

**ETHICS
PANEL DISCUSSION:
ETHICAL CHALLENGES
FACING IN-HOUSE
COUNSEL**

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IN THE LINE OF FIRE:
REGULATORY AND PROSECUTORIAL ACTIONS
AGAINST IN-HOUSE COUNSEL

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I. Increased Enforcement Activity Against In-House Counsel.

A. The SEC has maintained that “to preserve an appropriate level of advocacy, the Commission ordinarily will not sanction lawyers under the securities laws merely for giving bad advice, even if that advice is negligent and perhaps worse.”¹

B. In recent years, the SEC has stepped up its enforcement activities by targeting lawyers as “gatekeepers” because they are “paramount in ensuring that [the] markets are clean.”²

C. The SEC believes that targeting gatekeepers is an effective way to deploy its resources.³

D. In light of Sarbanes-Oxley’s focus on the role of lawyers as gatekeepers, the SEC has increased its scrutiny of lawyers in its investigation of corporate frauds.⁴

1. *See* SOX§ 307: Congress authorized SEC to issue rules “setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers.”

¹ Remarks by Giovanni P. Prezioso, SEC General Counsel, at Spring Meeting of the Association of General Counsel on April 28, 2005. Emphasis added. The remarks can be found at www.sec.gov/news/speech/spch042805gpp.htm.

² Speech by SEC staff: Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, “The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program,” UCLA School of Law, Los Angeles, CA (September 20, 2004). The remarks can be found at www.sec.gov/news/speech/spch092004smc.htm.

³ *See id.*

⁴ *See id.*

2. SEC rules were adopted January 29, 2003 (effective August 5, 2003) pursuant to § 307:

a. An attorney subject to SOX generally required to report “evidence of a material violation” by any issuer or any officer, director, employee or agent to the issuer’s Chief Legal Officer (CLO) or to both the CLO and the CEO (commonly referred to as “up the ladder reporting”).

II. Considerations In Enforcement Actions.⁵

A. Conduct v. legal advice: While the SEC maintains it will not sanction lawyers for violating the securities laws merely for giving bad advice, the SEC “will sanction a lawyer for conduct that – if carried out by any other person – would have given rise to an enforcement proceeding.”⁶

B. Another critical question is whether a lawyer is in fact acting as a lawyer or in some other capacity.

C. There is a general awareness that in-house counsel make difficult legal judgments and take legal positions with which SEC staff may not agree.

1. There are two competing policy considerations that drive the debate concerning how the SEC should approach the question of lawyer liability in an enforcement context.

First, many securities law violations could not occur without participation of lawyers, as they often have knowledge sufficient to prevent violations.

Second, the importance of zealous advocacy in securities law proceedings.

D. Some enforcement actions against corporate counsel involve a mixture of conduct and advice, which requires consideration of the following questions:

1. What was the role of the lawyer in the decision making process?
2. Did the lawyer give legal advice on the relevant issue (i.e., did the lawyer “advise anybody about anything”)?
3. What legal judgments were made by the lawyer?

E. The role of the SEC is not to second guess close or difficult judgment calls (although this is obviously a debatable policy statement among those appearing before the SEC).

F. A lawyer may be held accountable for corporate conduct in which he or she participated if, as a securities lawyer, he or she should have known the answer or, as a non-securities lawyer, he or she could not in good faith have failed to seek advice.

⁵ Based on remarks by Mr. Prezioso referenced in footnote 1 above.

⁶ Id.

G. The SEC is less inclined to sanction lawyers who represent clients in connection with an investigation or enforcement proceeding or otherwise in direct representation of the client before the SEC or its staff.

III. Illustrative Enforcement Actions Brought By The SEC.

A. *In the Matter of Google, Inc. and David C. Drummond*, Release No. 33-8523 (January 13, 2005).

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1. The Facts

- Mr. Drummond was General Counsel of Google, Inc.
- Mr. Drummond considered whether the value of company stock option grants exceeded or might exceed the \$5 million threshold set forth in Rule 701, promulgated under the Securities Act of 1933, in which case Google would have been required to disclose financial and other information to option recipients (Google was not willing to disclose this information due to the confidential nature of the information and its concern that the information would reach competitors).
- Mr. Drummond consulted with outside counsel and other attorneys on his staff and concluded that other exemptions from registration might be available, including the exemption set forth in Rule 506 and the exemption set forth in Section 4(2). *Mr. Drummond, however, did not raise the issue or share his analysis with the board of directors.*
- Google granted options with a value far in excess of the \$5 million threshold under Rule 701 but failed to provide the required financial and other information.
- Mr. Drummond later learned that Google had likely exceeded the \$5 million threshold even after taking into account the recipients who qualified under Rule 506; *however, Mr. Drummond erroneously concluded that Google could rely upon Section 4(2) and avoid providing the financial and other information that would otherwise be required under Rule 701 (this conclusion was found to be so egregious in that no informed securities lawyer would have reached this same conclusion).*
- In a later meeting of the board of directors, Mr. Drummond discussed the need for proposed additional stock option plans, *but did not advise the board of directors that the option grants would exceed the \$5 million threshold or the risk that other exemptions might not apply.*

2. SEC's conclusion

- Google violated the registration requirements of the Securities Act.
- Mr. Drummond caused Google to violate the foregoing requirements by failing to advise Google regarding the legal issues related to the option grants.

3. Punishment: cease and desist order against Google and Mr. Drummond.

4. Lessons Learned

- With respect to legal issues that do not involve close or difficult legal judgments, the accuracy of the legal conclusion is a material issue (*e.g.*, Mr. Drummond's conclusion regarding the availability of an exemption under Section 4(2) of the Securities Act was clearly incorrect).
- Corporate counsel must advise the company of difficult or problematic legal issues and disclose the basis for counsel's legal advice and the associated risks.
- Corporate counsel must not make unilateral decisions with respect to difficult or problematic legal issues.
- After initial consultation, corporate counsel should follow up with outside counsel to resolve difficult or problematic issues.
- [NOTE: On July 19, 2007, it was reported that Mr. Drummond and three other former executives of software company SmartForce PLC settled an SEC enforcement action involving claims that they had inflated earnings by \$127 million by paying \$2.3 million in disgorgement, interest, and penalties. Although an attorney, Drummond had served as the SmartForce CFO from June 1999 until January 2002. He then joined Google after leaving SmartForce.]

B. *In the Matter of John E. Isselmann, Jr.*, Release No. 34-50428 (September 23, 2004).

1. The Facts

- Mr. Isselmann was General Counsel of Electro Scientific Industries, Inc. ("ESI").
- The CFO of ESI unilaterally decided to terminate vested retirement and severance benefits owed to employees in Asia (primarily in Japan) so that the company could report a profit rather than a loss for the fiscal quarter ended August 31, 2002;

however, ESI was prohibited by law from unilaterally terminating the benefits.

- At an audit committee meeting to review the quarterly financial results—at which Mr. Isselman was present—the CFO reported to the Committee that the Japanese benefits could be unilaterally terminated and that the decision to eliminate the benefits had been approved by legal counsel; *however, Mr. Isselman had not reviewed or approved the decision.*
- In connection with auditor’s review of financial results, ESI gave the auditors a written memorandum stating that the benefits had been eliminated because ESI was not under any obligation to pay them and that the change was approved by the CFO and CEO of ESI; *Mr. Isselman received a copy of the memorandum but failed to speak to the auditors or inform them that he had not reviewed the issue or engaged outside counsel.*
- Mr. Isselman then asked outside counsel in Japan to analyze the issue; outside counsel informed Mr. Isselman in writing that the benefits could not be unilaterally terminated. *Mr. Isselman, however, did not convey this information to ESI’s auditors or the audit committee.*
- Mr. Isselman tried to raise the issue in a disclosure committee meeting (held to review the upcoming Form 10-Q), but the CFO objected and *Mr. Isselman did not raise the issue or provide Japanese counsel’s written legal advice to the participants in the meeting*; after the meeting, Mr. Isselman provided the written legal advice to the CFO.
- Before the Form 10-Q was filed, a member of the audit committee asked Mr. Isselman about the language describing the elimination of the benefits and the resulting accounting entry, *but Mr. Isselman did not convey Japanese counsel’s advice to the member.*
- Mr. Isselman later learned that the CFO had eliminated the benefits due to an accounting error that had negatively impacted earnings; an internal investigation was performed and ESI restated its financial results for the quarter ended August 31, 2002. The restatement revealed that ESI’s originally reported net income was overstated by 28%.

2. SEC’s conclusion: Mr. Isselman’s failure to convey written legal advice concerning the elimination of the Japanese retirement and severance benefits was the *cause* of ESI filing a materially false and misleading Form 10-Q.

3. Punishment: Cease and desist order and \$50,000 civil penalty.

4. Lessons Learned

- Corporate counsel must respond to red flags, speak up and convey legal advice to the appropriate persons.
- Corporate counsel must fully respond to questions from the board of directors and board committees regarding legal issues that are raised.
- Simply passing along legal advice to one executive is not enough when the issue is one that should be addressed by the board of directors or a particular committee.

C. *In the Matter of Ira Weiss*, Release No. 33-8641 (December 2, 2005) (although this action was brought against outside counsel, it highlights a possible departure by the SEC from longstanding enforcement policy and warrants the attention of in-house counsel as well).

1. The Facts

- Mr. Weiss served as bond counsel for a school district.
- The school district issued \$9.6 million in general obligation notes.
- Mr. Weiss reviewed and approved the offering documents and rendered an unqualified opinion that the interest on the notes would be exempt from federal income tax.
- The IRS later determined that the interest on the notes was taxable.

2. SEC's legal conclusion: Mr. Weiss's conduct "was at least negligent" and Mr. Weiss was responsible for misrepresentations and omissions in the offering documents and his legal opinion

- Mr. Weiss knew or should have known that the offering was intended to earn profits rather than construct projects as required by the applicable tax laws.
- Mr. Weiss failed to conduct adequate due diligence to determine the level of certainty of the school district's construction projects, the timeline for the projects and the costs associated with the projects, all of which are important considerations in determining whether the interest on a note will be tax-exempt.
- Mr. Weiss mischaracterized some of the requirements of the applicable tax laws and failed to adequately advise the school board regarding all of the requirements.

- The “Non-Arbitrage Certificate” prepared in connection with the legal opinion was short on relevant facts, including estimated project costs.
3. Punishment: cease and desist order and disgorgement of legal fees earned in connection with the offering.
 4. Lessons Learned
 - Although the action was brought against outside counsel, in-house counsel should be mindful that an SEC enforcement action for securities law violations may be based on mere negligence, a practice which appears to be a departure from longstanding SEC policy.
 - It is dangerous to render legal advice or a legal opinion without an understanding of the facts upon which the advice or opinion is based.
 5. Troubling aspects of decision
 - This enforcement action may represent a departure from longstanding SEC enforcement policy towards attorneys.
 - Not only is the action a possible departure from prior policy, it suggests that the SEC staff may investigate and bring enforcement actions against attorneys if their negligence causes a violation of the securities laws.

D. *In the Matter of Scott G. Monson*, Release No. 28323 (June 30, 2008).

1. The Facts

- Mr. Monson was the former general counsel of broker-dealer JB Oxford & Company.
- JB Oxford was found to have facilitated thousands of late trades in over 600 mutual funds for several institutional clients in 2002 - 2003, in violation of Rule 22c-1 of the Investment Company Act of 1940, which requires funds, their principal underwriters, dealers, and others authorized by the funds' prospectuses to consummate transactions in the funds to sell and redeem shares at a price based on the current net asset value ("NAV") next computed after receipt of an order to buy or redeem.
- Monson was alleged by the SEC to be the cause of the foregoing violations because of his role in drafting a "Mutual Fund Procedural Agreement" that permitted certain institutional clients of the firm to effect mutual fund trades after 4:00 p.m. Eastern

time (and receive the same day NAV, even though fund NAV is calculated at 4:00 p.m. daily) - i.e., engage in "late trading."

- Monson explained that he did not have much of a securities enforcement/compliance background and drafted the agreement in question based on a sample "template" agreement provided to him by one of JB Oxford's institutional customers.

2. SEC conclusion: proceedings against Monson dismissed (the same result reached by the administrative law judge below).

- SEC concerned that the enforcement allegations - that Monson departed from professional standards of competence *in rendering private legal advice to his client* - raise the risk of interfering with a lawyer's ability to provide unbiased, independent legal advice regarding the securities laws.
- SEC explained, "As far as we are aware, we have not sanctioned attorneys in litigated enforcement proceedings based on alleged negligent acts or omissions they may have committed in providing non-public legal advice to clients."
- However, the SEC went on to say, "This is not to say that lawyers have fallen outside the Commission's regulatory purview. To the contrary, the Commission has established that it will pursue cases against lawyers who allegedly violate the securities laws with scienter, render misleading opinions *used in public disclosures* [citing to *In the Matter of Ira Weiss*] or engage in conduct that would render a non-lawyer liable for the same activity under comparable circumstances (citations omitted)."

3. Lessons Learned

- Again, an SEC enforcement action against a lawyer may be based on mere negligence depending on the circumstances. Monson got a pass in the end based on the facts of his case, but others may not be so fortunate.

IV. **Criminal Prosecution Of In-House Attorney: *U.S. v. Black, et al* (N.D. Ill.).**

A. Background.

- Approximately \$84 million in payments from the sale of various subsidiary companies were characterized as non-competition payments or management break up fees and diverted, directly and indirectly, to executive officers of Hollinger International, Inc. ("Hollinger") rather than being paid to Hollinger itself.

- The payments made directly or indirectly to the executive officers were made at the request of the executive officers and not the purchasers.
- One purchaser was controlled by executive officers of Hollinger, resulting in payments being made to the executive officers not to compete with themselves.
- Some of the diverted payments were used to repay a debt owed by the holding company (which was controlled by certain executives) to Hollinger, resulting in the “round tripping” of the funds.
- Executive officers also mischaracterized certain bonus payments as non-competition payments.
- Criminal charges were filed against the executive officers to whom the payments were directly or indirectly made (and an entity controlled by some of the executive officers) *as well as the general counsel of Hollinger, Mark Kipnis.*
- Mr. Kipnis was indicted on nine counts of mail and wire fraud.
- For each count of the indictment, Mr. Kipnis faced a maximum penalty of five years and a \$250,000 fine (or, if greater, a fine equal to twice the gross profit to any defendant or twice the loss to any victim, whichever is greater).
- *Mr. Kipnis did not receive any of the diverted payments, but participated in reviewing and finalizing the transactions and signing documents on behalf of Hollinger; Mr. Kipnis also participated in the diversion of funds to the executive officers.*
- *Mr. Kipnis failed to disclose the related party transactions to the audit committee or independent directors; when certain payments were disclosed to the audit committee, board of directors or shareholders, the disclosure was false, incomplete and misleading; Mr. Kipnis prepared memorandum for the audit committee that were false and misleading in several respects.*
- On July 13, 2007, Mr. Kipnis was found guilty of three counts of mail and wire fraud.
- After the conclusion of the trial, one juror, in a press interview, explained the guilty verdict as to Kipnis: "We definitely came to the conclusion that he did know what was going on...he got himself into something and then couldn't find a way out...As much as you need to follow directions and do your job, if something doesn't seem right to you, you have to speak up or not do it."
- On December 10, 2007, Kipnis was sentenced to 5 years probation, 6 months home detention, and 275 hours of community service.

- During sentencing, the judge called Kipnis "clearly the least culpable person in this scheme." Kipnis was the only Hollinger executive to avoid prison time or a fine.

B. The Government's Position Regarding Mr. Kipnis' Conduct: "As [Hollinger]'s in-house attorney, Kipnis had a fiduciary duty of undivided loyalty to [Hollinger], which among other things, required Kipnis to disclose all material facts regarding all related party transactions to [Hollinger's] Audit Committee, and to refrain from assisting others in any breach of fiduciary duty against [Hollinger]."⁷

C. Lessons Learned.

- Corporate counsel must ensure that related-party transactions are disclosed to the appropriate committees and directors and that all disclosures regarding the transactions are accurate and complete.
- Corporate counsel may be *criminally liable* for even minimal participation (i.e., merely "going along") in fraudulent schemes whether or not counsel personally benefits from such schemes.

V. **Criminal Prosecution Of In-House Attorney: *U.S. v. Ferguson, et al (D. Conn.)*.**

- Robert D. Graham, a senior vice president in the law department of General Reinsurance Corporation, where he had worked since 1986, was indicted September 20, 2006, along with several other General Re executives, for conspiracy, securities fraud, making false statements to the SEC, and mail fraud.
- Graham was an insurance and regulatory expert and, among other duties, was responsible for General Re's SEC reporting.
- The prosecution stemmed from a fraudulent reinsurance contract, prepared in part by Graham, between American International Group and General Re designed to augment AIG's loss reserves by \$500 million in late 2000 and early 2001.
- On February 25, 2008, the jury found all defendants guilty.
- Graham currently is awaiting sentencing; at a hearing on October 9, 2008 the government urged the court to sentence Graham to over 200 years behind bars.

VI. **Criminal Prosecutions Of In-House Counsel Stemming From Stock Option Backdating Scandal.**

- William F. Sorin, General Counsel, Converse Technology, Inc. In November 2006, Mr. Sorin pleaded guilty to conspiracy to commit mail

⁷ Second Superseding Indictment at 5, United States v. Black, No. 05 CR 727 (N.D. Ill. Dec. 15, 2005), 2005 WL 3874321.

fraud, securities fraud, and wire fraud. Mr. Sorin thereafter paid a \$3.1 million fine to settle SEC charges that he conspired with the company's CEO and CFO to improperly backdate stock options. Earlier this spring, Mr. Sorin was sentenced to a year and a day in prison, followed by three years of supervised release. He also was ordered to pay \$51.8 million in restitution.

- Myron Olesnyckyj, General Counsel, Monster Worldwide, Inc. In February 2007, Mr. Olesnyckyj pleaded guilty to conspiracy and securities fraud relating to backdating stock options. An SEC enforcement action was simultaneously brought against Mr. Olesnyckyj.
- Kent H. Roberts, General Counsel, McAfee, Inc. In February 2007, Mr. Roberts was indicted for criminal fraud arising out of allegations that he manipulated his own stock option grant to increase its value and then hid his actions even as he recommended that another employee lose his job for separate options backdating transgressions. An SEC enforcement action was also commenced against Mr. Roberts.
- Kenneth I. Selterman, General Counsel, Take-Two Interactive Software Inc. On June 6, 2007, Mr. Selterman pleaded guilty to second degree falsifying business records in New York State Court in Manhattan stemming from the Company's improper backdating of stock options. Mr. Selterman will pay a \$50,000 fine, and be sentenced to probation and 200 hours of community service. Mr. Selterman also disgorged his profits from misdated options grants in a settlement with the Company.

VII. Other Notable SEC Actions.

- In re Woghin, Release No. 34-50653 (November 10, 2004) (participation in preparing false and misleading financial statements; backdating contracts; obstruction of justice).
- In re Orlick, Release No. 34-51081 (January 26, 2005) (participation in preparing false and misleading financial statements; signing false management representation letters).
- SEC v. Symbol Tech., No. 04CV2267, Securities and Exchange Commission Litigation Release No. 19585, 2006 SEC LEXIS 468, *2-3 (E.D.N.Y. Mar. 2, 2006) (alteration of exercise dates of stock options; the in-house counsel also pled guilty to criminal charges).

VIII. Recent Settlement With New York Attorney General.

- On October 7, 2008, David Aufhauser, (until recently) the general counsel of UBS AG, agreed to pay \$6.5 Million to settle insider trading claims stemming from the collapse of the auction rate securities market.

- Under the settlement, Aufhauser will be barred for two years from working with any company involved in the securities industry, from practicing law in New York and from serving as a director or officer of any public company.
- Aufhauser was accused of instructing his stockbroker to dump \$250,000 in auction rate securities shortly after receiving an email from UBS' chief risk officer that outlined the problems facing the auction rate securities market.



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Joel Hoxie has experience representing clients in all areas of civil litigation, including commercial and professional liability litigation. His practice emphasizes corporate, securities, banking, unfair competition, contract, business tort, racketeering, and real estate litigation, and arbitration.

Professional Recognitions & Awards

Southwest SuperLawyer, Law & Politics Magazine (2007-2008)

The Best Lawyers in America® (2007-2009)

Professional Memberships & Activities

State Bar of Arizona

American Bar Association

Maricopa County Bar Association

Arizona Bar Foundation, Fellow

Arizona Association of Defense Counsel

Securities Industry Association, Compliance and Legal Division

International Association of Defense Counsel

Other Professional Experience

Faculty member and author on national, state, and local continuing legal education programs.

Education

University of Iowa
College of Law (J.D.,
with high distinction,
1978)

Order of the Coif
Princeton University
(A.B., Politics, *cum
laude*, 1971)

Court Admissions

Supreme Court of
Arizona

United States Court of
Appeals, Ninth Circuit

United States Court of
Appeals, Tenth Circuit

United States District
Court, District of Arizona

