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SEC Liability for Audit Committee Members

Contributed by Eugene R. Licker of Loeb & Loeb LLP

In a recent speech before the Compliance and Legal Society of the Securities Industry and Financial Markets Association, Robert Khuzami—director of the Securities and Exchange Commission (SEC) Division of Enforcement—ran through a list of notable enforcement efforts over the past year or so. The audience, comprised as it was of securities industry practitioners and professionals, was keenly aware of what the SEC had done, and had failed to do, over the past number of years. We all listened politely and gave Khuzami the respect that he had earned as a successful prosecutor and now the chief securities law enforcement officer in the country.

Most of what Khuzami reported was familiar and expected. One item that he mentioned, however, definitely caught my attention. The reference, like my attention span, was brief. The potential impact, however, is not.

Khuzami referred to the case of DHB Industries Inc. (DHB), a company that spawned much work for law enforcement. Its founder and principal, David Brooks, was indicted and convicted in the U.S. District Court for the Eastern District of New York for a panoply of economic crimes.[1] The SEC too brought an action against Brooks and DHB. There were also private civil suits. All of this is relatively par for the course.

What is most notable, however, and worthy of comment and consideration, is that the SEC brought an action against the company's audit committee, including its Chair, for what the SEC diplomatically charged was a failure properly to acquit their responsibilities when confronted with red flags or irregularity. What the complaint actually alleges is that the audit committee was populated with Brooks sycophants who were bought and paid for by Brooks. Their alleged ignorance of red flags was more like alleged studied indifference fueled by greed, lawlessness, absence of character, or a combination of those things.

Khuzami said:

> We also remain focused on the conduct of boards and senior executives in contexts other than insider trading. For example, in addition to charging the Company and senior executives, we recently charged three outside directors and members of Audit Committee for ignoring obvious signs of the fraud at DHB Industries, including inappropriate management involvement in the internal investigation, resignation of the law firm conducting the internal investigation, and termination of the outside firm looking into allegation of unauthorized expenses by the CEO. Last year in the InfoUSA case, we similarly brought charges against senior executives based on the misappropriation of assets by the former CEO and we also charged an outside director and chair of the Audit Committee for failing to respond to obvious red flags relating to the CEO's misappropriation of funds.

The obvious bad news is that the SEC brought the case at all, issuing a loud and persuasive warning to all who serve as

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corporate watchdogs. The good news is that the alleged behavior here was so egregious as to set, what one can only hope is, a very high (or low, depending on how you look at it) bar for future cases.

The Audit Committee and Independent Investigations

Every public corporation has an audit committee. It is populated by independent directors–a defined, technical term–and has, among other things, purview over the retention and conduct of the company's outside auditors. For that reason, the members of the audit committee should have familiarity with the audit process, and the Chair should have an accounting background. One member of the audit committee is designated the "financial expert."

The audit committee, however, has additional responsibilities. As an adjunct to serving as the overseers of the annual audit, the audit committee serves as corporate watchdog, supposedly ever vigilant to indications of wrongdoing or even irregularity. When some such indication comes to its attention, the audit committee must investigate.

Investigations have become a way of life for the defense bar. Long ago, it became clear that corporate survival hinged on what prosecutors and other law enforcement personnel refer to as "good corporate citizenship." It made itself clear to me in the late 1980's and early 1990's through a series of circumstances in which companies that rallied support for key personnel under attack ended up going out of business, and those who jettisoned accused personnel and cooperated with the government had a chance for survival. The practice naturally was nurtured by law enforcement and grew to the point where the government labeled as the dreaded "non-cooperation" such venal acts as asserting the attorney client privilege and paying for counsel for personnel under attack. Things moderated a bit after law enforcement and KPMG LLP met in Judge Kaplan's courtroom, but the idea of corporate cooperation persists.

Cooperating companies, and their counsel, should not be too harshly blamed for their failure to support their employees who are under attack. The stakes are just too high. A RICO indictment–charges, not conviction–is enough to dry up short term borrowing and put a company out of business. A conviction presents the very real prospect of draconian remedies under the sentencing guidelines,[2] not to mention the adverse publicity and all that goes with that. Once in the prosecutor's cross hairs, a corporate target has no real option but to cooperate.

In this context, cooperation means a number of things, but the primary tool–especially after Judge Kaplan's ruling in the KPMG case (which should be required reading in every criminal law class)–of the trade is the internal or independent investigation. Usually conducted under the auspices of the audit committee, in an independent investigation, a law firm with no prior connection to the company is retained to investigate the allegations, usually identified in a scope memo and implemented through execution of an action plan. The law firm hires forensic accountants and goes to work. The SEC, the US Attorney's office, or both, are informed of the investigation, the scope, and possibly the action plan. Usually, the government is kept apprised at some level of the progress of the investigation. At some point, the company makes the decision as to whether or not to reveal the findings to the government.

Aside from the estimable fact that there is, arguably, no alternative course, the independent investigation, properly and seriously done, is an effective tool for all concerned. For the company, it offers perhaps the only possibility of survival. Moreover, in a somewhat less cynical vein, the company has a strong interest in ferreting out wrongdoing and determining how it happened in the first instance so as to prevent its recurrence. For the government, it can be win/win/win: the target undertakes the frequently exhausting task of investigating the alleged wrongdoing and usually turns the resulting work product over to the government; the target bears the financial cost of the investigation; and if the government is not satisfied with the results, it always has the option of conducting its own investigation. All it stands to lose is some time, and the government is not at all bashful about pressing the investigators to move quickly.

As with anything, however, there are always going to be those who feel they can manipulate or skirt the system. Which leads us to Brooks and DHB. Always considered something of a two edged sword, the independent investigation now, in light of the DHB case, takes on an additional, and very sharp, down side edge.

DHB

Brooks owned and ran DHB, a manufacturer of body armor. It doubtlessly did not help Brooks' profile with law enforcement that he plied his wrongdoings through, and at the expense of, a company whose mission was to protect U.S. servicemen and police and became immensely profitable after the tragic events of September 11, 2001. Brooks also controlled a company called Tactical Armor Products (TAP), nominally owned by his wife. TAP made the armor plates that went into the body armor vests made by DHB.

On October 25, 2007, the SEC sued Brooks in federal court in Florida, alleging that he had engaged in accounting fraud, misappropriation of corporate funds, and insider trading, as well as aided and abetted DHB's violations. The Department of Justice (DOJ) brought criminal charges against Brooks in New York for securities fraud, conspiracy, insider trading, and obstructing justice.

The laundry list of Brooks' offensive conduct is long and fairly familiar. It included technical accounting violations, such as misclassified expenses, and more common charges such as expensing as business costs millions of dollars of expenditures for Brooks' personal expenses. Paragraph two of the SEC's complaint against DHB alleges:

> DHB's lack of internal accounting and financial reporting controls allowed senior management and others to

manipulate the Company's reported gross profit, net income, and other key figures in its earnings releases and public filings. They did so by overstating inventory values, failing to include appropriate charges for obsolete inventory, and falsifying journal entries.

Brooks is alleged to have fraudulently transferred more than $10 million for his own benefit. The suits against Brooks and the company were in addition to the previous action, filed by the SEC on August 17, 2006, against DHB's former CFO, Dawn Schlegel, and its former COO, Sandra Hatfield, alleging that they aided and abetted DHB's violations regarding reporting, books and records, and internal controls, as well as their own conduct in violation of the antifraud provisions of the securities laws. The DOJ followed with similar criminal charges.

But even with that clean sweep of senior management, law enforcement was not through with this company and its personnel, and that is what gives rise to this cautionary tale. As so often is the case, it was not (just) the crime that garnered the attention of law enforcement. It was the cover up.

The alleged conduct is so egregious as to give future putative defendants a lot of room to argue for the exercise in prosecutorial discretion to the extent their alleged conduct does not meet this high bar of malfeasance.

The DHB Audit Committee

As noted above, the audit committee deals with the corporation's outside auditors in the conduct of annual audits and periodic reviews, and just as the audit is independent, so too are the audit committee members. That means that, unlike others on the board of directors, they are not part of the management of the company nor are they tied to management in any meaningful way. The audit committee members are supposed to be unafraid to confront and police management. They are the corporation's watchdogs.

The SEC, upon investigation and reflection, concluded that the DHB audit committee did not serve its role well in any respect. The SEC does not believe that the DHB audit committee members were independent of Brooks, nor does it think that the committee was even trying to do its watchdog job. If the allegations in the complaint are true, the SEC most certainly is correct on both counts.

DHB's audit committee was comprised of Jerome Krantz, Cary Chasin, and Gary Nadelman. They also constituted the company's compensation committee. According to the complaint against them, Krantz was a director and Chair of the audit committee from 2000 through May 2006 and was the owner of an insurance agency and financial consulting firm. Chasin served as a director and audit committee member from October 2002 through February 2007 and was an employee of DHB for several months in 1997 and again from November 1999 through April 2000. Nadelman was a director and audit committee member from November 1995 through August 2000 and again from July 2001 through February 2007.

The SEC alleges that, far from being independent, these three men were longtime friends and neighbors of Brooks who depended on Brooks for financial support and were entirely dominated by him. All three were alleged to have business relationships with Brooks. Krantz was his insurance agent. Chasin previously worked at DHB, which was his sole source of income from 1997 to 2000. Nadelman is alleged to have been a "significant investor" in a private company in large part owned and later taken public by Brooks. The three were alleged to have received "lucrative warrants" in 2003, 2004, and 2005, as well as other perquisites. In an interesting, and likely artful, pleading, immediately following the allegations of financial rewards given by Brooks to the three members of the audit committee, the SEC inserts the nearly obligatory salacious allegation: "Additionally, the three directors knew the Company was paying for services with no legitimate business purpose, such as prostitutes." The beneficiaries of this particular largess are not identified, other than by innuendo.

The Committee's Alleged Failures

As noted above, the good news coming out of this case is the extreme conduct, by omission and commission, in which the committee allegedly engaged. According to the complaint, at virtually every turn the committee failed properly to acquit its responsibilities, engaged in conscious avoidance of important red flags, allowed Brooks to control and subvert what should have been the investigative and protective process, or joined him in the wrongdoing. The alleged conduct is so egregious as to give future putative defendants a lot of room to argue for the exercise in prosecutorial discretion to the extent their alleged conduct does not meet this high bar of malfeasance.

– *Failure to Understand Their Responsibilities*

DHB's public and internal documents lay out the familiar litany of responsibilities of the audit committee, including monitoring financial reporting and internal controls. In a virtually ipse dixit allegation, the SEC claims that the members of the committee "made little or no effort even to understand their" responsibilities.[3]

– *Failure to Heed Red Flags*

The complaint details a long list of red flags that, according to the SEC, should have alerted the three defendants to the fact that Brooks was engaging in fraud. In this regard, the complaint is essentially facetious. It is unlikely that the SEC really believes that the committee members either missed these indications or failed to appreciate them as opposed to intentionally allowing Brooks to get away with wrongdoing in return for personal financial reward. In any event, the alleged litany of unheeded red flags, if proven, makes out an overwhelming case.

– *The Parade of Auditors*

In the five years between 2002 and 2006, DHB had an astounding four, or five if you count the doubling up (more on that later), different auditing firms. Grant Thornton LLP resigned on August 20, 2003. It was replaced by Weiser LLP, which resigned on April 8, 2005. Next came Rachlin Cohen and Hotz, P.A. (Rachlin). There is no allegation that Rachlin resigned, but there is an allegation that after Rachlin issued a statement pursuant to Section 10A of the Securities Exchange Act of 1934 on April 5, 3006, DHB (acting through Chasin) engaged Russell Bedford Stefano LLP to reaudit its 2003 and 2004 financials, which Rachlin was in the midst of doing. Shortly thereafter, in August 2006, the SEC and the U.S. Attorney's Office began commencing actions against DHB personnel.

– *The Auditors' Actions*

The multiple resignations were red flags in and of themselves, but the actions allegedly taken by the auditors during their truncated tenures constituted red flags as well:

- On July 2, 2003, Grant Thornton directed to Krantz specific questions regarding interested party transactions;
- On the day it resigned (August 20, 2003), Grant Thornton issued a material weakness letter regarding DHB's financial reporting controls;
- In February 2005, after it had resigned, Grant Thornton complained to Krantz that it had not been told of an important board resolution that supposedly had been adopted in 1997 and threatened to withdraw its 2002 audit opinion;
- In March 2004, Weiser raised concerns about DHB accounting;
- Shortly thereafter, Weiser recommended the hiring of "a CFO for the Florida operation, a Director of Financial Reporting, a cost accountant responsible for inventory cost accounting and reporting," and told the committee to replace Krantz as audit committee financial expert;
- In February 2005, Weiser met with the audit committee to discuss certain allegations raised by the Controller, telling the committee to investigate these matters;
- In that same meeting, Weiser told the committee that it intended to issue a material weakness letter, which it did in March 2005;
- In March 2005, Weiser informed the company that it could not rely on the 2004 annual audit report;
- In November 2005, Weiser refused to allow DHB to re-issue Weiser's audit reports; and
- On April 5, 2006, Rachlin sent DHB, the committee, and the SEC a Section l0A letter reporting potentially illegal acts.

– *The Investigations*

Just as there were multiple auditors, there were multiple investigators. Gibson Dunn and Crutcher, LLP had been retained in June 2003 to investigate possible related party transactions. In January 2004, the audit committee learned that Gibson had resigned. On February 9, 2004, Brooks hired Pepper Hamilton LLP and FTI Consulting, Inc. (FTI) to continue the investigation. FTI raised issues regarding Brooks' misuse of corporate assets and other matters, and in July 2004 Brooks terminated FTI. The Complaint does not address the fate of Pepper Hamilton's engagement.

Moreover, not only did Brooks exercise a unilateral veto with regard to the investigations, each time one was commenced, he, rather than the audit committee, controlled it. Thus, he allegedly refused to provide information despite repeated requests from the investigators. He also allegedly directed the scope and conduct of the investigations, the manner of reporting, the identity of witnesses, and the like. In short, the investigations were in no way independent and, according to the SEC, they had absolutely no integrity.

– *Additional Complaints and Accusations*

In addition to the questions and allegations raised by the auditors and the investigators, others put the audit committee on notice that something was amiss. In 2003, the Union of Needletrades, Industrial and Textile Employees raised possible disclosure issues. In early 2004, the SEC served a subpoena on DHB telegraphing its concerns about possible related party transactions. In February 2005, the company's recently-hired Controller raised issues with regard to accounting for inventory and said he was going to resign. Before the Controller could resign, however, Brooks fired him.

– *Participation in Wrongdoing, Including Sham Investigations*

Whether viewed as a failure to heed red flags, as the SEC primarily casts it in its complaint, or viewed as complicity in wrongdoing, the SEC alleges that the audit committee let Brooks get away with the financial equivalent of murder. As noted above, when allegations were raised by the various sources, DHB turned matters on their head. Under the guise of conducting an independent investigation of the allegations, which usually would be conducted under the auspices of the audit committee, the investigations were allegedly controlled by Brooks and were, for that reason, nothing more than a sham. According to the SEC, the audit committee had clear evidence that Brooks was using corporate assets for his personal benefit, yet it did nothing to stop the practice. Indeed, the SEC believes that Brooks manufactured a non-existent, after-the-fact corporate resolution in an attempt to justify his defalcations, and alleges that he enlisted the aid of audit committee members to provide a façade of legitimacy for his ruse.

The Case

The SEC commenced its action on February 28, 2011. Because all three of the defendants served as directors of the company, and signed the public filings, they were each charged with substantive violations of the securities laws. They each allegedly knew that the company's public filings were false. The vast bulk of the allegations, however, are cast in terms of aiding and abetting Brooks' wrongdoings. Of course, the SEC could have pled the case differently, placing emphasis on the claims of direct responsibility for securities fraud. By relying almost entirely on accessorial liability, however, it appears, at least to me, that the SEC is sending a loud and clear message: the audit committee is supposed to be the sheriff; if it is not going to serve that role, then its members are going to find themselves, figuratively speaking, on the wrong side of the cell, sharing it with the people whose misconduct they are empowering by failing to do their job.

The case is currently pending in federal district court in Florida. Very little has occurred in the case.

InfoUSA—the "Other" Case

In tone and content, the complaint against the DHB audit committee members is unique and unprecedented. It is not, however, the only case brought by the SEC against an audit committee member who failed to acquit his responsibilities properly. In March 2010, the Denver Regional Office of the SEC commenced, and settled, an action against Vasant Raval, Chair of the audit committee of InfoUSA. The story is familiar. The CEO of InfoUSA, Vinod Gupta, used corporate assets for personal benefits and engaged in interested party transactions. Raval, as Chair of the audit committee, ignored red flags and allowed Gupta to run amuck. He also signed public filings, knowing they were not true.

As befits a complaint pre-ordained for settlement, the Raval complaint is not nearly as detailed as the DHB complaint. The SEC alleged that the audit committee was informed of, and supposedly investigated the propriety of, a number of interested party transactions, and that Raval's investigation of the transactions did not reveal sufficient justification for at least some of the expenses.[4] Raval was exposed to other red flags, including information supplied to him by the head of internal audit and, later, after the head of internal audit was fired, by his replacement. Disclosure counsel also brought matters to Raval's attention.

Rather than taking corrective action, Raval wrote a report. The complaint does not describe or attach the report, but the implication is that while the report did not exonerate Gupta, it clearly did not provide the stinging revelations that the SEC thought were called for under the circumstances. The SEC thus sued.

Although the actions against Raval and against the DHB audit committee are similar in nature, and to some degree content, the two cases appear to send very different messages through their tone and tenor. The causes of action in the Raval case sound primarily in direct liability rather than accessorial liability. The charges were simple and straightforward—securities fraud and supervisory liability. Neither the rhetoric nor the charges themselves seemed designed to broadcast to similarly situated persons that the SEC would keep a keen eye out for a failure adequately to acquit audit committee duties. Moreover, no members of the audit committee other than Raval were named or even was made the subject of attention or criticism. Finally, although there most certainly are in the Raval complaint references to the committee's responsibilities, the rhetoric in the DHB complaint is far more charged and pointed.

As noted above, Raval consented to the entry of judgment against him. He was fined $50,000 and took a five year bar from serving as an officer or director of a public company. No criminal charges were filed. The penalties that result from a consent decree are, and should be, more lenient than a litigated case. No one would deny, however, that the relief obtained against Raval pales in comparison to the relief sought against the DHB defendants.

– The Road Ahead

In a recent conversation, an SEC Enforcement Division Staff Attorney explained to me that his less than patient attitude with my client reflected the approach of the "New SEC." I did not quiz him about what that meant, to me or my client or even to him, because I suspect that I know the answer. There has been something of a sea change at the SEC over the last couple of years. Some of it results from a natural progression due to a changing of the guard. Some results from a reasonable response to the chilling stimuli of horrendous economic conditions, inefficient and flawed (and perhaps fraudulent) markets, and unparalleled fraudulent conduct. Much of it results from the abject failure of the SEC to detect or prevent the fallout from all of this.

The SEC, however, is a proud and prestigious organization charged with obviously serious responsibility and peopled with quality personnel. Its current leadership is outstanding and its commitment is unquestioned.

All of this clearly portends in favor of more rigorous enforcement in general and, with regard to audit committee Chairs and members, a greater emphasis by the SEC on ensuring that these folks take their jobs seriously and do them well. Like the auditors with whom they interface, audit committee members must be skeptics, must ask the hard questions, must question the answers, and must demand proof. There is nothing new about that, but what is new is that a failure to do so seems more likely now to attract attention than in days gone by.

Once again, the DHB facts, as well as the Raval facts, are extreme. If the alleged (and in Raval, admitted) conduct took place, then the defendants were more than remiss, they were complicit. It does not take a great deal of imagination, or a crystal ball, however, to foresee the SEC pursuing less egregious cases, especially where studied indifference to red flags is coupled with economic incentive to do so. As a result, it seems likely that it will become harder to find people willing to serve on audit committees, and most assuredly corporations will have to offer greater financial incentives to offset the greater liability horizon. We are already seeing all of that as audit committee members find themselves more and more often named as defendants in civil suits. It all makes one wonder what happens when prospective audit committee members uniformly decide it is just not worth it.

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[1] By way of full disclosure, I should point out that Brooks interviewed me and others from my firm in consideration of retaining us to represent him in his criminal case. We were not, however, retained. Nothing addressed here is based on any privileged information, nor does the fact that our firm was considered have any effect on this article.

[2] Though no longer mandatory, the sentencing guidelines are routinely followed by most courts.

[3] The factual averments regarding the defendants' backgrounds do not provide a basis by which to judge their accounting acumen, although each is alleged to have held positions that would indicate some level of financial sophistication. Krantz was the designated "financial expert."

[4] Ironically, this information was supplied to the audit committee as part of a newly-adopted compliance policy.