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SEC Sets Standards For Imposing Corporate Penalties

By William F. Sullivan and Morgan J. Miller

On January 4, 2006, a unanimous Securities and Exchange Commission led by recently appointed Chairman, Christopher Cox, announced principles governing when and how it will impose financial penalties on companies.[1] In making penalty determinations, the SEC principally will consider whether the securities violation resulted in a direct benefit to the corporation, and the degree to which the penalty will compensate or further harm injured shareholders. The guidelines were said to bring "clarity, consistency and predictability" to the SEC's enforcement efforts. By way of example, the SEC concurrently announced the terms of its settlements with large California software manufacturer McAfee, Inc., in which it assessed a $50 million penalty, and the much smaller software manufacturer Applix, Inc., which did not require a money payment.[2]

This announcement comes at a time companies are still reeling from the recent trend of record breaking penalties sparked by the SEC's then-unheard of $10 million penalty levied against Xerox in 2002, and followed by numerous penalties in excess of $100 million spanning the last four years, including the $750 million penalty imposed on WorldCom.[3] Limited solely to corporations, the guidelines do not apply to individuals or regulated entities, such as self-regulatory organizations, broker-dealers and mutual funds, where recent penalties also reached unprecedented levels. While the SEC has not signaled a shift in its controversial campaign of very large monetary penalties, which some view as harming innocent shareholders, the SEC acknowledged its recent cases have not produced a clear view of its use of corporate penalties. Large penalties, the SEC urges, are required to effectuate an appropriate level of deterrence, especially where the conduct is difficult to detect.

The vast majority of SEC penalties against corporations are imposed in settled proceedings, and are often subject to considerable discretion by the SEC and its staff. While the SEC's determination concerning the appropriateness of a penalty is not binding on a corporation, companies often face no choice but to cooperate and attempt settlement, rather than turn to the uncertainty of litigation where the stakes are often overwhelmingly high for corporate officers and directors. In addition to penalties, settling corporations often face court orders to pay disgorgement of ill gotten gains and injunctions from future securities law violations or similar administrative cease and desist orders.

Penalty Considerations

The Commission identified two principal considerations for determining corporate penalties:

Whether the corporation received a direct benefit as a result of the volatile conduct. The Commission cited a corporation's direct and material benefit from the offense, or otherwise unjust enrichment, heavily supports a corporate penalty. Specifically, the strongest case for a penalty arises where the shareholders of the corporation received an "improper benefit" as a result of the offense. In contrast, the weakest case is described as one in which the shareholders are the principal victims of the violation. This factor implicitly recognizes that the shareholders have benefited indirectly from the offense and so a penalty does not harm shareholders.

The degree to which the penalty will recompense or further harm the injured shareholders. The Commission found the ability to use a penalty as a source of funds to compensate injured shareholders also supports imposition of a penalty. The likelihood, however, that a corporate penalty would "unfairly injure investors, the corporation, or third parties weighs against its use as a sanction." Section 308 of the Sarbanes-Oxley Act of 2002 (the Fair Funds provision) permits the Commission to collect penalties paid by individuals and entities and disburse those monies along with disgorgement funds to victims.

The Commission also set out seven additional factors properly considered in determining whether to impose a penalty on a corporation:

The need to deter the particular type of offense. The likelihood that the penalty will act as a strong deterrent to others also impacts the SEC's penalty determination. Conduct likely to be repeated by those involved or others similarly situated is a factor favoring a penalty.

The extent of the injury to innocent parties. The SEC will consider the egregiousness of the harm, the number of victims, and the extent of "societal harm" if the conduct goes unpunished.

Whether complicity in the violation is widespread throughout the corporation. The pervasiveness of the violation within the corporation also favors use of a penalty. The SEC indicated it is more inclined to seek a corporate penalty where the violations are widespread within the organization as opposed to the isolated conduct of few individuals. The SEC will also consider whether the corporation has taken appropriate employment action against culpable individuals.

The level of intent on the part of the perpetrators. The SEC will more likely impose a penalty where the conduct at issue was deliberate and evidenced fraudulent intent by the perpetrators.

The degree of difficulty in detecting the particular type of offense. The SEC deems offenses that are particularly difficult to detect require penalties to effectuate appropriate deterrence.

Presence or lack of remedial steps by the corporation. Prompt remedial action by management will weigh against the use of a penalty. In contrast, the SEC states it is more inclined to insist upon a penalty where management fails to take appropriate remedial steps.

Extent of cooperation with Commission and other law enforcement. Consistent with the SEC's previously stated factors in the Seaboard matter for evaluating a corporation's cooperation with its investigation,[4] the SEC's penalty determinations also depend upon the degree to which a corporation self-reports the offense and otherwise cooperates with the investigation and remediation.

Case Study: McAfee and Applix

In announcing its policy, the Commission compared its concurrently filed settlements with McAfee and Applix. McAfee, formerly known as Network Associates, Inc., agreed to pay a $50 million penalty to settle the SEC's claims, while Applix settled with the Commission by agreeing to undertake certain remedial actions but was not required to pay any money. Both cases were settled by the companies without admitting or denying the Commission's allegations.

According to the SEC's complaint, McAfee fraudulently overstated its revenues to meet projections and earnings targets. Linda Thomsen, the SEC's Director of Enforcement, described McAfee's conduct as "egregious and pervasive."[5] McAfee's former chief financial officer and controller were alleged to have directed the fraud, which was concealed through secret payments, the creation of wholly-owned subsidiaries, false entries on McAfee's books and records, and manipulation of reserve accounts. McAfee also purportedly used its overvalued stock to acquire other companies. McAfee consented to the entry of a court order enjoining it from future violations of the federal securities laws, and ordering it to pay a $50 million civil penalty.

Applix, a much smaller software company, allegedly recognized software licensing revenue in one transaction upfront in order to meet previously announced revenue goals. According to the Applix complaint, the agreement included a right to resell a future product in development, which required revenue to be recognized ratably over the term of the contract. In another transaction, the SEC contends Applix recognized revenue for a contract even though the customer had not accepted the product. As a result, Applix purportedly understated its net loss for the quarter by over 30%. As part of its settlement with the Commission, Applix agreed to continue to cooperate with the SEC staff's investigation, and retain through its board of directors an independent financial consultant to review and strengthen its financial and accounting policies and procedures. The Commission is continuing to pursue its action and seeks to impose penalties against Applix's former Chief Executive Officer, Chief Financial Officer and Director of Worldwide Operations.

To illustrate the differing penalty determinations, Enforcement Director Thomsen pointed out that while McAfee benefited from its conduct through acquisitions using its overvalued stock, Applix did not similarly benefit and there were no direct benefits to its shareholders. The larger McAfee also was deemed financially strong and the agreed penalty was unlikely to cause McAfee shareholders undue hardship. On the other hand, a large financial penalty imposed upon the much smaller Applix would cause a disproportionate effect on the company's financial condition, largely to the detriment of its shareholders. The Commission also anticipated penalty monies could be effectively distributed to McAfee shareholders injured by the fraud, while it was thought impractical to impose a penalty large enough upon Applix to make a distribution without causing undue harm to the company and its shareholders. Finally, in McAfee, the SEC pointed to pervasive conduct that spanned a significant time period, in contrast to the limited conduct in Applix.

Commentary

It remains unclear whether the guidelines signal an end or even a dampening of the recent trend of megafines. The guidelines seem consistent with the SEC's enforcement practices since the Xerox settlement in 2002, and the staff's resolve to impose harsh penalties appears intact. The Commission appropriately recognized that corporate penalties carry the risk of subjecting innocent shareholders to bear the brunt of the punishment. Critics of SEC penalties, however, will continue to contend that even where corporate penalties are distributed to injured investors, it is often a cost paid for by a corporation's current and equally innocent shareholders. Nevertheless, demystifying the penalty process and providing clear examples of penalty determinations is a step in the right direction.

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Notes:

1. *Statement of the Securities and Exchange Commission Concerning Financial Penalties,* Release No. 2006-4 (January 4, 2006).
2. *Securities and Exchange Commission v. McAfee, Inc.*, Civil Action No. 06-009 (PJH) (N.D. Cal.) (January 4, 2006); SEC Litigation Release No. 19520 (January 4, 2006); *In the Matter of Applix, Inc.,* Exchange Act Release No. 53049 (January 4, 2006); SEC Litigation Release No. 19521 (January 4, 2006).
3. *See, e.g., Securities and Exchange Commission v. Xerox Corporation,* Litigation Release No. 17465 (April 11, 2002) ($10 million); *Securities and Exchange Commission v. Computer Associates International, Inc.,* Litigation Release No. 18891 (September 22, 2004) ($221 million); *Securities and Exchange Commission v. WorldCom, Inc.,* Litigation Release No. 18210 (July 2, 2003) ($750 million); *Securities and Exchange Commission v. Qwest Communications International Inc.,* Litigation Release No. 18936 (October 21, 2004) ($250 million); *Securities and Exchange Commission v. Royal Dutch Petroleum Company and The "Shell" Transport and Trading Company,* Litigation Release No. 18844 (August 24, 2004) ($120 million); *Securities and Exchange Commission v. Time Warner Inc.,* Litigation Release No. 19147 (March 21, 2005) ($300 million).
4. *In the Matter of Gisela de Leon-Meredith,* Exchange Act Release No. 44969 (October 23, 2001) (identifying several factors the SEC will use to determine how to credit companies for their affirmative efforts in connection with the discovery and remediation of misconduct).
5. Speech by SEC Staff: Statement Regarding McAfee, Inc. and Applix, Inc. by Linda Thomsen, Washington, DC (January 4, 2006); Speech by SEC Chairman: Statement of Chairman Cox Concerning Objective Standards For Corporate Penalties, Washington, DC (January 4, 2006).