04 Civ. No. 2477 (M.D.Fla., Nov. 15, 2004)

3. Lawyers' activities in connection with unregistered distributions of securities. See Section V below.

4. Lawyers participating in the preparation and filing of false and misleading Forms 10-K, 10-Q, 8-K, 10 and 13D. See Section VI below.

5. Lawyers issuing improper legal opinions. See Section VII below.

And the corporate securities bar has been warned that there is more to come. Mr. Cutler emphasized in his above quoted speech:

We have more to do in this area. Based on our current investigative docket, I think you can expect to see one or more actions against lawyers who, we believe, assisted their clients in engaging in illegal late trading or market timing arrangements that harmed mutual fund investors. We are also considering actions against lawyers, both in-house and outside counsel, who assisted their companies or clients in covering up evidence of fraud, or prepared, or signed off on, misleading disclosures regarding the company's condition. One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may



have taken actions to actively obstruct such investigations.<sup>11</sup>

Many of the actions briefly noted in this Introduction were referred to in the context of lawyers as gatekeepers in Mr. Cutler's speech quoted above and in speeches by other senior SEC officials. The current enforcement climate with respect to securities lawyers under Sarbanes-Oxley has been summarized as follows:

In the current enforcement climate following implementation of the 2002 Sarbanes-Oxley Act, securities attorneys acting on behalf of public companies carry important "gatekeeper" obligations, top Securities and Exchange Commission enforcement officials said April 15, [2005.]

On a panel at the 25th Annual Ray Garrett Corporate and Securities Law Institute at the Northwestern University School of Law, Merri Jo Gillette, director of the SEC's Midwest Regional Office, said securities attorneys, in this gatekeeper role, have a legal, professional, and ethical duty to guide their corporate clients toward compliance with the law.

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<sup>11</sup> Speech by Stephen M. Cutler, The Themes of Sarbanese-Oxley as Reflected in the Commission's Enforcement Program, UCLA School of Law, Los Angeles, CA, (Sep. 20, 2004)

In extraordinary circumstances, they are also obligated to report material violations of the law by public issuers, Gillette added. She said the commission would not hesitate to take enforcement action against attorneys who ignore these gatekeeper obligations.

At the same time, Gillette said the SEC does not expect securities attorneys to betray confidences or to spy on their clients. The agency also does not wish to restrain attorneys from vigorously defending their public company clients and providing them with the best legal advice possible.

"There is a natural tension between wanting to hold lawyers to an appropriate standard in terms of their roles as gatekeepers, but at the same time avoiding a chilling effect," Gillette told attorneys. "We want people to seek legal advice and get good legal advice and take it."

Gillette said the SEC attempted to spell out attorneys' gatekeeper obligations within Sarbanes-Oxley in the Part 205 rules under Section 307. Among other provisions, the rules require that attorneys practicing before the commission report evidence of

material violations of law to the issuer's chief legal officer or chief executive officer.

Gillette said attorneys unclear about their obligations should review the Part 205 rules and also look at the commission's recent litigation against David Drummond, general counsel at the search-engine company Google Inc. Drummond entered into a settlement with the SEC in connection with the company's alleged failure to register options grants granted to employees between 2002 and 2004.

Peter Bresnan, SEC associate enforcement director, noted that the role of gatekeeper will often place attorneys at odds with management. At the same time, Bresnan reminded attorneys that Sarbanes-Oxley views the issuer as the client, not the issuer's directors, officers, or employees.<sup>12</sup>

The somewhat harsh manner in which the SEC has reconciled the "natural tension" between "gatekeeping" and traditionally vigorous independent advocacy in an adversarial system in a free society is manifested perhaps most clearly in the SEC actions discussed below. In studying these actions and evaluating their effect on practicing securities lawyers, it is important to remember

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<sup>12</sup> 37 BNA Sec. Reg. & Law Rep. 728 (Apr. 25, 2005)

that as a practical matter the securities lawyer charged in an SEC proceeding against him/her personally faces devastating consequences regardless of the outcome. The initiation of the charges alone may be enough to destroy the lawyer's professional reputation and livelihood. Ultimate exoneration will do very little to resuscitate the lawyer's career.

We turn now to a discussion of the various SEC actions against lawyers following the enactment of Sarbanes-Oxley on July 30, 2002. As one of our most distinguished jurists has written "[t]he prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law." Holmes, Path of the Law.<sup>13</sup> The following analysis is what the SEC is "doing in fact" with respect to securities lawyers.

### **III. SEC ACTIONS AGAINST LAWYERS - DIRECT LINK TO FINANCIAL OR ACCOUNTING FRAUD - FURNISHING FALSE INFORMATION TO AUDITORS**

As stated in the Introduction, a substantial number of SEC actions against lawyers post Sarbanes-Oxley have been cases alleging a direct link between the lawyer and financial or accounting fraud through his/her omitting to furnish material information or providing false information to a company's independent auditors. The SEC justifies these actions as consistent with Sarbanes-Oxley's policy of improving the quality, transparency and integrity of corporate financial reporting as

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<sup>13</sup> 10 Harv. L. Rev. 457, 461 (1897)

well as fitting comfortably within the SEC's view of the securities lawyer as a gatekeeper.

In *SEC v. John E. Isselmann, Jr.*,<sup>14</sup> the SEC alleged that the failure of the inside general counsel of a public company "to fulfill his gatekeeper role was a cause of [the company's] reporting materially false financial results to the public and violated the Commission's rule barring officers and directors of public companies from omitting to state or causing another person to omit to state a material fact to their accountants." The lawyer's "failure to fulfill his gatekeeper role" was his alleged failure to provide important information to his company's audit committee, board of directors and auditors regarding a significant accounting transaction that enabled the company to report a profit rather than a loss. A full description of the SEC's allegations enables one to assess the appropriateness of the Commission's action against counsel.

6. Isselmann, age 35, resides in Portland, Oregon, and is licensed to practice law in the State of Oregon. He served as General Counsel of ESI from May 2000 until his resignation in August 2003.

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<sup>14</sup> 04 Civ. No. 1350 (D.Ore., Sept. 23, 2004)

## FACTUAL ALLEGATIONS

7. ESI is an Oregon corporation with its principal place of business in Portland. The Company makes manufacturing equipment for electronics and other high technology companies. ESI common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades on the Nasdaq National Market.

8. In order to meet external expectations that ESI would be profitable, the Company's CFO and Controller engaged in a scheme to fraudulently inflate ESI's financial results for its quarter ended August 31, 2002. ESI's CFO and Controller reduced expenses and increased ESI's bottom line by \$1 million by secretly and unilaterally deciding to eliminate vested retirement and severance benefits in ESI's Asian offices (which included primarily Japan, but also Taiwan and Korea). This accounting transaction violated generally accepted accounting principles because ESI could not legally eliminate the benefits as it had purported to do. The accounting transaction enabled the CFO and the Controller to avoid a loss and report a profit in line with external expectations.

9. Isselmann was not involved, present, or consulted when the CFO and the Controller made the accounting decision described above.

10. On September 17, 2002, Isselmann participated in a meeting with ESI's Audit Committee and auditors to review the quarterly financial results, including the financial impact of eliminating the retirement and severance benefits. During the meeting, ESI's CFO told the Audit Committee that the Japanese benefits were not legally required and that the decision to eliminate them had been approved by legal counsel. During the same discussion, Isselmann identified ESI's legal counsel in Japan, causing an Audit Committee member to believe that outside legal counsel had reviewed the decision. Although Isselmann was unaware that the CFO had decided to eliminate the benefits in order to fraudulently inflate ESI's financial results, and did not question the CFO about his statements, Isselmann was aware that at that time he had not reviewed or approved the decision to eliminate benefits nor had he, as General Counsel, sought any outside legal review of the issue. At the conclusion of the meeting, the Audit Committee approved the inclusion of the \$1 million transaction relating to

the benefits in ESI's financial results for the quarter.

11. During the same time frame, Isselmann was informed that ESI's auditors had been told that the elimination of the benefits had legal support. In connection with the auditors' review of ESI's quarterly financial results, ESI provided the auditors with a written memorandum stating that the benefits had been eliminated because ESI was under "no legal obligation" to pay them and that the change was approved by ESI's CFO and CEO. Isselmann subsequently received a copy of this memorandum and was told that it had been written for the auditors. However, Isselmann did not speak directly with the auditors and did not inform them that he had not reviewed the retirement benefits issue and that he had not retained outside counsel to do so.

12. On October 3, 2002, Isselmann sought legal advice from ESI's counsel in Japan on whether ESI could eliminate the benefits.

13. On October 7, 2002, the outside counsel informed Isselmann in writing that ESI could not unilaterally eliminate its retirement and severance benefits in Japan and that if ESI wanted to terminate



the benefits it was required to first consult with and obtain the consent of ESI's Japanese employees. As Isselmann was aware, ESI had neither consulted the Japanese employees nor obtained their consent to the elimination of their retirement benefits. Despite the contradiction with information Isselmann had been told had been written for ESI's auditors, Isselmann did not speak directly with the auditors. Nor did Isselmann provide the information to the Audit Committee, despite the fact that they had questioned the legal review of the matter.

14. ESI's Disclosure Committee met on October 7, 2002 to review and ensure the accuracy of ESI's quarterly report to the Commission on Form 10-Q. Isselmann, other ESI officers and employees, ESI's external auditors, and its Portland-based outside corporate counsel attended the meeting, which had been arranged by Isselmann. During the meeting, Isselmann tried to raise the issue of the termination of the Asian retirement benefits. However, the CFO objected and, as a result, Isselmann provided no further detail and did not provide the written legal advice to the participants in the meeting. After the meeting, Isselmann spoke with the CFO and provided him with a

copy of the written legal advice. The CFO subsequently signed the Form 10-Q, which included the \$1 million increase to the bottom line resulting from the elimination of the benefits.

15. On October 15, 2002, ESI filed its Form 10-Q, reporting net income of \$158,000 and earnings per share of \$0.01 for the quarter. Before the Form 10-Q was filed with the Commission, an Audit Committee member questioned Isselmann about the language describing the elimination of the benefits and the \$1 million accounting entry. Isselmann failed to convey the legal advice to the Audit Committee member in response. As a result, the Form 10-Q was not changed.

16. On March 31, 2003, Isselmann learned that the CFO (who had been promoted to CEO in December 2002) had eliminated the accrued liability for the benefits late at night after learning of an accounting error that negatively impacted earnings. On the night of March 31, 2003, Isselmann reported to ESI's outside counsel his suspicions that the CFO had engaged in misconduct. The next day Isselmann informed the Audit Committee.

17. On April 1, 2003, after receiving the written legal advice, the Audit Committee commenced an

internal investigation. In August 2003, following the completion of an internal investigation by its Audit Committee, ESI restated its financial results for the quarter ended August 31, 2002. The previously recorded accounting transaction was reversed and the accrued liability of \$1 million for the payment of Asian retirement and severance benefits was restored.

There are a number of observations to be made with respect to the SEC's allegations against Isselmann.

First, the SEC specifically used the words "gatekeeper role" in the complaint. While these words have been used in speeches by senior SEC officials, they have rarely been used in formal court complaints probably because of an absence of legal precedent supporting the use of these words with respect to lawyers. The inclusion of the term in a charging document emphasizes the extent to which the SEC seeks to formalize and institutionalize the phrase "gatekeeper" as a term of art to describe in shorthand the newly broadened obligations of counsel. We view this evolution of the use of the term from SEC speeches to actual pleadings as more than a matter of mere semantics.

Second, Isselmann, a 35-year-old lawyer, is not charged with illegal actions but rather with a failure to act under

somewhat difficult and ambiguous circumstances requiring in essence an interpretation of Japanese law.

Third, the SEC's complaint appears to imply that one of Isselmann's derelictions of duty was permitting ESI's CFO to report on advice of Japanese legal counsel to ESI's audit committee and auditors in the meeting on September 17, 2002 (Referred to in paragraph 10 of the complaint). As set out in the complaint, during that meeting ESI's CFO told the audit committee that the decision to eliminate the Japanese benefits had "been approved by legal counsel." The complaint goes on to say that Isselmann "identified ESI's legal counsel in Japan, causing an Audit Committee member to believe that the outside legal counsel had reviewed the decision." According to the complaint, at the time of the September 17 meeting, Isselmann had no reason to believe that the CFO was acting improperly and therefore presumably had no reason to doubt the CFO's assertion that the CFO had obtained legal advice from Japanese counsel. A corporation in a global economy often seeks and obtains legal opinions from multiple counsel on multiple topics related to multiple jurisdictions.

A reasonable inference from the complaint language is that the CFO reported that he, the CFO, had obtained advice from legal counsel in Japan that the benefits could be eliminated. It appears that at the September 17, 2002 meeting Isselmann

merely identified the name of the Japanese counsel. It appears somewhat overzealous to argue that Isselmann in that circumstance was somehow duty bound to stop the meeting and emphasize that Isselmann could not personally vouch for whatever the CFO had learned from Japanese counsel, because he, Isselmann, had not spoken to Japanese counsel directly, and because he, Isselmann, had not done his own research of Japanese law to reach an independent opinion with regard to the issue.

Of course, the fact that Japanese counsel would later issue a written opinion denying the appropriateness of the elimination of the benefits was not a fact that Isselmann knew or could have known in the September 17, 2002 meeting.

The general insinuation the SEC appears to be making in this section of the complaint is troubling. Not only are attorneys to be "gatekeepers", but they seem to be expected to check, double-check, and confirm every legal opinion that corporate officers claim to have obtained from all other counsel.

Fourth, while the language of the complaint is not a model of clarity, one could infer that it was not until March 31, 2003, that Isselmann first learned of the circumstances under which the then CFO had eliminated the accrued liability, and first realized that misconduct had occurred. Once Isselmann was

aware of the fraudulent activities by top management he immediately informed the audit committee and outside counsel.

Fifth, Isselmann consented to a civil injunction, a \$50,000 fine and a cease-and-desist order, and the effect of the action on him personally and professionally was probably quite devastating. This seems to be a rather harsh sanction in light of the facts set out in the complaint.<sup>15</sup>

The majority of the SEC's actions against lawyers post Sarbanes-Oxley for omitting to furnish material information or providing false information to a company's independent auditors appear to have more justification based upon their facts than the circumstances in *Isselmann*. Of course, one must always remember that all of these actions against counsel have been terminated through consents incorporating only the SEC's allegations rather than having been tested in the full crucible of an adversarial proceeding. The reason for the unanimity of these resolutions by consent is that the lawyer's reputation and livelihood have already been destroyed by the charges alone, and the lawyer has little to gain from a long and expensive fight against the government.

The SEC's civil injunctive action and administrative proceeding under its Rule 102(e) against Gemstar-TV Guide's

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<sup>15</sup> SEC v. John E. Isselmann, Jr., SEC Litigation Release No. 18896 (Sept. 24, 2004)

inside general counsel, executive vice president and director, Jonathan B. Orlick, emphasized that Orlick facilitated Gemstar's fraudulent revenue enhancement scheme by providing false representations to Gemstar's auditors. The SEC's complaint alleged "that from June 1999 through September 2002, Gemstar overstated its total revenues by at least \$248 million to meet its ambitious projections for revenue growth from IPG licensing and advertising...; that Orlick participated in Gemstar's fraudulent recording and disclosure of certain IPG licensing and advertising revenue...; that Orlick knew, but omitted to disclose, that Gemstar was improperly recognizing and reporting material amounts of licensing revenue from two companies...; that Orlick participated in Gemstar's fraudulent recognition of this licensing revenue by repeatedly signing false management representation letters to Gemstar's auditors regarding the status of negotiations with one of the companies [and that] Orlick failed to disclose material information regarding certain of Gemstar's IPG revenue. The complaint charge[d] Orlick with securities fraud, falsifying Gemstar's books and records, aiding and abetting Gemstar's reporting and record-keeping violations, and lying to auditors, in violation of Sections 10(b), 13(a), 13(b) (2) (A), and 13(b) (5) of the Securities Exchange Act of 1934

and Rules 10b-5 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder.”<sup>16</sup>

Orlick “was permanently enjoined by consent from violating the antifraud and other provisions of the federal securities laws and ordered to pay a total of \$305,510.62 in disgorgement, interest, and penalties. Additionally, Orlick was prohibited from serving as an officer or director of a public company for ten years. Orlick... also agreed, in a related administrative action, to be suspended from appearing or practicing before the SEC as an attorney. Orlick consented to the relief without admitting or denying the SEC’s allegations.”<sup>17</sup>

A case where inside general counsel was alleged not to have provided false information to a company’s independent auditors but appears to have been a key participant in a fraudulent revenue enhancing scheme is SEC v. Bruce Hill, et al.<sup>18</sup> The SEC’s complaint summarized the allegations against Hill.

1. This enforcement action involves material overstatements of revenue during 1998 by Inso Corporation (“Inso”), a publicly-traded company then headquartered in Boston, Massachusetts. Between approximately September 1998 and April 1999,

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<sup>16</sup> SEC Litigation Release No. 19047 (Jan 21, 2005)

<sup>17</sup> SEC Litigation Release No. 19047 (Jan 21, 2005). See also In the Matter of Jonathan B. Orlick, Esq., Securities Exchange Act Release No. 51081 (Jan. 26, 2005); SEC v. Henry C. Yuen, et al., 03 Civ. No. 4376 (C.D. Calif., Jan. 21, 2005)

<sup>18</sup> 02 Civ. No. 11244 (D. Mass., Jun. 21, 2002)



Defendants Bruce Hill ("Hill"), then general counsel of Inso, and Graham Marshall ("Marshall"), then vice president and general manager of Inso's electronic publishing division, engaged in a fraudulent revenue recognition scheme designed to falsely boost the amount of Inso's third quarter and annual revenues for 1998.

2. By on or about September 30, 1998, the last day of Inso's 1998 fiscal third quarter, Inso's sales team had failed to conclude a sale of \$3 million of software licenses to US Airways Group, Inc. ("US Airways") that Inso had been negotiating since at least early 1998. Although no distributor had been involved in this deal prior to the end of the third quarter of 1998, on or about September 30, 1998, Marshall and others at Inso attempted to locate a distributor who would place an immediate order for the \$3 million of software licenses in order to allow Inso to record revenue from the transaction in the third quarter.

3. On or about September 30, 1998, Marshall contacted a potential distributor for the US Airways deal -- a software company located in Malaysia ("the Malaysian distributor"). Hill and Marshall then entered into a

phony \$3 million sales transaction with the Malaysian distributor. The sale transaction was a sham because of an undisclosed oral side agreement between Hill and Marshall and the Malaysian distributor which provided that Inso would sell the software to US Airways directly and that the Malaysian distributor would not have to pay for its supposed \$3 million purchase.

4. Hill and Marshall took further actions after the third quarter of 1998 to cover up the sham nature of the third quarter transaction with the Malaysian distributor. Among other things, Hill orchestrated the providing of \$4 million in letters of credit to the Malaysian distributor to finance the payment of the third quarter receivable, caused a false board resolution to be provided to Inso's bank purporting to authorize the letters of credit, and gave false information to Inso's chief financial officer ("CFO") and outside auditors about the purpose of the letters of credit. Marshall provided false information and documents to Inso's CFO to conceal the purpose of a payment to the Malaysian distributor....

6. In March 1999, after conducting an internal investigation, Inso restated its financial results for the first three quarters of 1998, reversing

approximately \$3 million in revenue from the fraudulent transaction entered into by Hill and Marshall in the third quarter of 1998.

7. As a result of the acts and omissions of Hill, Marshall, and Paxhia (Inso's CEO), Inso's financial statements included in Form 10-Q filed with the Commission for the third quarter of 1998, and referenced in a Form S-3 filed in connection with an offering of stock in December 1998, and summarized in a press release issued in October 1998, materially overstated Inso's third quarter revenue by approximately \$3 million. Inso's internal books and records also materially misrepresented the company's true financial condition.

8. By engaging in the acts and practices alleged in this Complaint, Defendants Hill and Marshall, directly or indirectly, violated the antifraud, periodic reporting, books and records, and internal accounting controls provisions of the federal securities laws.

Hill was later convicted of committing perjury in his investigative testimony before the SEC regarding the above

events. As of June 7, 2005 the SEC's action against Hill was still pending.<sup>19</sup>

*Isselmann, Orlick and Hill* all involved inside counsel allegedly participating in or failing to act in the face of financial and accounting frauds through omitting to furnish material information or providing false information to their company's independent auditors. The underlying accounting frauds all allegedly involved schemes to enhance their company's revenues by "cooking the books." Three additional post Sarbanes-Oxley SEC actions against lawyers involving these same elements were *In the Matter of James A. Fitzhenry*,<sup>20</sup> *In the Matter of David S. Pearl*<sup>21</sup>, and *In the Matter of Elliot S. Fisher*.<sup>22</sup>

Fitzhenry consented to a five year suspension under Rule 102(e) from appearing or practicing before the SEC as an attorney as well as a cease-and-desist order under Exchange Act Rule 13b2-2. According to the SEC's allegations (which Fitzhenry neither admitted nor denied as set out in the SEC's Administrative Order), Fitzhenry was general counsel for FLIR Systems, Inc. ("FLIR"). FLIR designs and manufactures thermal imaging and broadcast camera systems that detect infrared radiation. During a 1998 year-end audit of FLIR's financial statements, FLIR's outside auditors, PricewaterhouseCoopers, LLP

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<sup>19</sup> See SEC Litigation Release No. 19253 (Jun. 7, 2005)

<sup>20</sup> Securities Exchange Act Release No. 46870 (Nov. 21, 2002)

<sup>21</sup> Securities Exchange Act Release No. 48257 (Jul. 30, 2003)

<sup>22</sup> Securities Exchange Act Release No. 46954 (Dec. 6, 2002)

("PwC") selected certain sales that FLIR had recognized as revenue for testing. PwC sent an accounts receivable confirmation, which the sales representative refused to return. Fitzhenry personally attempted to negotiate with the company's independent sales representative to obtain a binding and unconditional agreement to purchase the goods for which the company had already booked the revenue, but the independent sales representative refused to agree. According to the SEC, therefore, Fitzhenry was aware that certain sales were conditional in nature and should not have been booked as revenue. Fitzhenry signed management representation letters to PwC asserting that the independent sales representative had made a fixed commitment to purchase the goods.

In the *David S. Pearl* administrative proceeding referred to above, counsel also was suspended under Rule 102(e) from appearing or practicing before the SEC as an attorney. The SEC's Administrative Order contained findings which Pearl neither admitted nor denied. According to the SEC, Pearl, an attorney, knowingly helped to prepare phony and back-dated agreements and other documents that created an appearance of rapid financial growth in his employer issuer's 1998 fiscal year.

In the *Elliot S. Fisher* administrative proceeding referred to above, counsel was suspended from appearing or practicing before the SEC as an attorney. In addition, counsel was

criminally convicted of making false and misleading statements to auditors. The SEC's Administrative Order asserted that Fisher participated in a conspiracy to commit securities fraud and make false and misleading statements to auditors. It appears that the SEC's action followed a criminal prosecution of Fisher in which Fisher was convicted of the same activity. Fisher was sentenced to six months in prison. An SEC injunctive action against Fisher is described in SEC Litigation Release No. 17880 (Dec. 6, 2002).<sup>23</sup>

The allegations in *SEC v. Universal Express, et al*,<sup>24</sup> contained the elements of counsel's link to an accounting fraud through counsel's furnishing misleading information to the company's independent auditors. In lieu, however, of a scheme to enhance revenues by "cooking the books", an element which we have seen emphasized in the other proceedings summarized in this Section, *Universal Express* had a somewhat different twist. Here inside counsel allegedly helped to facilitate an illegal unregistered distribution of 500 million shares of his company's stock to the investing public. According to the SEC, Universal Express disseminated false information to the investing public, aided by the efforts of its attorney, Chris Gunderson. The SEC's allegations include, inter alia, that Gunderson

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<sup>23</sup> SEC v. Arthur L. Toll, *et al*, 98 Civ. 2325 (E.D. Pa., May 4, 1998)

<sup>24</sup>04 Civ. 02322 (S.D.N.Y., Mar. 24, 2004)

participated in the scheme to cause Universal to sell company stock at substantial discounts to insider "resellers" who then immediately flipped the stock for a substantial risk-free profit. The resulting dilution led to a fall in the stock price, which was then artificially stabilized by false announcements of funding commitments. The SEC's allegations assert that Gunderson was directly involved in wrongdoing including preparing false legal opinions, backdating stock purchase letters to auditors and other overtly improper conduct. As of the date of this writing, the SEC's action against Gunderson was still pending.

As stated above, a substantial number of SEC actions against lawyers post Sarbanes-Oxley have been cases directly linking the lawyer to financial or accounting fraud through his/her omitting to furnish material information or providing false information to a company's independent auditors. In addition, there has been the occasional similar case of a company's inside counsel omitting to furnish material information or providing false information to a company's outside counsel,<sup>25</sup> or an outside lawyer omitting to furnish material information or providing false information to a company's attorney.<sup>26</sup>

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<sup>25</sup> See In the Matter of Steven Woghin, Esq., Securities Exchange Act Release No. 50653 (Nov. 10, 2004)

<sup>26</sup> See SEC Litigation Release No. 19002, SEC v. Jack D. Weiss, 04 Civ. 9889 (S.D.N.Y., Dec. 17, 2004)

**IV. SEC ACTIONS AGAINST LAWYERS - PREPARING AND FILING  
FALSE AND MISLEADING NOTICES OF LATE FILING - FORMS  
12B-25**

If perhaps the largest number of SEC actions against lawyers post Sarbanes-Oxley have been cases of lawyers omitting to furnish material information or providing false information to a company's independent auditors, see Section III above, perhaps the most interesting case explored in depth post Sarbanes-Oxley has involved questions raised in the context of a prominent law firm's filing an allegedly false and misleading Form 12b-25. A court ordered independent examiner's report filed in SEC v. Spiegel, Inc.<sup>27</sup> and made public by court order addresses certain issues surrounding a law firm's filing an allegedly false and misleading Form 12b-25.

Spiegel was a Delaware corporation, headquartered in Illinois, with 10% of its equity represented by non-voting Class A shares publicly traded on NASDAQ and 90% of its equity represented by voting Class B shares privately held by a single German businessman, Michael Otto. Otto owned and controlled a global retail empire consisting of 89 companies in 21 countries employing 79,000 people. Spiegel, which consisted of three retail subsidiaries selling apparel, home furnishings and other merchandise and a wholly owned credit card bank, was the empire's single American division. Spiegel's American management team was controlled from Germany by a German executive board committee.

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<sup>27</sup> 2003 WL 22176223 (N.D.Ill., 2003)



In 1999 in order to boost lagging retail sales, Spiegel embarked upon an "easy credit" plan aimed at high risk retail customers and financed by Spiegel's wholly owned credit card bank. Within a short period the subpar credit scheme faltered, Spiegel's credit charge-off rates doubled, and Spiegel's debt mushroomed by 35%. Spiegel defaulted on its loan covenants and hundreds of millions of dollars of long-term debt became immediately due and payable. Spiegel's efforts to reorganize its finances failed.

Spiegel's annual report on Form 10-K for the year 2001 was required to be filed with the SEC by the end of March, 2002. Shortly before the report was due, KPMG, Spiegel's independent accountants, advised Spiegel that it would receive a "going concern" opinion - an auditor's statement that there is a substantial doubt about the company's ability to continue as a going concern. The independent examiner concluded: "Spiegel feared the impact a going concern opinion would have on vendors selling goods to Spiegel on credit, as well as on Spiegel's investors and employees. Its answer was simply not to file its annual report and not to make disclosure of its auditors' going concern position and other material adverse information. The decision to make this response came against the recommendation of Spiegel's Chicago-based management, its attorneys Kirkland & Ellis and its auditors at KPMG. However, as time went by, these managers and professionals did little to press their point. And

the advisers relied on by Spiegel's Hamburg-based decision makers, White & Case, failed to support the recommendation to file. Spiegel then failed to file its annual report for almost a year and also failed to file its 2002 quarterly reports, and only did so as the SEC's Enforcement Division was launching an investigation of the company."<sup>28</sup>

In June, 2002, NASDAQ delisted Spiegel for its continuing failure to file its Form 10-K. Finally, in February, 2003 Spiegel filed the delinquent Form 10-K and ten days later filed in bankruptcy.

The independent examiner made the following evaluations with respect to the performance of counsel.

#### D. Involvement of Spiegel's Professional Advisers

In the present case, the SEC charged Spiegel with fraud, and Spiegel consented (without admitting or denying liability) to a fraud injunction against the company. When a fraud charge hits a public company, the question naturally arises whether its professional advisers could have done anything to prevent this "train wreck" that hurt the company and its shareholders, creditors and employees.

*Spiegel's Legal Advisers.* In evaluating the performance of Spiegel's lawyers, it is useful to

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<sup>28</sup> 2003 WL 22176223 (N.D.Ill., Sept. 15, 2003)

consider rules recently adopted and other rules recently proposed by the SEC under Section 307 of the Sarbanes-Oxley Act, even though these SEC rules were not in effect at the time of the conduct here. Under SEC rules effective August 5, 2003, lawyers representing a public company must report "up the ladder"--as high as the board of directors, if necessary--if the lawyers "become aware" of "evidence" of a "material violation" of federal or state securities law or a material breach of fiduciary duty by the company (or its officer, director, employee or agent). 17 C.F.R. Part 205.

In addition, the SEC has proposed (but not yet adopted) so-called "noisy withdrawal" rules that would require lawyers to assess whether the company has made an "appropriate response within a reasonable time" to the matter the lawyer has reported up the ladder, and if not, whether "substantial injury" to financial interest or property of the issuer or investors has occurred or is likely. An outside attorney must then "withdraw forthwith from representing the issuer," and tell both the company and the SEC that the withdrawal was for "professional considerations." An inside attorney must cease participation in the matter. Both

outside and inside attorneys must also disaffirm to the SEC any document the attorney assisted in preparing that "may be" materially false or misleading.

Robert Sorensen joined Spiegel as its general counsel at the end of June 2001. He brought in the firm of Kirkland & Ellis as principal outside counsel, in place of Rooks Pitts, to provide additional depth in corporate and securities matters. Rooks Pitts continued to represent Spiegel in securitization and other matters. As described above, by mid-May 2002, Kirkland & Ellis had plainly advised Spiegel that it was violating the law by not filing its Form 10-K, and that this illegal act could have serious consequences, including action by the SEC. Sorensen plainly concurred in this advice. The advice reached Spiegel's management, including its president Martin Zaepfel, who was also a member of Spiegel's board committee, which had the power to act for the full board. By the end of May, Zaepfel reported the advice to Michael Otto and Michael Cruesemann, the other two members of the board committee. Kirkland & Ellis also repeated this advice by phone to Spiegel's audit committee at the end of May. Plainly, Kirkland & Ellis and Sorensen

reported "up the ladder" to Spiegel's audit committee and its board committee.

However, this was a case where reporting "up the ladder" was not enough. The advice from the lawyers here was rejected by Spiegel's audit and board committees, and the material information that should have reached investors was kept under wraps. White & Case became involved in Spiegel's affairs as counsel for Spiegel's "sole voting shareholder," Michael Otto and his corporate vehicles. [FN29] Through its Hamburg partner Urs Aschenbrenner, White & Case "interpreted" for the Otto interests the advice received from Spiegel's U.S. legal advisers, and it clearly played a substantial role in helping Otto and the Spiegel board committee evaluate that advice. Aschenbrenner consulted with White & Case's New York office on Spiegel issues, and lawyers from the firm's New York office were substantively involved on various Spiegel matters--again as representatives of Spiegel's sole voting shareholder--during much of 2002.

FN29. Michael Otto and his family owned all of Spiegel's voting stock through an intermediary, SHI, and also owned a separate

finance entity that made capital contributions to Spiegel.

Aschenbrenner began accompanying Cruesemann to meetings with Spiegel's lender banks in Spring 2002, and also attended Spiegel's delisting hearing before Nasdaq on May 17, 2002. On May 31, 2002, the day Spiegel's audit and board committees made the final decision not to file the Form 10-K, Aschenbrenner was invited to be present at the audit committee meeting, and the audit committee had Aschenbrenner phone Kirkland & Ellis on a speakerphone for the committee to get advice. Aschenbrenner was heard to challenge Kirkland & Ellis' advice on the need to file Spiegel's Form 10-K and the consequences of non-filing. In the days following the May 31, 2002 meeting, it appears that neither Aschenbrenner nor his New York partners did anything to express their agreement with Kirkland & Ellis' advice.

Whatever the conclusion as to the lawyers' performance around the time of the May 31, 2002 audit and board committee meetings, the question naturally arises as to what the lawyers did to press Spiegel to make its required SEC filings through the balance of 2002--or otherwise to update, supplement or correct disclosures

made in Spiegel's Forms 12b-25 and/or its press releases. There does not appear to be a record of either Kirkland & Ellis or White & Case advising Spiegel of the dire consequences of its continuing failure to file its Form 10-K and make full disclosure to investors after May 31, 2002.

After May 2002, it appears that Spiegel's German directors considered Kirkland & Ellis and Sorensen, along with the rest of Spiegel's U.S. management, to be "black painters"--meaning pessimists who were exaggerating the seriousness of the situation. Over the summer, Cruesemann suggested that Kirkland & Ellis, and perhaps Sorensen, be replaced. The effort to replace Kirkland & Ellis failed only when U.S. management pointed out the cost of bringing in a new firm to draft documentation for the refinancing and other pending matters.

At the same time, while ostensibly still only counsel for Spiegel's sole voting shareholder, White & Case assumed a prominent role in negotiating on Spiegel's behalf with its banks on the refinancing effort, with the OCC on FCNB [credit card bank] issues, and with the insurer of the Spiegel securitizations. While still not technically retained as Spiegel's counsel,

White & Case clearly enjoyed the confidence of Spiegel's sole voting shareholder, and an effort by White & Case to report "up the ladder" to Spiegel's audit and board committees that it shared the views of the "black painters" Kirkland & Ellis and Sorensen could well have caused Spiegel to comply with its obligations and avoid a fraud charge from the SEC.

As the months went by, Kirkland & Ellis continued to prepare and file Spiegel's Forms 12b-25 providing official notice of Spiegel's failure to file its remaining quarterly reports (Form 10-Q) for the balance of 2002. All of these recited that Spiegel was not filing its periodic reports because it was 'not currently in compliance with its 2001 loan covenants and is currently working with its bank group to amend and replace its existing credit facilities,' and thus [was] 'not in a position to issue financial statements ... pending resolution of this issue.' Of course, as Kirkland & Ellis knew, the real reason why Spiegel was not filing its periodic reports was that it did not want to disclose KPMG's going concern qualification and other material bad facts and circumstances threatening Spiegel's survival. [FN30]



FN30. Rule 12b-25(a) provides that a Form 12b-25 "shall contain disclosure" of the reasons "in reasonable detail" why "all or any required portion" of a periodic report cannot be filed within the prescribed time period. Moreover, the rule states that it applies only to an "inability" to file a periodic report, not an unwillingness to file. Here, Spiegel was unwilling, not unable, to file its periodic reports, and the reason for its unwillingness was its desire not to tell investors, vendors and employees about KPMG's going concern position. And Spiegel's unwillingness persisted not just for the 15 calendar day extension afforded by the rule, but for a period stretching from April 2002 until February 2003. Form 12b-25 itself contains a warning (just below the signature and just above the instructions for the form) that underscores the importance of accuracy in completing the form:

"ATTENTION: Intentional misstatements or omissions of fact constitute Federal Criminal Violations (See 18 U.S.C. 1001)."

None of Spiegel's legal advisers withdrew--"noisily" or otherwise--from representing Spiegel. If the SEC's proposed withdrawal rule had then been in effect, the SEC would have been alerted to take action sooner, and investors would have received information they could have acted on to make informed investment decisions about Spiegel. In this case, the absence of a "noisy withdrawal" requirement allowed Spiegel to keep investors and the SEC in the dark.<sup>29</sup>

A number of points are relevant with respect to these evaluations set forth by the independent examiner.

First there is a question with respect to the status and the value as precedent of the entire 100 page independent examiner's report. When this issue was raised with the court, the court advised that readers should look to the Court Order for guidance as to the nature of its directive regarding the examiner's report. The Court Order states:

ORDER

This cause coming to be heard on the motion of Plaintiff, Securities and Exchange Commission

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<sup>29</sup> 2003 WL 22176223 (N.D.Ill., Sept. 15, 2003) (footnote omitted)

("Commission"), for an Order making the Independent Examiner's September 5, 2003 Report available to the public ("Order"), the Court having considered the Commission's motion and the Court being advised in the premises, finds:

1. That this Court has jurisdiction over the subject matter of this case and there is good cause to believe it will have jurisdiction over all parties hereto.

2. On March 11, 2003, as amended on March 27, 2003, the Honorable Judge Zagel entered an Order (the "Final Order") appointing Stephen J. Crimmins to serve as the Independent Examiner in this matter. The Independent Examiner's mandate was to provide the Court with a written report discussing Spiegel's financial condition and identifying any material accounting irregularities.

3. Pursuant to the Final Order the Independent Examiner submitted his report ("the Independent Examiner's Report") to Judge Zagel in chambers on September 5, 2003.

4. Pursuant to the Court's Order, the Independent Examiner's Report discussed Spiegel's financial condition and identified material accounting irregularities.

5. Nothing in the Final Order prohibits the Commission or Spiegel from disclosing the Independent Examiner's Report to the public.

6. The information contained in the Independent Examiner's Report is material to the investing public and it is in the public interest to make the Independent Examiner's Report available to the public.

I.

IT IS HEREBY ORDERED that, effective September 15, 2003, the Independent Examiner's report, submitted to this Court on September 5, 2003, shall be available to the public.

II.

IT IS FURTHER ORDERED that, effective September 15, 2003, the Clerk of the Court shall include the Independent Examiner's Report as part of the filings for this matter.

III.

IT IS FURTHER ORDERED that, effective September 15, 2003, the Clerk of the Court shall post the Independent Examiner's Report on the website for the Federal District Court for the Northern District of Illinois.

IV.

IT IS FURTHER ORDERED that the Independent Examiner shall provide the Clerk of the Court for the Northern District of Illinois a copy of the report in an electronic format appropriate for such posting.

V.

IT IS FURTHER ORDERED that Plaintiff Commission and Defendant Spiegel may disseminate the Independent Examiner's Report through other means.<sup>30</sup>

Since the Court Order describes the information contained in the report as "material to the investing public" and mandates wide public dissemination, the Court would appear to be contemplating a considerable degree of precedential importance. On the other hand, since the Court's mandate to the examiner was limited to a "written report discussing Spiegel's financial condition and identifying any material accounting irregularities", the examiner's analysis and evaluation of the lawyers' performance appears to be substantially beyond the scope of his mandate from the court. Moreover, as the examiner admits, the SEC's 17 C.F.R. 205 series of rules promulgated under Sarbanes-Oxley pursuant to which the examiner is evaluating the lawyers' performance were not in effect at the time of the lawyers' conduct; and the "noisy withdrawal" rules

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<sup>30</sup> 2003 WL 22176223 (N.D.Ill., Sept. 15, 2003)

which the examiner refers to as some sort of panacea were never adopted. In sum, while important and very useful, the examiner's report may be treated with a degree of caution as binding precedent with respect to the conduct of securities lawyers.

Second, the role of White & Case is interesting. White & Case represented Spiegel's sole voting shareholder, Michael Otto, and his corporate vehicles. In this representation White & Case was not subject to the same strictures regarding lawyers' conduct with respect to Spiegel as was Kirkland & Ellis, Spiegel's SEC counsel. The advantages to controlling persons of corporations to retain their own private counsel who can render advice unburdened by many of the SEC rules promulgated under Sarbanes-Oxley are starkly illustrated in the Spiegel situation.

Third, the examiner emphasizes that neither Kirkland & Ellis nor White & Case pressed Spiegel to make full disclosure to investors after Spiegel's audit and board committees made their final decision on May 31, 2002 not to file the Form 10-K. Moreover, the examiner states that while not "technically retained" as Spiegel's counsel, an effort by White & Case to "report up the ladder" could well have caused Spiegel to comply with its SEC reporting obligations. These observations tend toward placing corporate counsel in the undesirable role of a corporate overseer or corporate policeman, a role that has been specifically rejected by the SEC, see Section I above.

Finally, after carefully studying *Spiegel*, one may take issue with some of the examiner's evaluations of the performance of counsel. Kirkland and Ellis' Form 12b-25 filings, while not a model for corporate disclosure, may be deemed acceptable given an extraordinarily difficult set of circumstances. As the filings disclosed, Spiegel was in fact "not filing its periodic reports because it was 'not currently in compliance with its 2001 loan covenants and is currently working with its bank group to amend and replace its existing credit facilities,' and thus [was] 'not in a position to issue financial statements ... pending resolution of this issue.'"<sup>31</sup> If the considered opinion of the company's executive governing board was that disclosure of the going concern qualification would destroy the company, it is difficult to see how this additional disclosure would have protected shareholders. Moreover, Kirkland & Ellis were not principals, they were only lawyers; and in light of the clear directive from their client regarding disclosure their only other option was resignation. It is also difficult to see how their resignation would have protected shareholders. Also, even the examiner admits that Kirkland & Ellis clearly reported "up the ladder." As regards White & Case, its representation of Michael Otto and his corporate vehicles may also be deemed acceptable given the existing circumstances. White & Case had no

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<sup>31</sup> 2003 WL 22176223 (N.D.Ill., Sept. 15, 2003)

duty to support Kirkland & Ellis' positions and no duty to police Spiegel with respect to its SEC filing responsibilities. White & Case's duty was to represent Michael Otto and his interests, and it is certainly arguable that White & Case fulfilled this duty.

In *Spiegel* when the client chose to ignore counsel's advice to disclose material transactions, counsel determined to continue in its position. Sarbanes-Oxley, however, was not yet in effect. By contrast, in *SEC v. TV Azteca S.A. de C.V., et al.*,<sup>32</sup> a case not involving Form 12b-25, when the client chose to ignore counsel's advice to disclose material transactions, counsel resigned, citing its obligations under the newly applicable §307 of Sarbanes-Oxley. The SEC's Release for the *TV Azteca* case cogently summarized the allegations.

According to the SEC, a TV Azteca officer and director, Ricardo Salinas Pliego ("Salinas") arranged to purchase \$325 million worth of indebtedness from Unefon, a TV Azteca subsidiary. At the time Salinas purchased the indebtedness, he was aware that Unefon was in negotiations with another large telecom company which would provide substantial cash to Unefon enabling Unefon to pay off the full amount of indebtedness that Salinas had purchased at a substantial discount. Salinas

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<sup>32</sup> 1:05 Civ. 00004 (D.D.C., Jan. 4, 2005), SEC Litigation Release No. 19022 (Jan. 4, 2005)



purchased the indebtedness at a discount because, hypothetically, he was taking on risk that the indebtedness would never be repaid.

The reality, however, was that Salinas had inside information that the repayment of the debt was assured. Only three months after the deal closed with the other telecom company, Salinas received full payment of his debt netting \$109 million in profit. In various filings and public statements during this course of events, TV Azteca and its management discussed publicly the Unefon debt transactions while either failing to disclose Salinas' involvement, or in several instances, falsely denying Salinas' involvement.

TV Azteca's U.S. legal counsel discovered one news article containing Salinas' false denial of his involvement with the Unefon debt transaction. U.S. counsel advised another director and officer of TV Azteca that corrective disclosure was necessary. Despite the falsity of the statement, and the advice of counsel, the directors and officers of TV Azteca did nothing to correct Salinas' false denial. U.S. counsel then resigned citing its obligations under Section 307 of Sarbanes-Oxley. Subsequently TV Azteca issued a press release confirming that Salinas was involved in the debt transactions.

For another case (like Spiegel) involving corporate counsel's allegedly filing false and misleading notices of late

filing on Forms 12b-25 see SEC v. Craig Scott.<sup>33</sup> The Commission's Release summarized its allegations.

According to the SEC, Craig Scott was the CFO and general counsel at FFP Marketing Company, Inc. ("FFP"). FFP was a Texas-based owner and operator of convenience stores and gas stations whose stock was listed on the American Stock Exchange. The SEC alleged that Scott committed securities fraud, and that he aided and abetted FFP's violations of SEC reporting rules. Scott neither admitted nor denied the SEC's allegations, but settled the case by agreeing to pay a civil monetary penalty of \$25,000.

The SEC's complaint alleged that the company was plagued by accounting lapses leading to an internal investigation. According to the SEC, certain late filing notices falsely attributed losses that were actually related to the company's accounting lapses to other business conditions. Scott allegedly prepared what the SEC termed false and misleading notices of late filing and caused FFP to file them.

**V. SEC ACTIONS AGAINST LAWYERS - LAWYERS' ACTIVITIES IN CONNECTION WITH UNREGISTERED DISTRIBUTIONS OF SECURITIES**

If one of the most important common themes or threads permeating SEC actions against lawyers post Sarbanes-Oxley is the theme that securities lawyers representing public companies carry important "gatekeeper" obligations, see Section I, above,

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<sup>33</sup> 3:05 Civ. 0302 (N.D.Tex., Feb. 14, 2005), SEC Litigation Release No. 19077 (Feb. 14, 2005)

then deciding whether or not to allow an issuer and/or its controlling persons to distribute the issuer's securities to the investing public would appear to be the quintessential example of counsel guarding the gate to the public securities markets. Indeed, top SEC officials recently advised securities lawyers who might be "unclear" about their post Sarbanes-Oxley gatekeeper obligations to review the new 17 C.F.R. 205 series of SEC rules and also to study the Commission's January 13, 2005 action against David Drummond, the inside general counsel of search-engine company Google, Inc.<sup>34</sup> Because of the SEC's emphasis upon the importance of its decision regarding Drummond we quote a description of the SEC's findings.

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<sup>34</sup> See Section I, above, and 37 BNA Sec. Reg. & Law Rep. 728 (Apr. 25, 2005).

## A. Summary

1. Google, a Silicon Valley search engine technology company, issued over \$80 million worth of stock options to the company's employees and consultants from 2002 to 2004 without registering the offering and without providing financial information required to be disclosed under the federal securities laws. As a result, Google employees and other persons accepted Google securities as part of their compensation without certain detailed financial information about the company. By issuing the options without registering the offering and without the legally required disclosures, Google violated the securities registration provisions of Section 5 of the Securities Act. As described below, Google's General Counsel, David C. Drummond, caused Google to violate these provisions.

## B. Respondents

2. Google, Inc. is a Delaware corporation with its principal executive offices located in Mountain View, California. Founded in 1998, Google is an Internet search engine technology provider. On April 29, 2004, Google filed a registration statement for an initial public offering of securities with the Commission,

which became effective on August 19, 2004. The company's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act, and is quoted on the Nasdaq Stock Market.

3. David C. Drummond, age 41, resides in San Jose, California. Drummond is Google's General Counsel, Vice President of Corporate Development and Secretary. He is an attorney licensed to practice law in the State of California.

#### C. Facts

##### Legal Background

4. Under Section 5 of the Securities Act of 1933, a company cannot offer or sell securities to the public without first registering the offering with the Commission or having a valid exemption from registration. Registration ensures that potential investors will have detailed information about the issuer's finances and business, and allows the Commission to review the company's disclosures.

5. Rule 701 promulgated under the Securities Act provides an exemption from registration for certain issuers offering and selling stock options (or other securities) to employees and consultants under compensatory benefit plans. However, Rule 701 requires

(among other things) that any company issuing more than \$5 million in stock options over a 12-month period provide detailed financial statements and other disclosures to the option recipients. The Rule allows privately-held companies to compensate their employees with securities without incurring the obligations of public registration and reporting, while ensuring that essential information is provided to employees.

#### Google's Failure To Comply With Rule 701

6. Since its inception, Google has granted stock options to its employees and consultants as a form of compensation. Under Google's stock option plans, Google's Board of Directors granted the company's employees and consultants options to buy a certain number of Google unregistered shares at an exercise price set by Google's Board. Although the stock options were not registered, Google relied on Rule 701 of the Securities Act to exempt those securities from the registration requirements of the federal securities laws.

7. In September 2002, Google became aware that its continued issuance of stock option grants might reach levels requiring financial disclosures under Rule 701. Google temporarily stopped issuing stock grants. In

contrast to its chief competitors, Google was a private company, and did not have to report its financial results and other significant business information to the public in filings with the Commission. Google viewed the public disclosure of its detailed financial information as strategically disadvantageous, as Drummond recognized, and the company was concerned that providing option recipients with the financial disclosures required by Rule 701 could result in the disclosure of this information to the public at large and, significantly, to Google's competitors.

8. By January 2003, Google was again considering granting stock options to its employees. Drummond learned that the stock option grants being considered for approval by Google's Board might cause Google to grant more than \$5 million worth of options in a 12-month period and therefore would require Google to provide option recipients with financial disclosures under Rule 701. Drummond, in consultation with outside counsel and personnel in Google's legal department, determined that other exemptions for certain of the stock option grants permitted Google to issue the option grants without registering the securities or

providing disclosures otherwise required by Rule 701. For example, Rule 506 of Regulation D of the Securities Act exempts from registration certain sales to "accredited investors" (including investors meeting a particular level of net worth or annual income). Drummond also considered the potential applicability of Section 4(2) of the Securities Act, an exemption from registration for certain private securities offerings. Finally, Drummond determined that, even if it were later determined that his analysis of the applicability of other registration exemptions was incorrect, Google could make an offer of rescission to the option holders.

9. Drummond concluded that a sufficient number of options had been issued to Google's employees and executives who were accredited investors under Rule 506 to avoid exceeding Rule 701's \$5 million threshold, at least for the immediate future.

10. Drummond attended a January 2003 meeting of Google's Board of Directors and advised the Board to approve a new stock option plan for employee and consultant option grants going forward. Drummond also advised that the Board issue stock option grants pursuant to that new stock option plan, which grants



were to become effective when the plan became effective in February. Drummond did not report to the Board that issuing the new option grants might cause Google to exceed the \$5 million disclosure threshold of Rule 701, and that Google would be relying on other exemptions from the registration requirements.

11. At the January 2003 meeting, Google's Board approved the new stock option plan and the option grants pursuant to that plan, and the additional options became effective on February 7, 2003. Contrary to Drummond's expectations, the option grants resulted in Google exceeding Rule 701's \$5 million disclosure threshold. Even excluding option grants arguably exempt from registration under Rule 506, the dollar value of options granted by Google over the prior 12-month period exceeded \$5 million. Google, however, failed to provide the financial disclosures and other information mandated by Rule 701. Absent compliance with Rule 701, the options issued during this 12-month period were not exempt from registration, and Google's securities issuance violated the registration provisions of Section 5.

12. Between February and May 2003, Google continued to issue additional stock options to its employees. By

unanimous written consent, Google's Board approved additional stock option grants on February 28, 2003, March 31, 2003, April 24, 2003, and May 9, 2003. As a result of these option grants, the value of securities issued by Google during a 12-month period was approximately \$11 million, far in excess of the \$5 million disclosure threshold of Rule 701, yet Google did not provide the legally required disclosures to the option recipients. Throughout this period, Google failed to monitor its stock option grant levels, and failed to determine whether the company was in compliance with Rule 701.

13. In approximately June 2003, Drummond learned that Google probably had exceeded the \$5 million disclosure threshold of Rule 701. Drummond further believed that there were not likely to be enough stock option recipients who qualified as accredited investors to render the securities exempt from registration, and thus the company could not avoid the disclosure obligations of Rule 701 by relying on Rule 506.

14. Drummond believed that Google's stock option grants might be exempt under Section 4(2) of the Securities Act, an exemption available for certain private placements of securities.

15. At a June 2003 meeting, Google's Board of Directors adopted two new stock option plans allowing for the issuance of additional options beginning in July 2003. Drummond discussed the need for the stock option plans, but he did not advise the Board that Google's option grants would exceed the \$5 million disclosure threshold of Rule 701 or of the risk that other exemptions from registration may not apply. Based in part on Drummond's advice, Google issued additional options in the months following the Board approval exceeding the \$5 million disclosure threshold.

16. Google's option grants did not qualify for exemption under Section 4(2). Among other things, Google offered millions of dollars worth of stock options to all of its employees without considering the financial sophistication of each employee, and did not provide its employees with the information found in a registration statement.

17. For the twelve months ended December 31, 2003, Google issued approximately \$49 million worth of stock options. Pursuant to the stock option plans adopted in June 2003, Google issued an additional \$33 million worth of options in the first four months of 2004,

prior to the company's filing of a registration statement for its initial public offering. None of these option grants were accompanied by the disclosures required by Rule 701.

18. On August 4, 2004, Google filed a Form S-1 with the Commission to register a rescission offer for the stock option grants and the purchase of shares upon the exercise of options made between September 2001 and June 2004 to Google's employees and consultants. The Form S-1 was declared effective on November 24, 2004. However, the rescission offer does not cure a violation of Section 5.

#### D. Legal Conclusion

19. Section 5(a) of the Securities Act prohibits the use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell a security unless a registration statement is in effect as to such security. Section 5(c) of the Securities Act prohibits the use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy a security unless a registration statement has been filed as to such security.

20. Google offered to sell and sold its securities without a registration statement filed or in effect and without a valid exemption from registration. As a result of the conduct described above, Google violated, and Drummond caused Google to violate, Sections 5(a) and 5(c) of the Securities Act. The Commission previously has charged attorneys for causing Section 5 violations. See, e.g., *In the matter of John L. Milling, Esq.*, Securities Act Rel. No. 33-8189 (Feb. 3, 2003).<sup>35</sup>

Drummond and Google neither admitted nor denied the SEC's findings and consented to the imposition of an administrative Cease-and-Desist Order regarding future violations of Securities Act §5.

There are a number of points that are relevant with respect to the SEC's action in *Google*.

First, it seems somewhat unfair to target counsel for disciplinary action. Management determined to issue the options. The board of directors authorized the issuance. And counsel, after consulting with Google's outside lawyers as well as Google's inside legal department, did a reasonable job of patching together a series of exemptions. In fact, the SEC did

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<sup>35</sup> In the Matter of Google, Inc. and David C. Drummond, Securities Act Release No. 8523 (Jan. 13, 2005)

not base its enforcement action on Drummond's legal judgment regarding the registration issues. Rather, the Commission's action was focused upon Drummond's failure to raise the registration exemption issues together with the material attendant risks with Google's board of directors.

Second, counsel had to be sensitive to the fact that the company was in a very difficult position. To have refused to issue the options would have shut out employees who had labored long and hard for what was fairly certain to be, and did in fact become, a once-in-a-lifetime bonanza. Moreover, to have refused to issue the options would probably have deprived the company of valuable personnel. On the other hand, to have issued a prospectus would have meant the disclosure of confidential Google information which, in management's judgment, would have been "strategically" and competitively "disadvantageous." Under these circumstances, counsel's advice was probably the best course of action for the company, particularly when a future rescission offer was available to mitigate any significant financial exposure.

Finally, when one studies the opinion in *Google* one tends to conclude that the primary reason Drummond and the company settled was to expedite the SEC's clearance of the company's initial public offering. Indeed, one SEC staff member's reported rationale for the Drummond proceeding - "that Mr. Drummond

exposed himself to liability because he assumed a 'businessman's' decision-making role with respect to Securities Act compliance through his failure to advise Google's board of the legal risks of his determination regarding compliance" - is somewhat less than overwhelming.<sup>36</sup>

The SEC's action against John L. Milling, Esq. referenced in the last sentence of the *Google* action quoted above, is also somewhat less than overwhelming.<sup>37</sup> The Commission's findings, which Milling neither admitted nor denied, described the proceeding.

A. RESPONDENT

Milling, age 69, is a resident of Tenafly, New Jersey, has been licensed to practice as an attorney in New York since 1957, and in New Jersey since 1960, and has a specialized practice in securities law. During the period relevant to this proceeding, Milling was legal counsel to LinkNet, Inc. ("LinkNet") and LinkNet de America Latina, Ltd. ("Latina"). Milling's services included opining on the securities registration requirements of securities offerings by LinkNet and Latina.

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<sup>36</sup> Board Member, SEC Enforcement Actions Target Internal Counsel, from Hogan & Hartson LLP (Apr. 7, 2005)

<sup>37</sup> In the Matter of John L. Milling, Esq., Securities Act Release No. 8189 (Feb. 3, 2003)

B. FACTS

1. LinkNet is a Utah corporation located in Salt Lake City, Utah. Latina is a Nevada corporation located at the same office as LinkNet in Salt Lake City, Utah.

2. From at least 1999 through 2000, LinkNet conducted an offering of its securities to persons located throughout the United States, selling those securities through a division of LinkNet created, staffed and operated for that purpose. In a report on Form D filed by LinkNet with the Commission, LinkNet stated it raised \$9,659,663 from 1246 investors through the offering.

3. During 2000, Latina conducted an offering of its securities to persons located throughout the United States, selling its securities through a division of Latina created, staffed and operated for that purpose. In a report on Form D filed by Latina with the Commission, Latina stated it raised \$7,252,248.50 from 655 investors through the offering.

4. Milling prepared drafts of the Forms D referred to in paragraphs 2 and 3 above.

5. In conducting their offerings, neither LinkNet nor Latina complied with requirements of Rule 506 of Regulation D [Rule 506 of Regulation D of the



Securities Act exempts from registration certain sales to "accredited investors" which includes investors meeting a particular level of net worth or annual income], or any other provisions that exempt or except securities offerings from the registration requirements of the federal securities laws.

6. In June 2000, upon learning the staff of the Commission was investigating LinkNet and Latina for possible violations of the federal securities laws, and upon receiving information concerning possible violations of the federal securities laws in connection with the offerings of LinkNet and Latina stock, Milling recommended that LinkNet and Latina conduct a joint rescission offer to the purchasers of securities in those offerings.

7. However, Milling advised LinkNet and Latina that the rescission offer not be registered with the Commission in order to expedite the rescission offer.

8. Milling drafted the rescission offer which was reviewed and edited by persons associated with LinkNet and Latina, including Allen Johnson, the president of LinkNet and chairman of the board of Latina. Johnson signed the rescission offer on behalf of both companies.

9. The joint rescission offer was conducted in the Fall of 2000 by LinkNet and Latina without having been registered with the Commission.

10. Based on the foregoing, the Commission finds that Milling caused violations of Sections 5(a) and 5(c) of the Securities Act.

Milling, like Drummond in *Google*, consented to the imposition of an administrative Cease-and-Desist Order regarding future violations of Securities Act §5.

The SEC's action against Michael L. Labertew for his activities in connection with four unregistered offerings of securities carries considerably more substance than the SEC's actions against either Drummond or Milling. Labertew prepared court petitions and opinions to free up for public distribution without SEC registration over 47 million shares of Rocky Mountain Energy Corporation as part of a manipulative scheme orchestrated by the issuer's president. Labertew received 410,220 shares in the transactions which he sold into the public markets for \$62,088. As a result of his actions, Labertew was enjoined from violations of Securities Act §5, ordered to disgorge \$62,088 with interest, and ordered to pay a civil penalty of \$25,000.<sup>38</sup> Labertew was also suspended from appearing or practicing before the SEC as an attorney. The SEC's findings, which Labertew

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<sup>38</sup> SEC v. Rocky Mountain Energy Corporation, 03 Civ. No. 1133 (N.D.Tex., Dec. 30, 2003); SEC Litigation Release No 18522 (Dec. 23, 2003)

neither admitted nor denied, were contained in the Commission's Administrative Order under Rule 102(e).

A. At all relevant times, Labertew, age 39, was a resident of Salt Lake City, Utah, where he was licensed to practice as an attorney.

B. On December 30, 2003, a final judgment was entered against Labertew, permanently enjoining him from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933 in the civil action entitled *Securities and Exchange Commission v. Rocky Mountain Energy Corporation et. al*, case number H-03-CV-1133 in the United States District Court for the Southern District of Texas. Labertew was also ordered to pay disgorgement of \$62,088, prejudgment interest of \$2,525, post-judgment interest at the statutory rate, and a civil money penalty of \$25,000.

C. The Commission's complaint alleges that, from July 2002 to April 2003, Rocky Mountain Energy Corporation issued over 47 million shares of common stock, or approximately 60% of its outstanding shares, in four unregistered offerings. The shares were purportedly issued in exchange for the outstanding stock of four private companies in reliance on the exemption from registration found in Section 3(a)(10) of the

Securities Act.<sup>39</sup> In fact, according to the complaint, the vast majority of the shares issued in these offerings were not issued to acquire the four companies; rather, they were issued and sold to raise capital for Rocky Mountain and for the personal benefit of its CEO. Accordingly, the four offerings did not qualify for the Section 3(a)(10) exemption, or any other exemption from registration. For each offering, the complaint alleges that Labertew prepared and filed a petition on behalf of Rocky Mountain with a Utah state court seeking an order approving the purported exchange offer transaction. After obtaining the court's approval of each offering, Labertew prepared a legal opinion letter to Rocky Mountain's transfer agent. In addition, the complaint alleges that Labertew received a total of 410,220 Rocky Mountain shares issued in the four offerings, which he sold into the market for \$62,088.<sup>40</sup>

**VI. SEC ACTIONS AGAINST LAWYERS - LAWYERS PARTICIPATING IN THE PREPARATION AND FILING OF FALSE AND MISLEADING FORMS 10-K, 10-Q, 8-K, 10 AND 13D.**

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<sup>39</sup> Section 3(a)(10) provides an exemption from registration for offers and sales of securities in certain exchange transactions such as when securities are exchanged for other securities, claims, or property interests. Before an issuer can rely on the exemption, certain conditions must be met, including approval by a court or authorized governmental entity that the terms and conditions of the exchange are fair.

<sup>40</sup> In the Matter of Michael L. Labertew, Securities Exchange Act Release No. 49039 (Jan. 8, 2004).

In Section III above we addressed SEC actions against lawyers involved in providing false information to a company's independent auditors. In Section IV above we discussed SEC actions against lawyers preparing and filing false and misleading Forms 12b-25. In Section V above we examined SEC actions against lawyers for their activities in connection with unregistered distributions of securities. In this Section VI we analyze SEC actions against lawyers for participating in the preparation and filing of false and misleading Forms 10-K, 10-Q, 8-K, 10 and 13D.

One of the most important SEC actions against a lawyer for participating in the preparation and filing of a false and misleading Form 10-K and Form 10-Q involved Stanley P. Silverstein, the former vice president, general counsel and secretary of The Warnaco Group. During the relevant period Warnaco was a Fortune 500 company that traded on the New York Stock Exchange. The SEC made the following findings in its administrative proceeding against Silverstein which he neither admitted nor denied.

C. Facts

1. Inventory Restatement

a. Discovery of Inventory Overstatement

Warnaco is one of the largest manufacturers and distributors of apparel in the United States. It designs and manufactures a broad line of intimate apparel, sportswear, swimwear and other clothing under

a variety of well-known brand names. Warnaco's Intimate Apparel Division ("IAD") is a leading supplier of intimate apparel to department and specialty stores in the United States.

During the period at least 1997 through early 1999, the cost accounting and internal control systems at IAD were severely outdated and inadequate, given the size of the division's operations. IAD operated on a standard cost system that had not been updated in decades. IAD did not have a perpetual inventory system or other means for accurately determining the value of its inventory on a regular basis. The division valued its inventory accounts only once a year, when the physical inventory count was taken mid-year and reconciled to the general ledger. Further, out-of-date and missing standard costs led to large and increasing variances between actual and standard cost. By the end of 1997, capitalized variances accounted for forty-two percent of the value of inventory at the division.

As Warnaco's General Counsel, Silverstein became aware that IAD's accounting systems were antiquated. Silverstein also knew that, on the advice of its auditors, PwC, Warnaco hired PwC consultants to update and correct IAD's standard cost system ("the Standard

Cost Project") in late 1997. In August 1998, PwC informed the board and management, including Silverstein, that the Standard Cost Project had revealed that a material reduction in the value of IAD's inventory of \$60 million or more might be required.

In the Fall of 1998, IAD completed its annual physical inventory count and attempted to reconcile the value of the physical inventory to the value of the inventory on IAD's books. The reconciliation process confirmed the findings of the Standard Cost Project: the value of IAD's actual physical inventory was \$60 million to \$80 million less than the value recorded on IAD's internal records and publicly reported in Warnaco's periodic reports.

b. PwC's Audit Work Confirms the Overstatement

Warnaco informed PwC in late October or early November 1998 of the inventory discrepancy identified by the IAD reconciliation. Given the magnitude of the inventory discrepancy, the audit team informed Warnaco's senior management that PwC could not rely upon the company's books and records or internal control systems in determining the correct value of IAD's inventory. Instead, PwC created a new "valuation

model" to revalue IAD's inventory, bypassing IAD's own accounting systems.

In the course of this work, PwC identified flaws in IAD's cost accounting system, including missing, incomplete and outdated standard costs, that had prevented the system from properly reducing the value of inventory recorded on Warnaco's books as inventory was sold. During a meeting in December 1998 and in subsequent discussions, PwC notified Warnaco's senior management, including Silverstein, of their findings. These findings were consistent with the errors the PwC consultants had identified in March 1998 during the Standard Cost Project.

In February 1999, the auditors completed their work and determined that Warnaco's inventory was overvalued by \$159 million. Warnaco sought to treat the overstatement as start-up costs that would be written off as part of the company's adoption of new accounting pronouncement Statement of Position ("SOP") 98-5, which required companies to record start-up costs as they were incurred instead of amortizing them over time. However, PwC determined that the inventory overstatement could not be written off as start-up costs and informed the company that it would have to



restate its financial results for the preceding three years to correct the error.

Over the course of two days in late February 1999, Silverstein attended a series of meetings between PwC and Warnaco's senior management. During these meetings, senior management attempted to convince the auditors that Warnaco should be permitted to write off the overstatement as start-up costs under SOP 98-5. After reviewing the information provided by Warnaco in the light most favorable to the company, PwC determined that, at most, only \$14 million of the overstatement arguably could be reclassified as start-up costs. The remaining \$145 million could not be written off as start-up costs.

The auditors informed Silverstein and other members of Warnaco's senior management of this decision at the end of the day on Sunday, February 29, 1999. Silverstein and other members of senior management were also present the next day, March 1, 1999, when PwC informed Warnaco's board of directors that the inventory error could not be written off under SOP 98-5 and would require Warnaco to restate its financial statements for a three-year period.

As shown below, the restatement had a material impact upon the company's previously reported results for 1996, 1997, and the first three quarters of 1998: [Net income and Earnings per share declined by 281% for 1996, by 154% and 155% respectively for 1997, and by 26% and 51% respectively for the first three quarters of 1998.]...

c. Warnaco's 1998 Annual Report on Form 10-K

On April 2, 1999, Warnaco filed its annual report on Form 10-K for fiscal 1998. In this report, the company "revised" its financial results for fiscal 1996-1998 to reduce inventory and increase cost of goods sold by \$145 million, as required by GAAP. Warnaco continued, however, to insist misleadingly that the restatement was related to the company's adoption of SOP 98-5.

In the annual report, the notes to the audited financial statements explained the restatement by claiming that the inventory "revision" was the result of "start-up related and production inefficiency costs" identified by the company during its adoption of new accounting standard SOP 98-5....

The Form 10-K was misleading and inaccurate. The restatement was not the result of "previously

deferred" start-up costs and was not related to the company's adoption of SOP 98-5. Rather, the restatement was precipitated by a material failure of Warnaco's inventory accounting system. The annual report did not clearly explain to investors that Warnaco had restated its financial results for a three-year period to correct a \$145 million inventory overvaluation, and did not disclose that this restatement was caused by the failure of the company's accounting system to properly deduct costs from inventory as goods were sold.

As general counsel of Warnaco, Silverstein reviewed the fiscal 1998 Form 10-K and approved its filing. Silverstein knew or should have known that the disclosures contained in the Form 10-K mischaracterized the cause of the restatement. Silverstein knew or should have known that there were significant flaws in IAD's cost accounting and internal control systems. From his attendance at the meetings with PwC in late February and early March 1999, Silverstein knew or should have known that Warnaco's auditors had determined the inventory overstatement could not be attributed to misclassified start-up costs. Silverstein also knew or should have

known that it was incorrect to imply that the restatement was related to the adoption of SOP 98-5.

Warnaco did not correct the misleading disclosure until May 16, 2000, when it filed an amended 1998 Form 10-K. The amended report removed all references to start-up related production and inefficiency costs and for the first time, informed investors that:

*Reclassifications and Restatement:*

. . . In connection with the fiscal 1998 year-end closing, the Company determined that in fiscal 1996, 1997 and the first three quarters of 1998, as merchandise was sold, inventories were relieved at less than actual cost per unit, leaving an accumulation of inventory costs. As a result, costs related to [those periods] have been restated to reflect additional costs of goods sold[.] . . . This restatement resulted from flaws in the Company's Intimate Apparel Division inventory costing control system that have since been addressed.

d. Silverstein's Bonus

As an executive of the company, Silverstein participated in Warnaco's Incentive Compensation Plan. The plan provided for bonuses of up to 100 percent of salary, based upon certain criteria. In 1998, executives at the company were eligible to receive a bonus if Warnaco met certain EBIT (earnings before interest and taxes), inventory turn, and cash flow targets.

Warnaco met the 1998 cash flow target, but did not meet the inventory turn target. Warnaco did not meet the EBIT target, either, due to the effect of the \$145 million restatement upon the company's income. However, Warnaco calculated the company's EBIT as if the restatement had never occurred. By doing so, Warnaco appeared to meet the EBIT target, resulting in larger bonuses for the executives, including Silverstein, than they should have received. As a result of the improper EBIT calculation, Silverstein received an additional \$125,305 in Incentive Compensation for 1998.

## 2. Improper Offset of Debt Against Cash in the Third Quarter of 2000

In the Summer of 2000, due to its deteriorating financial situation, Warnaco was unable to meet the

financial covenants of its long-term debt, which totaled nearly \$2 billion. The company sought and subsequently obtained waivers of the financial covenants from its banks. It then entered into a series of negotiations with its bank consortium to restructure its long-term debt. As Warnaco's general counsel, Silverstein participated in these negotiations as one of Warnaco's representatives. The negotiations culminated in an agreement between the banks and Warnaco that was signed on October 6, 2000.

On November 2, 2000, Warnaco publicly announced its earnings for the third quarter of 2000. In the consolidated balance sheet attached to the press release, Warnaco reported that it had shareholders' equity of \$348 million, cash of \$227 million, and debt of \$1.79 billion as of the end of the third quarter on September 30, 2000.

Shortly after the press release was issued, Warnaco's lenders contacted Warnaco to inquire whether the company was in compliance with the financial covenants in its license agreement with Calvin Klein, Inc. The financial covenants in that license required Warnaco to maintain a debt-to-equity ratio of less than 5-to-1. The debt and equity amounts reported in

the earnings release, however, revealed that Warnaco's debt-to-equity ratio had risen above 5-to-1. Under the terms of the licensing agreement, a violation of the covenant could result in termination of the license, which accounted for more than twenty-five percent of Warnaco's gross revenues.

After Warnaco's then-CFO confirmed that the lenders' calculations were correct, the CFO decided to retroactively offset the company's cash on hand as of September 30 against its debt, which would reduce Warnaco's debt on paper and create the appearance that Warnaco had remained in compliance with the debt-to-equity covenant as of the end of the quarter. The CFO asked Silverstein to send a letter to the auditors confirming that Warnaco and its lenders had entered into a legally enforceable agreement as of September 29, 2000 that Warnaco's cash on hand would be offset against its debt. Silverstein sent the letter without ascertaining whether a legally enforceable agreement had been reached by that date. No legally enforceable agreement existed as of September 30.

On November 12, 2000, Warnaco filed its quarterly report on Form 10-Q for the third quarter of fiscal 2000. At the CFO's direction, the company used the

revised debt and cash amounts to prepare the consolidated balance sheet for the report. Using the revised amounts, Warnaco's debt-to-equity ratio was slightly less than 5-to-1, thereby creating the appearance that the company remained in compliance with the Calvin Klein licensing agreement. The quarterly report did not disclose that the cash and long-term debt amounts it reported differed from the amounts Warnaco had previously announced in its earnings release on November 2, 2000. Nor did the report disclose that Warnaco had offset \$190.5 million in cash against long-term debt in order to reach the reported cash and debt amounts. As General Counsel of the company, Silverstein reviewed and signed Warnaco's Form 10-Q.

The revised cash and debt amounts that Warnaco reported in its Form 10-Q were not calculated in conformity with GAAP. Under Financial Accounting Standards Board ("FASB") Interpretation No. 39 ("FIN 39"), accounts can be offset only in certain limited instances:

[T]he offset of assets and liabilities in the balance sheet is improper except where a right of setoff exists. . . . A



right of setoff exists when all of the following conditions are met: (a) Each of two parties owes the other determinable amounts; (b) The reporting party has the right to set off the amount owed with the amount owed by the other party; (c) The reporting party intends to set off; and (d) The right of setoff is enforceable at law.

FIN 39 also states that cash cannot be treated as an amount owed to the depositor by the financial institution and cannot be subject to set-off.

None of the FIN 39 requirements were met. FIN 39 specifically prohibits the set off of cash held on deposit at a financial institution, and therefore Warnaco could not treat its cash deposits as a "debt" owed to it by the banks. Moreover, there was no legally enforceable agreement between the company and its banks to repay the \$190.5 million that was setoff. Finally, Warnaco never repaid \$190.5 million, indicating that there was no agreement to offset that amount. Therefore, under GAAP, Warnaco was not permitted to offset the \$190.5 million against debt. As a result, the quarterly report was misleading.

D. Violations...

By filing a fiscal 1998 Form 10-K annual report on April 2, 1999 that misleadingly and inaccurately described the reason for the restatement of the company's financial statements, Warnaco violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder. Silverstein willfully aided and abetted and caused Warnaco's violation of Section 13(a) and Rules 12b-20 and 13a-1 by approving the annual report that he knew or should have known contained a materially inaccurate and misleading description of the reasons for the company's restatement and the cause of the inventory overstatement.

By filing a third quarter 2000 Form 10-Q quarterly report on November 12, 2000 that improperly offset \$190.5 million in cash against long-term debt, Warnaco violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder. Silverstein willfully aided and abetted and caused Warnaco's violation of Section 13(a) and Rules 12b-20 and 13a-13 thereunder by approving and signing a quarterly report that he knew or should have known did not accurately represent Warnaco's debt and cash.

#### E. Findings

Based on the foregoing, the Commission finds that Silverstein willfully aided and abetted and caused Warnaco's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

#### F. Undertakings

Silverstein undertakes and agrees that, for a period of two years from the date of the issuance of the Order:

1. He will not sign any documents to be filed with the Commission, except for those filings made in his individual capacity that relate to his personal stock holdings; and

2. He will not participate in or be responsible for the preparation or review of any documents to be filed with the Commission, except for those filings made in his individual capacity that relate to his personal stock holdings. Although he may provide information to others, upon request, for inclusion into documents to be filed with the Commission by or on behalf of Warnaco or another public company, he must

provide a copy of any such information to the Audit Committee of the Board of Directors of such company....

ACCORDINGLY, IT IS HEREBY ORDERED, effective immediately,

A. Pursuant to Section 21C of the Exchange Act, Silverstein cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 promulgated thereunder.

B. Pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice, Silverstein is hereby censured.

C. IT IS FURTHER ORDERED that Silverstein shall, within ten days of the entry of this Order, pay disgorgement and prejudgment interest in the total amount of \$165,772 to the United States Treasury.<sup>41</sup>

There are a number of observations to be made with respect to the SEC's findings in *Silverstein*.

First, the SEC's findings have, at best, a very tenuous connection to legal advice. The main thrust of the SEC's action is focused upon two accounting issues; and the SEC's findings as

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<sup>41</sup> In the Matter of Stanley P. Silverstein, Securities Exchange Act Release 49676 (May 11, 2004)

to Silverstein are either that he knew, or should have known, of certain reporting violations with respect to these accounting issues.

Second, when the SEC's Director of Enforcement, Stephen Cutler, discussed the *Silverstein* case in a contemporaneous speech, Mr. Cutler described the respondent as having "recently settled our charges against him for *certifying* a misleading annual report containing material misstatements that were at the heart of the company's reporting violations." (Emphasis Added) As one can see from the words of the SEC's findings, however, there is no mention of the word "certifying" with respect to Mr. Silverstein. One wonders if Mr. Cutler was diverted by issues of improper accounting into a Freudian slip with respect to a lawyer's responsibility for problems essentially beyond his legal domain.

Third, in our opinion this is a case that probably would not have been brought against counsel individually in the pre-Sarbanes-Oxley era. The SEC's findings appear one-sided and too replete with "should have knowns" with respect to Mr. Silverstein. After studying the SEC's opinion, one would very much like to hear Mr. Silverstein's side of the story.

For an action by the SEC against a lawyer, however, that would have been brought in the pre Sarbanes-Oxley era see In the

Matter of Robert J. Cassandro.<sup>42</sup> The SEC's colorful court complaint described the allegations.

NATURE OF THIS ACTION

1. This case arises out of a fraudulent scheme to manipulate the price of the stock of a publicly traded company, Spectrum Brands Corp. ("Spectrum Brands"), by exploiting the fear of bio-terrorism following September 11, 2001. A centerpiece of this scheme was the claim that a product sold by Spectrum Brands could "wipe out surface germs in less than 5 seconds, including anthrax." In press releases, e-mails, faxes, and other communications to potential investors in late 2001, the stock promoters controlling Spectrum Brands issued false and misleading statements touting the company's success in the war on "bioterrorism" and made unfounded predictions of dramatic increases in the stock price.

2. Throughout the relevant period, Spectrum Brands was secretly managed and controlled by a group of stock promoters in Hicksville, New York, led by Saverio Galasso III ("the Hicksville promoters"), some of whom were convicted felons. To conceal its true ownership from the investing public, on or about

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<sup>42</sup> Securities Exchange Act Release No. 50938 (Dec. 28, 2004).

October 31, 2001, Spectrum Brands stated in a document filed with the SEC (Form 8-K) that a Michael J. Burns was the sole officer and director of the company and that the corporate address was in Hauppauge, New York. In truth, Burns had little or no management responsibility for Spectrum Brands and the Hauppauge address was a mail drop. Spectrum Brands was actually controlled and managed by the Hicksville promoters.

3. Defendant Robert J. Cassandro participated in drafting the false and misleading statements in the Form 8-K while knowing that the statements were false and misleading. Defendants Michael Cardascia and Stephen E. Apolant helped promote the Spectrum Brands stock via internet, radio, bulk e-mail, and fax while knowing that these communications contained false and misleading statements regarding the identity of the persons controlling and managing Spectrum Brands....

B. The Stock Manipulation

15. By the end of October 2001 Galasso had obtained distribution rights to a hand-held ultra-violet lighting device known as the "DeGERMinator." On or about November 5, 2001, Spectrum Brands stated on its website that the "DeGERMinator" was capable of

"wip[ing] out surface germs in less than 5 seconds, including anthrax."

16. Spectrum Brands used its website, press releases, faxes, and e-mails to tout its alleged success in combating "bio-terrorism" and "cyber-terrorism," and to predict dramatic increases in the stock price. These promotional materials falsely indicated that Burns was in charge of the company and did not disclose that Spectrum Brands was controlled by Galasso.

17. The price of Spectrum Brand's stock rose from approximately \$4 per share on November 1, 2001, to \$11.75 on November 5, with an intra-day high of \$14 on November 5.

18. As of December 11, 2001, Galasso had placed approximately one million shares of Spectrum Brands stock in an offshore account he controlled. However, before Galasso was able to dump this stock on unsuspecting investors, Galasso, Hutter, and Dilluvio were arrested on criminal fraud charges....

#### D. Cassandro's Role In The Fraud

22. In late 2001 Cassandro served as an attorney for Spectrum Brands and knew that Galasso controlled the company. Indeed, Cassandro helped Galasso acquire



the preexisting corporate shell and install Burns as nominal president. Cassandro also helped Galasso obtain the distribution rights to the DeGERMinator and incorporate a wholly-owned subsidiary to market the DeGERMinator.

23. In October 2001 Cassandro helped prepare a Form 8-K on behalf of Spectrum Brands. On or about October 27, 2001, a former owner of the Spectrum Brands shell e-mailed Cassandro a draft Form 8-K. The draft stated that Burns was the "sole director" of the company. Spectrum Brands' corporate address was not identified.

24. On October 30, 2001, Dilluvio [one of the Hicksville promoters] e-mailed Cassandro a revised draft of the Form 8-K. The revised draft stated that Burns was the sole officer and director of the company, and that the corporate address was in Hauppauge.

25. Cassandro then reviewed and revised the portions of the draft Form 8-K relating to corporate management, inserting language identifying specific corporate actions that allegedly left "Mr. Burns as the Sole Officer and Director." Cassandro made no

change to the provisions identifying Hauppauge as the corporate address.

26. Cassandro knew when he reviewed and revised the draft Form 8-K that Spectrum Brands was controlled by Galasso, not by Burns, and that the Hauppauge address was a sham. Cassandro also knew that Galasso was a convicted felon.

27. Cassandro received 25,000 shares of Spectrum Brands stock as compensation for his work for Spectrum Brands. He subsequently sold 500 shares for \$1.90 per share.<sup>43</sup>

On December 10, 2004, the court entered an order permanently enjoining Cassandro, by consent, from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Cassandro was ordered to pay \$950 in disgorgement, plus \$142 in prejudgment interest, and a \$25,000 civil money penalty. Cassandro was also suspended from appearing or practising before the SEC as an attorney.

For an SEC action against lawyers for preparing Forms 10, 10-K, 10-Q and 13D that they allegedly knew, or recklessly disregarded, contained material misrepresentations and omitted material facts see SEC v. Syndicated Food Service International,

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<sup>43</sup> SEC v. Cassandro, et al, 04 Civ. No. 4199 (E.D.N.Y., Dec. 10, 2004)

Inc. et al.<sup>44</sup> The SEC's complaint contains very little specific detail with respect to the allegations against the lawyers.

#### **VII. SEC ACTIONS AGAINST LAWYERS - LAWYERS ISSUING IMPROPER LEGAL OPINIONS**

In his speech at the UCLA Law School on September 20, 2004, which addressed lawyers' responsibilities after the enactment of the Sarbanes-Oxley Act, Stephen M. Cutler, the then Director of the SEC's Division of Enforcement, focused specifically upon SEC actions against lawyers for issuing improper legal opinions.

Last April, for example, we brought an action against counsel to a Pennsylvania school district based on two unqualified legal opinions he issued regarding a note offering. [In the Matter of Ira Weiss and L. Andrew Shupe II, SEC Admin. Proc. No. 3-11462 (Feb. 25, 2005)]. More recently, we sued another bond counsel who, we allege, issued favorable legal opinions on a series of municipal bond underwritings, despite his knowledge that the bond proceeds were being wrongfully commingled and diverted. [SEC v. Kasirer, et al. 04 Civ. No. 4340 (N.D.Ill.), Jul. 1, 2004.]<sup>45</sup>

The first action noted by Mr. Cutler resulted in a clear defeat for the government at the hands of one of the SEC's own administrative law judges. Since these "in-house" judges are not particularly noted for their impartiality in deciding Commission

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<sup>44</sup> 04 Civ. 1303 (E.D.N.Y. Mar. 29, 2004).

<sup>45</sup> Speech by Stephen M. Cutler, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, UCLA School of Law, Los Angeles, CA, (Sep. 20, 2004).

enforcement actions, the SEC prosecutors' defeat and the forceful opinion articulating the reasons for that defeat are particularly noteworthy and particularly stinging. The following quotation from Weiss gives the flavor of the ALJ's strong rejection of the SEC's position in the case.

The Order Instituting Proceedings (OIP) alleges that in June 2000 the [Pennsylvania] School District fraudulently offered and sold \$9,600,000 of General Obligation Notes, Series 2000, dated May 15, 2000 and maturing May 15, 2003 (Notes or Note Transaction). The OIP alleges that the Notes were offered and sold to investors based on a legal opinion, issued knowingly or recklessly by [lawyer Ira] Weiss, to the effect that the interest thereon would be exempt from federal taxation, and on a representation that the note proceeds would be used to fund the School District's capital improvement projects. The OIP alleges that both of these statements were materially false and misleading and, additionally, that at the closing for the Notes Weiss knowingly or recklessly rendered another opinion to the effect that nothing had come to his attention that led him to believe that the Official Statement was materially inaccurate or incomplete.

The tax-exempt status of the Notes was dependent upon, among other matters, the School District reasonably expecting, on an objective basis, to spend substantially all of the proceeds of the Notes on capital projects within three years of the Notes' issuance. The OIP alleges that the School District explicitly advised Weiss that it had not made any final decisions on its primary capital projects and that it did not want to be locked into undertaking the controversial project of renovating or adding to an existing school building by virtue of the financing. The OIP charges that Weiss, nevertheless, reassured the School Board members that as long as they "intended" to undertake the aforementioned project, the School District was not actually required to spend the money or to do the project in order to keep the arbitrage profit.

The OIP further charges that thereafter, a School District official executed an inaccurate certificate, prepared by Weiss, that concerned the School District's plans to expend proceeds of the Notes during the three-year period on capital projects. The OIP alleges that, at all relevant times, the School District intended to use the Note proceeds solely to

obtain \$225,000 of interest rate arbitrage profit, which created significant risk that the interest from the Notes would not be exempt from federal income tax. As a result of the conduct described above, the OIP alleges that Weiss: (1) violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and; (2) caused the School District to violate Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

If I conclude that the allegations in the OIP are true, I must then determine whether: (1) pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Weiss should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and; (2) pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, an order requiring disgorgement, including reasonable interest, should be entered against Weiss....

Municipalities are prevented by law from garnering arbitrage profit by issuing municipal bonds, and using

the proceeds solely for investing tax free in Federal Government bonds at a higher interest rate. The principal role of bond counsel in a municipal bond transaction is to give a legal opinion as to the validity of the bonds, and as to federal income tax exemption status of the interest paid on the bonds. Bond counsel's role evolved in the nineteenth century after municipalities defaulted on bonds, due to state constitutional debt limits, and other factors that were ignored by the issuer. Purchasers of the bonds began to insist that a lawyer with recognized expertise in the area give an opinion as to the validity of the offering. Bond lawyers, such as Weiss, are listed in the Red Book, a national publication of the trade publishers of the Bond Guide. Division Exhibits 5 and 6 are the Model Opinion Report standards for bond lawyer practice in 1993 and 1997. If bond counsel concluded that it would be unreasonable for a court to rule against the bond counsel's opinion on tax matters, an unqualified opinion could be given as to a municipal bond issue. The Internal Revenue Service (IRS) has established a three-prong test for determining whether a bond complies with the arbitrage restriction rules that

apply to municipalities. First, the expenditure test requires that eighty-five percent of the proceeds must be spent on capital projects within three years. Second, the time test requires that, within six months of issuance, the issuer must enter a substantial binding obligation to an outside party to expend at least five percent of the bond proceeds. And third, the due diligence test requires that the bond proceeds be used for completion of capital projects with due diligence. If the IRS concludes that any one prong of the test is not met, then the bonds will be classified as arbitrage bonds, and subject to federal income taxation....

After graduating from Duquesne University School of Law in 1973, Weiss clerked in Pennsylvania for an attorney who specialized in municipal and school law. In 1979, he opened his own practice in the same field. By the date of the hearing, Weiss had served as solicitor for more than a dozen school districts and municipalities, and as general counsel or special counsel for many others. Weiss has also served as a board member and chairman of the Allegheny County Sanitary Authority. Weiss's experience with municipal bonds and notes stems from his work as solicitor, bond



counsel, issuer, or underwriter's counsel during his legal career. Weiss appeared in the Red Book in 1986, and has participated in about 100 bond transactions as note or bond counsel. In 1999, Weiss had represented the School District in the trial and successful appeal of a state tax matter. During the relevant time period, seven of nine members of the Board had also been active in the tax case. Weiss attended several Board meetings during which he was questioned as to tax matters.

Weiss was retained by the School District for the transaction at issue. Weiss knows that bond counsel is retained in a municipal bond transaction "to assure that the bonds are validly issued and to provide an opinion to that effect, as well as to the effect that they are issued on a tax-exempt basis...." Opinions of bond counsel are required so that purchasers can be assured that the interest on the bonds are "exempt from federal taxes." Before issuing his opinion, Weiss ensures that the transaction meets all tax requirements. Weiss considered the defined project in the instant case to be capital repairs, renovations, and an addition to the elementary school. Mento [School District Superintendent], whom Weiss had known

since 1994, was Weiss's primary contact with the School District....

Weiss told Solicitor Flannery [School Board's Counsel] "that during the three-year period, provided the District was doing the projects, they could invest the money they weren't using and gain positive interest." In his conversation with Weiss, Weiss made it clear to Solicitor Flannery that "there had to be projects intended...." Weiss stated that the bond proceeds "could have been spent any time during the three years, as long as it was spent on the projects." Weiss also made it clear to Solicitor Flannery that "until the [School] District proceeded with the projects, that they could legitimately earn interest on investments...."

Weiss did not tell Solicitor Flannery that the School District had to spend five percent of the notes within six months, but Weiss did not consider it to be an "issue," since the Board was "moving forward." Weiss concluded from conversations with Solicitor Flannery and Mento that Eckles [architect] had an oral contract or commitment to perform work related to the listed projects. In Pennsylvania, the architect receives the majority of his fee before the project is advertised

for a bid. That fee is usually six or seven percent of construction costs. From Mento, Solicitor Flannery, and the Board, Weiss concluded that an architect was on "board." Weiss knew that the Board was committed to "doing the elementary school," which had electrical wiring problems. The Notes were structured on a three-year basis with a one-year call. Ultimately, the Board called the Notes at the end of the year.

During a May 8, 2000, Board meeting (May 8 Meeting), Shupe [investment banker] presented his note proposal. Shupe told the Board about a "loophole" in the tax laws that would allow school districts to borrow tax-free money "as long as we had a pending building project." This "loophole" would allow the School District to earn \$225,000. During the presentation Shupe told the Board that they could borrow money just to invest the proceeds for profit. Weiss knew Shupe was wrong, and contradicted him. Weiss informed the Board that what Shupe described "[was not] exactly the case." Weiss told the Board "that they had to have projects, that they had to spend the money in three years and they had to proceed with [the projects]" and that "if they didn't want to do the project, [he] shouldn't be there."

President Flannery recalled that Weiss told the Board at the meeting that eighty-five percent of the proceeds of the Notes had to be spent on projects or contracted for before the end of the three years. I credit President Flannery's testimony....

Weiss gave the Non-Arbitrage Certificate to Solicitor Flannery for his review eight days before the closing date, and Weiss relied upon it for the issuance of his opinion. The description of the capital projects in the Non-Arbitrage Certificate is consistent with the plans described by the Board, Mento, Solicitor Flannery, and other project language in similar certificates that Weiss had seen and generated in his legal career. Weiss is familiar with the U.S. Treasury Regulations relevant to this transaction and concluded that the Non-Arbitrage Certificate in the instant case met the Regulations. Weiss prepared the standard solicitor's opinion for the signature of Solicitor Flannery. He also issued his unqualified Bond Opinion as to tax-exempt status of the Notes. "The purpose of the Notes was to fund capital improvement projects." However, no proceeds from the sale of the Notes were used to provide funds for the capital improvements of the School District. Weiss received a fee of \$9,000,

plus costs of \$509.63 for his work in the instant case. The Notes were issued at closing on June 28, 2000....

The Division [of Enforcement] alleges that Weiss violated the antifraud provisions by making several material misrepresentations and omissions during the course of his representation in the Note Transaction. The Division alleges that Weiss knew, or was reckless, in not knowing that the Notes were issued solely to gain illegal arbitrage profit when he: reviewed the preliminary official statement and Official Statement which represented that the issuance of the Notes was to provide funds for capital improvements; issued his unqualified Bond Opinion that the Notes would be exempt from federal income taxation; and, issued his Supplemental Opinion to the effect that nothing had come to his attention that led him to believe that the Official Statement was materially inaccurate or incomplete. Specifically, the Division alleges that the representations communicated to noteholders in the Bond Opinion, the Supplemental Opinion, and the Official Statement, are the basis for Weiss's direct violations of the securities laws. The Division argues that the misrepresentations and omissions made to the

School District serve as evidence of scienter. The Division alleges that Weiss either knew the School District issued Notes for the sole purpose of obtaining arbitrage profit, or was reckless or negligent in not knowing, because he failed to follow industry standards. The Division alleges that the following facts are evidence of Weiss's knowing or reckless misconduct: the May 2 Letter from Weiss to the Solicitor Flannery, in which Weiss misstated both his experience and the law (specifically, 26 C.F.R. §1.148-2(e)); the May 8 Meeting and Weiss's reactions/communications in which he failed to advise the School Board that the transaction was illegal (pursuant to 26 C.F.R. §1.148-2(e)); Solicitor Flannery raised concerns with Weiss and pointed out that the School District had not decided what projects they were going to undertake; Board members asked Weiss "pointed questions," including what happens if the School District does not spend the money; Shupe presented Weiss with a document prior to the Note issue showing Shupe's intention to tie the money up for three years in an illiquid investment; Weiss failed to obtain cost estimates from the School District for the projects, despite a Treasury

Regulation that requires estimates as a part of the process; and, when the IRS began its investigation, Weiss assisted the School District in redeeming the Notes, rather than advising the School District to quickly enter into binding commitments as there was still time to meet the Treasury Regulation requirements. The Division, additionally, alleges that Weiss failed to investigate whether the School District took any of the required steps required by Pennsylvania law to undertake construction projects.

The Division's position fails to take into account the unique events that affected the Board's decisions. It also mischaracterizes the relationship between Weiss and the Board members. Weiss acted with the requisite standard of care. Weiss contacted Mento, who informed him that the School District was committed to renovations and other repairs, and that there was an architect on board. When he met with Mento, he advised Mento of the pertinent Treasury Regulations, and was informed that the School District was "committed" to renovations. During the May 8 Meeting, Weiss contradicted Shupe, after Shupe told the Board that they could borrow money in advance of construction projects and legally keep the investment earnings. At

the May 8 Meeting, he advised the School Board that this was not the case. While he never received the estimates for the projects that he requested from Mento, Weiss reasonably believed he could issue his opinion based on his conversation with School Officials and his own experience. Weiss also attended two Board meetings and forwarded the closing documents to Solicitor Flannery eight days before closing. I conclude that Weiss's actions were consistent with the actions of a reasonable bond counsel. This conclusion is based on the expert opinions of Weiss's witnesses, Henry Klaiman and Wayne Gerhold.

I conclude that the School District did not issue the Notes solely for the purpose of obtaining arbitrage profit. I also conclude that Weiss did not act recklessly, or negligently, during the course of his representation of the School District for the Note Transaction. I reject the opinions of the Division's expert witnesses, Joseph H. Johnson and Charles Anderson. The securities laws generally define recklessness as an act so highly unreasonable and such an extreme departure from the standard of ordinary care to the extent that the "danger" was either known or so obvious that the accused must have been aware of



it. See *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999). The parties are in agreement that at the time of the Note issuance the prevailing standard of practice for counsel issuing a tax opinion was set forth in the National Association of Bond Lawyer's (NABL) Model Bond Opinion Report for 1997, which states:

Bond counsel should not render an unqualified opinion as to the validity and tax exemption of bonds unless it has concluded that it would be unreasonable for a Court to hold to the contrary. Bond counsel may reach such a conclusion as to federal income tax issues addressed in the opinion by determining that there is no reasonable possibility that the [IRS] would not concur or acquiesce in the opinion if it considered all material legal issues and relevant facts.

The plain language of the NABL Model Bond Opinion Report for 1997 is clear: a bond counsel's opinion must be reasonable, and, in reference to tax matters, there must be no reasonable possibility that, if it considered all material legal issues and relevant

facts, the IRS would not concur. Taking the material legal issues and relevant facts into account, it would be an impermissible extension of the legal responsibility of bond counsel to conclude that Weiss violated the antifraud provisions of the securities laws....

I conclude that Weiss's failure to include cost estimates does not make him reckless or negligent. With his vast experience in municipal and school law, and with the material facts and circumstances known to him at the time, it was reasonable for Weiss to issue his opinion without cost estimates in the closing documents. He knew that the projects would cost \$10 million to complete and he knew that the projects had been planned for years and were overdue. Weiss completed the Non-Arbitrage Certificate, and gave it to Solicitor Flannery for review eight days before the transaction closed on June 28, 2000. The Non-Arbitrage Certificate stated that the purpose of the Notes was to fund "capital projects in the [School] District," and also set out the expenditure, time, and due diligence tests in Treasury Regulation §1.148-2. Weiss's representation of the School District ended when the transaction closed. At no time before the

Notes closed on June 28, 2000, did anyone associated with the School District indicate that they planned to abandon the projects in order to enrich the School District's coffers with arbitrage profits. To the contrary, it is clear that at the time of the closing for the Notes, the School District reasonably expected to proceed with the projects. There were newspaper articles about the School Districts engaging in capital projects and Mento had been hired for the express purpose of leading the completion of the capital projects. The School District had also hired a municipal consultant to perform demographic work and, at the very least, consulted with an architect who provided cost estimates for several projects. The School District knew that renovations were long overdue and that the total cost would be over \$10 million.

Thus, at the time the Notes were issued, the School District reasonably expected to satisfy Treasury Regulation §1.148-2. I credit the testimony of President Flannery who concluded that at the time of the May 8 Meeting, he and the entire Board had reasonable expectations that capital improvement projects would be completed with the proceeds from the

Notes. I therefore conclude that a prudent person in the same circumstances would have reached the same expectations and taken the same actions. The School District stated that it reasonably expected to satisfy the expenditure, time, and due diligence tests, but was "thrown into turmoil due to several highly contentious, controversial, and largely unforeseeable events" immediately after the issuance of the Notes. Although the School District ultimately settled with the IRS, the closing agreement between the School District and the IRS specifically states that the School District "contends that it issued the [Notes] with the reasonable expectations to use the bonds for governmental purposes." The Division fails to take into account the Board's reasonable explanation for its own conduct.

In a case nearly on point, the United States District Court for the Western District of Oklahoma held that a bond counsel's opinions regarding the tax-exempt status of bonds were violations of the issuer, not the issuer's attorney, even if the bond opinions were wrong. *SEC v. Haswell*, 1977 WL 1074 (W.D. Okla. 1977), *aff'd*, 654 F.2d 698 (10th Cir. 1981). In *Haswell*, a bond attorney, in issuing his tax opinion, failed to

insist upon viewing the underwriter's final form of the offering circular, which improperly omitted financial projections. Id. at \*3-4. The Commission characterized this as a violation of the antifraud provisions of the federal securities laws, alleging that his bond opinions as to the tax-exempt status of the bonds were falsely issued. Id. While stating that "a more careful attorney would have insisted" upon reviewing the final offering circular, the court held that failure to do so did not necessitate a finding of fraudulent or reckless behavior. Id. In making its decision, the court found that the bond opinions were carefully considered and made in "utmost good faith." Id. at 4.

It would be an impermissible interpretation of the law to conclude that Weiss violated the antifraud provisions of the federal securities laws. The Division points out, correctly, that the bond opinions in Haswell were never challenged by any governmental agency charged with enforcement of the Internal Revenue Code, while the IRS has "determined" that the Notes in the case at hand were not tax-exempt. A settlement agreement, even one with the IRS, is not binding as to any legal issue in this case. In fact,

the closing agreement states that it is binding between the School District and IRS, and is limited specifically to those parties and to the issue of the tax-exempt status of the Notes. The facts show that Weiss followed the then-applicable standards when arriving at the conclusions in his bond opinions and that in doing so he acted in good faith. I therefore conclude that Weiss's opinions were not fraudulently, recklessly, or negligently issued. To find otherwise would be to hold Weiss responsible for the inaction of the School District after the issuance of the Notes....

The Division bases its Section 8A Securities Act claim and Section 21C Exchange Act claim on the same theory on which it based Weiss's primary violations of the antifraud provision of the federal securities laws. That is: the School issued a false Official Statement and Weiss, in preparing the Non-Arbitrage Certificate, Bond Opinion, and Supplemental Opinion, caused the School District to violate the antifraud provisions of the federal securities laws. For the same reasons that Weiss did not violate Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, I conclude that Weiss did not cause

the School District to violate the antifraud provision of the federal securities laws....

I conclude that the Division has failed to prove by a preponderance of the evidence that Weiss violated Section 17(a) of the Securities Act, or Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. I further conclude that the Division has failed to carry the necessary burden and prove that, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Weiss caused the School District to violate Section 17(a) of the Securities Act, or Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Thus this matter must be dismissed....<sup>46</sup>

The second SEC action against a lawyer for rendering an improper legal opinion noted by Mr. Cutler in the excerpt from his speech quoted above, *SEC v. Kasirer, et al*, resulted in the more common resolution of the lawyer consenting to the entry of a final judgment without admitting or denying the SEC's allegations. The final judgment (1) permanently enjoined the lawyer, Joel T. Boehm from violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder; and (2) ordered Boehm to pay disgorgement in the amount of \$152,500, plus

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<sup>46</sup> In the Matter of Ira Weiss, and L. Andrew Shupe II, SEC Admin. Proc. No. 3-11462 (Feb. 25, 2005).

prejudgment interest in the amount of \$62,902.64, did not impose a civil penalty and waived payment of all but \$24,167.99 of the disgorgement and prejudgment interest ordered based on Boehm's representations to the Commission regarding his financial condition.

The factual allegations with respect to Boehm were detailed in the SEC's complaint.

1. From February 1996 through August 1999, the Defendants, acting in concert, fraudulently offered and sold over \$131 million of municipal revenue bonds to members of the public. The Defendants offered and sold the bonds in question through a series of eleven offerings underwritten by the now-defunct, Minnesota firm of Miller & Schroeder Financial, Inc. ("Miller & Schroeder"). The Defendants sold the bonds to more than 1,800 investors residing in 36 States.

2. The purported purpose of each bond offering was to finance the development of a specified healthcare facility by Heritage Housing Development, Inc., a company effectively controlled by Defendant Kasirer ("Heritage"). The Heritage facilities consisted of various senior assisted living facilities and a hospital. All together, there were ten Heritage



facilities located in the States of Texas, Florida, Illinois and California.

3. The Defendants represented in offering documents that the proceeds from each bond offering would be used to finance one specific healthcare facility. In fact, however, from the very beginning the costs of developing the Heritage facilities, including payments to Defendant Kasirer and some of his family members, outstripped the proceeds from the facilities' respective bond offerings.

4. The Defendants covered the resulting cash shortfalls by operating a type of Ponzi scheme, commingling bond proceeds and diverting bond proceeds from more recent offerings to pay the expenses of earlier projects. Eventually all ten of the Heritage facilities failed.

5. The diversion of bond proceeds from one project to another went on for three years. The Defendants did not mention their diversion of bond proceeds in any of the offering documents, and instead falsely represented that the bond proceeds from each offering would be used only for that respective Heritage facility. Miller & Schroeder continued to sell the Heritage bonds to investors until early

August 1999. The following month, September 1999, the Defendants' commingling and diversion of bond proceeds was publicly disclosed. Beginning in February 2000, the Heritage facilities ran out of money and defaulted on their obligations to the bondholders. Presently, all the Heritage facilities are in default on their bonds.

6. Defendants Kasirer and Goldstein, the primary architects of the scheme, controlled Heritage. Defendants Kasirer and Goldstein personally directed the commingling and misapplication of bond proceeds. Defendants Iverson and Dhooge, representatives of Miller & Schroeder, managed the underwriting of the various bond offerings, despite their knowledge that bond proceeds were being wrongfully commingled and diverted. Defendant Boehm, an attorney who acted as counsel for Miller & Schroeder in the bond offerings, issued favorable legal opinions despite his knowledge that bond proceeds were being wrongfully commingled and diverted. Defendants Kasirer, Goldstein, Boehm, Iverson and Dhooge, acting knowingly or with a reckless disregard for the truth, all took part in writing, reviewing, or disseminating bond prospectuses ("Official Statements") which misled investors with

regard to, among other things, Defendant Kasirer's role in the affairs of Heritage, the financial condition of the Heritage facilities, and the true uses to be made of the bond proceeds. All the Defendants personally profited from the scheme.

7. Defendants Kasirer, Goldstein, Boehm, Iverson and Dhooge, directly and indirectly, have engaged in and, unless enjoined, will continue to engage in, acts, practices and courses of business which constitute and will constitute violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 promulgated thereunder.

8. Plaintiff brings this action to enjoin such acts, practices and courses of business, and for other equitable relief, pursuant to Section 20(b) and 20(c) of the Securities Act and Sections 21(d) and 21(e) of the Exchange Act....

16. At all times relevant to this Complaint, Defendant Boehm, who is 57 years old, lived in or near Carlsbad, California. Boehm, who is an attorney, served as counsel to the underwriter, Miller & Schroeder, for nine of the bond offerings at issue in

this suit and as bond counsel for one of the bond offerings at issue in this suit....

34. Defendant Boehm acted as the Underwriter's Counsel for nine of the Heritage Bond offerings—those for the Danforth Gardens, Sam Houston, St. Joseph Gardens, House of Sarasota, Duval Gardens, Eastwood Gardens, House of Seminole and Valley Gardens projects. Defendant Boehm also served as Bond Counsel for the second Heritage Hospital ("Rancho") offering. As Underwriter's Counsel, Defendant Boehm was responsible for preparing the Heritage bond Official Statements. Defendant Boehm also was responsible for performing due diligence regarding the Heritage bonds. As Bond Counsel, Boehm was responsible to ensure that the second Heritage Hospital offering was validly issued under state bond law. Defendant Boehm provided information for and reviewed each of these Heritage bond Official Statements before it was distributed to investors....

39. Defendant Kasirer's family also benefited from the Heritage bond offerings. Defendant Kasirer's wife, Debra Kasirer, was paid, under her maiden name, as an interior design consultant by one of the Heritage Affiliates, although she performed no work

for that Affiliate. Moreover, Golden State Health Centers, Inc., of which Kasirer's father was the Vice President and Chief Operating Officer, was hired by a Heritage Affiliate to be the supervisory manager of the Sarasota project. Defendant Kasirer's father was unaware of this arrangement.

40. Defendant Kasirer also received money from the underwriter's counsel, Defendant Boehm. On or around September 1998, Boehm wrote a check to Defendant Kasirer in the amount of \$18,000 pursuant to an undisclosed agreement under which Defendant Boehm shared a portion of the underwriter's counsel fees with Defendant Kasirer. Defendant Boehm's payments to Defendant Kasirer purportedly were to compensate Defendant Kasirer for time spent by Defendant Kasirer and employees of Health Care Holdings in assisting in the preparation of the Official Statements. In effect, Defendant Kasirer was receiving a portion of the fees of the lawyer who was supposed to be conducting due diligence with respect to Defendant Kasirer. In addition, Defendant Boehm's law firm, Atkinson, Andelson, Loya, Ruud and Romo, wire-transferred monies to Debra Kasirer on October 29, 1998 in the sum of

\$24,000; on January 22, 1999 in the sum of \$48,000 and on April 12, 1999 in the sum of \$24,000....

49. As alleged above, each Heritage bond Official Statement stated that the proceeds from each offering would be disbursed to fund debt service and to pay certain specified expenses in connection with the facility for which each offering was being conducted.

50. Nevertheless, although each Heritage Official Statement specified that the bond proceeds would only be used on the project identified in that Official Statement, Defendant Kasirer, through Rubin and other Heritage personnel, began commingling and diverting the bond proceeds among Heritage and the Heritage Affiliates shortly after the very first offering had been completed in 1996. The commingling and diversion of the proceeds from the Heritage bond offerings continued until at least August 1999.

51. Defendants Goldstein, Boehm, Iverson, and Dhooge each learned of the commingling and diversion of bond proceeds at various times during 1997 and 1998, as alleged below. Nevertheless, after learning of the misuse of bond proceeds, Defendants Goldstein, Boehm, Iverson, and Dhooge continued to participate in

the drafting and distribution of Official Statements and in the offer and sale of Heritage bonds, without disclosing the commingling and diversion of the bond proceeds. Indeed, after he became an officer of Heritage, Defendant Goldstein personally directed numerous wrongful disbursements of bond proceeds among Heritage and the Heritage Affiliates....

63. Defendants Kasirer, Goldstein, Boehm, Iverson and Dhooge knew or were reckless in not knowing that bond proceeds were being improperly commingled and diverted.

64. On March 6, 1997, Bond Counsel for the Sam Houston project wrote to Defendant Boehm advising Defendant Boehm that he had learned of an agreement, under which a Heritage entity had incurred a liability in connection with the St. Joseph's acquisition and that the Heritage entity intended to repay the liability when the Sam Houston bonds were issued. In Bond Counsel's letter, which was addressed to Defendant Boehm and copied to Defendants Goldstein, Kasirer, and Dhooge, Bond Counsel stated:

[I was advised] that in connection with the St. Joseph's acquisition, a Columbia entity loaned Heritage V \$32,878.30 for which

Heritage V gave a promissory note ("the Heritage V. Note"). . . . Heritage V agreed to repay the Heritage V Note when the Sam Houston bonds are issued. . . . As we are sure you are aware, the Sam Houston bond proceeds may not be used to repay the Heritage V Note.

Thus, as early as March 6, 1997 Defendants Boehm, Kasirer, Goldstein and Dhooge were advised that bond proceeds from one project could not be diverted to another project.

65. In performing an audit of the 1996 financial statements of the Rancho project, Heritage's independent auditors discovered that during 1996 Heritage had disbursed bond proceeds for the Rancho project in ways that were inconsistent with the Official Statement for the Rancho offering. On May 30, 1997, the Heritage auditors sent a letter to the Board of Directors of the Heritage Affiliate for the Rancho project. In this letter, the auditors stated:

The funds received from the bond proceeds were not used according to the covenants and agreements i.e. the receivable from Heritage



Housing. If this is not corrected, the tax exempt status of bonds could be in jeopardy.

The Board of Directors of the Heritage Affiliate for the Rancho project consisted of the Directors of Heritage.

66. In March 1998, Heritage auditors spoke with Defendants Boehm and Dhooge and expressed concern about the transfers of bond proceeds among various Heritage projects. Defendant Boehm told the auditors that such "inter-company transfers" were not prohibited under the Heritage bond offering documents and that while such transfers were not preferred, they were common among non-profit entities and did not break any laws.

67. On June 1, 1998, a meeting took place in Miller & Schroeder's Solana Beach office. Defendants Kasirer, Goldstein, Boehm, Iverson, and Dhooge all attended the meeting. Defendants Goldstein and Kasirer informed those present of at least one instance of a misappropriation of investor funds and a wrongful transfer of these funds. At the meeting Defendant Dbooge instructed Defendants Kasirer and Goldstein that only surplus revenues, not bond proceeds, could be loaned from one project to another project.

68. Defendants Iverson, Dhooge, and Boehm did not attempt to obtain more specific information from Defendants Goldstein and Kasirer at the meeting. Defendants Iverson, Dhooge, and Boehm also did nothing to notify the [Bond Indenture] Trustee or the investors of the misappropriation that had taken place. Nor did Defendants Iverson, Dhooge, and Boehm take any action to prevent the misappropriation of bond proceeds in the future. In fact, at or after the meeting, Defendant Iverson instructed Defendant Dhooge not to tell the Minneapolis office of Miller & Schroeder or the [Bond Indenture] Trustee about the misappropriation of investor funds....

74. Each Heritage bond Official Statement contained a section regarding "Estimated Sources and Uses of Funds." In each Official Statement, the listed uses—purchase price of existing facility, renovation, architecture and engineering, costs of issuance—all related to costs of the facility for which the bonds were issued.

75. Each Heritage bond Official Statement also contained a summary statement such as the following, from the Valley Gardens offering Official Statement; "The proceeds derived from the sale of the [Valley

Garden] Bonds will be used to repay certain debt obligations incurred in connection with the acquisition of the Existing Facility, perform the Renovation Project, fund a Debt Service Reserve Fund, initially fund the Valley Gardens Indigency Fund, fund start-up costs and capitalized interest and pay certain costs of issuance with respect to the [Valley Garden] Bonds." In each offering, the stated uses for the bond proceeds relate only to the particular facility involved with that offering.

76. None of the Heritage bond Official Statements discloses that a possible use of the bond proceeds might be a transfer of those proceeds to other, failing, Heritage projects.

77. None of the Heritage bond Official Statements disclosed the extensive commingling of bond proceeds among the various Heritage projects, the financial interdependence of the Heritage projects, the contemplated use of bond proceeds to pay existing facilities expenses, or the construction delays, cost overruns and financial difficulties experienced at the other Heritage projects. The Heritage bond Official Statements did not disclose these material facts, even though Defendants Kasirer and Goldstein knew, and

Defendants Boehm, Iverson and Dhooge knew, or recklessly disregarded, the undisclosed facts.

78. Four of the Heritage facilities, (Duval Gardens, Eastwood Gardens, House of Seminole, and Valley Gardens) were part of a master indenture financing structure. This master indenture financing structure was instituted at the request of Miller & Schroeder and allowed surplus revenues of the projects—not bond proceeds, but, rather operating revenues remaining after debts and other obligations had been met—to be utilized to obligors under the master indenture. The master indenture financing structure did not permit the transfer of bond proceeds from one project to another.

79. Each of the Official Statements represented that Heritage and the Heritage affiliate involved in that offering were governed by an Independent Board of Directors which was responsible for overseeing and managing the affairs of Heritage and the Heritage affiliate. These representations were false and misleading. In fact Heritage and the Heritage affiliates involved in the offerings were effectively controlled by Defendant Kasirer.

80. Each of the Heritage bond Official Statements touted the experience and abilities of Defendant Kasirer. The Official Statements highlighted Kasirer's experience in developing retirement communities, assisted living facilities and healthcare facilities for non-for-profit owners. However, the Official Statements failed to disclose Defendant Kasirer's control of Heritage, his several prior business failures, and several judgments that had been entered against him. Defendants Goldstein and Boehm knew of Defendant Kasirer's prior business failures; and Defendants Iverson and Dhooge knew or were reckless in not knowing of Kasirer's prior business failures.

81. The Heritage Official Statements fail to disclose the conflict of interest created by the fact that the underwriter's counsel had entered into an agreement with Kasirer, wherein the underwriter's counsel was giving a portion of his fees to Kasirer.<sup>47</sup>

For another example of an SEC action against a lawyer for issuing an improper opinion see Section III above, SEC v. Universal Express, et al, 04 Civ. 02322 (S.D.N.Y., Mar. 24, 2004) where the SEC alleged in Paragraph 25 of its complaint

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<sup>47</sup> SEC v. Kasirer, et al, 04 Civ. No. 4340 (N.D.Ill., Jul. 1, 2004). See also SEC Litigation Release No. 19131 (Mar. 14, 2005).

that Universal's counsel, Gunderson, had "prepared a legal opinion falsely stating that the shares were 'covered by the company's S-8 registrations for its common shares'."

#### **VIII. SEC ACTIONS AGAINST LAWYERS - REFLECTIONS**

As can be seen after reviewing the compendium of cases presented here, there are a number of areas in which the SEC has initiated actions against lawyers following the enactment of the Sarbanes-Oxley Act. There are certain conclusions which may be drawn from the tenor, tone, and approach adopted by the SEC in these cases.

First, as stated in Section I above, the sheer number of SEC actions against lawyers after the enactment of Sarbanes-Oxley has increased dramatically. It appears to the authors of this article, who have a combined experience of over 100 years practicing and teaching securities law, that the SEC has changed from a pre-Sarbanes orientation of presumptively not initiating actions against lawyers to a post-Sarbanes orientation of aggressively targeting lawyers for disciplinary action, often for not fulfilling some vague, SEC conceived role as "gatekeepers."

Second, as can be seen in Sections I through VII above, the range and diversity of the legal theories employed by the SEC in actions against lawyers has expanded dramatically. The new spectrum of actions extends all the way from the traditionally serious offenses of furnishing false information to accountants, participating in preparing false SEC filings, and knowingly

issuing improper opinions, to the relatively minor participation in filing an allegedly misleading Form 12b-25.<sup>48</sup>

Third, along with the dramatic expansion in the range and diversity of the legal theories employed by the SEC in actions against lawyers, there has been an increasing disparity between SEC actions against lawyers involving serious offenses on the one hand and SEC actions against lawyers sanctioning minor transgressions on the other hand. Thus in Section III above we have seen the contrast between *Isselmann* and *Hill*, in Section V the gap between *Google* and *Labertew*, in Section VI the gulf between *Silverstein* and *Cassandro*, and in Section VII the disparity between *Weiss* and *Boehm*. And, as we have discussed, actions against lawyers is not an area where the SEC can achieve a just result by calibrating the punishment to fit the transgression. Any SEC action against a lawyer, no matter what the ultimate outcome, may destroy the lawyer's ability to effectively practice his/her profession and/or engender "collateral damage" of emotional devastation and financial ruin.

Fourth, while SEC personnel have voiced the importance of understanding the "tension" between the role of attorneys as gatekeepers/whistleblowers and the role of attorneys as zealous advocates/confidence keepers, there is scant evidence that the SEC enforcers much care about the advocacy side of the equation. A survey of the cases fails to reveal any express demonstration

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<sup>48</sup> Form 12b-25 is not required to be distributed to the investing public.

of the SEC evaluating, interpreting, or considering the obligations of the attorneys involved to the clients represented. While the language of the actions focuses on the gatekeeper function, in not one of the cases reviewed can it be discerned whether the SEC made any attempt to evaluate the respective attorney's obligation to "push the envelope" for the benefit of the client.

The SEC's enforcement division is, by the nature of its mission, analogous to a criminal prosecutor's office. While the SEC and criminal prosecutors are well-situated to address circumstances like egregious cases of document falsification and outright falsehoods, in those cases involving gray areas the filing of an SEC complaint with its severe collateral consequences may be too blunt an instrument to use in calculating whether the lawyers involved properly balanced their advocacy and "gatekeeper" duties.

Finally, during the post-Sarbanes era, the SEC has initiated actions against lawyers for activities which would never have been sanctioned pre-Sarbanes. *Isselmann* discussed in Section III, *Google* and *Milling* examined in Section V, *Silverstein* addressed in Section VI, and *Weiss* in Section VII rejected by the SEC's own Administrative Law Judge - all fit within this category.

Multiple commentators have taken on the challenge of interpreting and opining on the Sarbanes-Oxley provisions involving lawyers. While these debates are useful and thought-provoking, the real test must involve an ongoing review of the



actual cases brought, the issues raised, and the results reached. Sarbanes-Oxley may be the SEC's recipe, but the proof, as always, is in the pudding.