January 7, 2006

Corporate Penalty Guidelines

On January 4, 2006, the Securities and Exchange Commission issued an important statement that discusses the guidelines that it will use in determining whether to impose financial penalties on corporations and, if so, how large those penalties should be.[1] In its statement, the SEC concluded that the appropriateness of a penalty turns principally on two considerations: first, the presence or absence of a direct benefit to the corporation as a result of the violation, and, second, the degree to which the penalty will either recompense or further harm the injured shareholders.[2]

Regarding the first, or corporate benefit, consideration, the SEC concluded that the strongest case for imposition of a corporate penalty is one in which the shareholders of a corporation have received an improper benefit as a result of the violation while the weakest case is one in which the current shareholders of the corporation are the principal victims of the violation. The more the corporation is enriched, the more a penalty is appropriate, whereas less enrichment should result in a lower penalty. For those cases in which the corporation loses rather than gains money, there will be a strong argument that penalties should not be imposed.

Regarding the second, or shareholder harm, consideration, the SEC concluded that innocent shareholders of the subject corporation should not unfairly bear the burden of a penalty. The likelihood that a corporate penalty will unfairly injure investors, the corporation or third parties weighs against a penalty, while the opportunity for a penalty to be a meaningful source of compensation for injured shareholders weighs in the opposite direction. Much will depend on how the SEC applies this consideration's balancing test when a large penalty will unfairly harm a corporation but will also recompense injured shareholders.

After discussing these two principal considerations, the SEC identifies seven "additional factors that are properly considered" in determining whether to impose a corporate penalty:

1. The likelihood that a corporate penalty will serve as a strong deterrent to others weighs in favor of a penalty, while circumstances making the offense unlikely to be repeated weigh against.

2. The greater the harm done to investors and others, the more likely a corporate penalty is appropriate.

---

[1] SEC Statement of the Securities and Exchange Commission Concerning Financial Penalties available at http://www.sec.gov/news/press/2006-4.htm.

[2] The SEC enunciated its framework for penalty determinations in the context of two sources of statutory authority: the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 and Section 308 of the Sarbanes-Oxley Act of 2002 (the Fair Funds provision). The former gave the SEC authority generally to seek civil money penalties, including from corporate issuers, in enforcement cases. The latter allows the SEC to use penalties paid and disgorgement obtained in enforcement actions to compensate victims of securities law violations.

3. The more widespread the participation in the offense within the corporation the more likely a corporate penalty is appropriate.

4. The more egregious the level of culpability and fraudulent intent the more likely a corporate penalty is appropriate. A corporate penalty is less likely if there is no "deliberate intentionally fraudulent conduct."

5. The greater the degree of difficulty in detecting a particular type of offense, the more likely a corporate penalty is appropriate, because an especially high level of deterrence is important for such offenses.

6. The failure of management to take remedial steps weighs in favor of a corporate penalty, while exemplary conduct by management in this respect weighs against a penalty.

7. The failure of management to report offenses that have been discovered and to cooperate with the SEC weighs in favor of a corporate penalty, while self-reporting such offenses and otherwise cooperating with the investigation and remediation of the offense weigh against such a penalty.

The SEC issued the guidelines at the same time that it announced two settlements, each involving fraud charges related to improper revenue recognition. In one, *SEC v. McAfee, Inc.*, the SEC alleged that the conduct lasted for over 18 months and was egregious and pervasive, having involved the company's CFO and Controller who were criminally charged, as well as a variety of secret payments, false entries, manipulation of reserve accounts and creation of a subsidiary to further the fraud. McAfee used its stock, overvalued because of the fraud, to acquire other companies thus benefiting its shareholders. McAfee agreed to an injunction and a $50 million civil penalty.

In the second case, *In the Matter of Applix, Inc.*, the improper revenue recognition involved only two transactions, each of which allowed Applix to meet revenue goals and to understate its net loss for the period. Applix agreed to a cease and desist order and retention of a consultant to review its policies and procedures with no civil penalty.

SEC Chairman Christopher Cox and Enforcement Division Director Linda Chatman Thomsen commented on the cases and provided gloss on the guidelines. Chairman Cox made two key points in his remarks. First, he served notice that the $50 million penalty in McAfee should not be seen as unusual but instead as a typical penalty in a serious case as the SEC sees the use of its penalty authority. Second, the Chairman emphasized the "key question" in applying the new guidelines would be "whether an issuer's violative action resulted in benefit or harm to the shareholders."

Chairman Cox concluded that on the one hand it is important to punish, deter and remedy harm to shareholders, all long-held goals of the SEC. He also concluded, however, and this is the perspective the guidelines add to prior SEC practice, that it is important "not to compound the harm already caused to investors" by levying penalties which take from a corporation and its shareholders value far beyond any benefit to the corporation in the matter.

In her remarks, Division Director Thomsen pointed out how the guidelines were applied to McAfee and Applix. She made four points. First, she said that McAfee benefited from its conduct, especially through acquisitions made with inflated stock, while Applix did not. Second, she said McAfee is financially strong and so its shareholders will suffer no undue hardship from the penalty, while Applix is a small company on which a large penalty could have a disproportionate effect with hardship to its shareholders. Third, she said the McAfee penalty money could be effectively distributed to injured shareholders, while in Applix it would be difficult to impose a penalty large enough to make distribution to victims practical without causing undue harm to the company and its current shareholders. Fourth, she pointed out that in McAfee the conduct was pervasive while in Applix it was not.

Of note in Ms Thomsen's remarks is that the financial health and size of the subject corporation are important to the calculus. Thus, in weighing harm to the subject corporation and its shareholders under the guidelines, she would consider size and success of the corporation. Even a large penalty in excess of any benefit to the corporation may not be viewed as causing undue harm to the shareholders of the corporation if it amounts to only a diminution in the value of a still-successful company.

The SEC's new guidelines do not mark a clear departure from current practice. Most of the considerations set forth in them are already part of the dialogue with SEC Staff in every settlement discussion. However, the guidelines create as a core consideration in determining whether a corporate penalty is appropriate the question of harm to the corporation's shareholders. Much will depend on how the guidelines are interpreted in practice, but this new emphasis on unfair harm that a large penalty may cause to a corporation's shareholders is a welcome addition to dialogue with the SEC and its Staff.

Bruce A. Baird
David B.H. Martin

* * *

This information is not intended as legal advice, which may often turn on specific facts. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our securities and white collar practice groups:

Bruce Baird	202.662.5122	bbaird@cov.com
David Martin	202.662.5128	dmartin@cov.com