

2016 Business Law Institute

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Presenter Biographies

2016 Business Law Institute

Presenter Biographies

William Slease is Chief Disciplinary Counsel for the New Mexico Supreme Court Disciplinary Board. In addition to his duties as Chief Disciplinary Counsel, he serves as an adjunct professor at the University of New Mexico School of Law where he has taught employment law, ethics and trial practice skills. He also chairs the Supreme Court of the State of New Mexico's Lawyer's Succession and Transition Committee and serves on the State Bar of New Mexico Professionalism Commission which is responsible for operating and administering the "Bridge the Gap: Transitioning Into the Profession Program" for new lawyers in New Mexico. He is a member and the 2016-17 President of the National Organization of Bar Counsel.

Heather Travis Boone is Chief Regulatory Compliance Officer for the New Mexico Finance Authority. Ms. Boone has 15 years' experience representing financial institutions and previously served as Chief Legal Officer and a General Counsel for Los Alamos National Bank. Ms. Boone is a graduate of Trinity University in San Antonio, Texas and Washington & Lee University School of Law in Lexington, Virginia.

Thomas D. Walker is a shareholder in the Albuquerque law firm of Walker & Associates PC where he concentrates his practice in the areas of bankruptcy law, commercial litigation and real estate law. He regularly represents businesses, individuals, committees and trustees in bankruptcy cases, and represents parties in business litigation and transactions, foreclosure actions, workout negotiations, real estate and lease negotiations and other commercial matters. Walker speaks frequently on bankruptcy and other business litigation topics. He received an undergraduate degree in economics from Tulane University in 1981, attended the Institute of Political and Economic Studies in London, and received his J.D. degree from the University of New Mexico School of Law in 1985. He has been a member of the State Bar of New Mexico since 1985 and is a member of the U.S. District Court for the District of New Mexico and Tenth Circuit Court of Appeals. He is past chair of the Bankruptcy Law section of the State Bar of New Mexico, and has served on its Board of Directors since 1990.

Chris M. Gatton is a shareholder in the Albuquerque-based law firm of Giddens, Gatton & Jacobus, P.C. His practice focuses on bankruptcy law, representing debtors, creditors, a chapter 7 trustee, and unsecured creditor committees in all chapters of bankruptcy and in bankruptcy litigation. He is a 2009 graduate of the University of New Mexico School of Law, where he received the 2009 Medal of Excellence in Bankruptcy from the American Bankruptcy Institute. Chris is admitted in the State of New Mexico and the U.S. District Court, District of New Mexico. He holds memberships in the American Bar Association, the Albuquerque Bar Association, and the National Association of Consumer Bankruptcy Attorneys. He also served on the Bankruptcy Local Rules Committee for the most recent revisions to the Local Bankruptcy Rules. Chris has been named a Rising Star for 2015 and 2016 in the area of Business Bankruptcy in the Southwestern SuperLawyers edition. Giddens, Gatton & Jacobus, P.C., is an AV® Preeminent firm, peer rated for the highest level of professional excellence.

Olsi Vrapi is the managing partner at Noble & Vrap*i* P.A. He was born and raised in Albania and came to the U.S. as a student in 1999. Mr. Vrap*i* graduated Magna Cum Laude from the University of New Mexico with a degree in Political Science and Spanish in 2003. He graduated Cum Laude from the UNM School of Law in 2006. Mr. Vrap*i* started his career in immigration law in 2003. He has been a licensed attorney since April 2007. Mr. Vrap*i* is a member of AILA (American Immigration Lawyers Association) and is heavily involved in AILA's activities to promote the interests of immigrants in the U.S. Mr. Vrap*i* has served in various capacities at AILA such as a member of the Amicus Committee, Publications Board, EOIR National Liaison Committee, and Chair of Annual Conference. Mr. Vrap*i* is fluent in Spanish, Albanian, Italian, and has good knowledge of French.

Sarah Thomas of Noble & Vrap*i*, P.A. in Albuquerque, specializes in business immigration, including employment-based immigration and I-9 compliance. Ms. Thomas has experience with strategic immigration planning for U.S. and international companies and the international relocation of personnel both from and into the United States. She works with clients to address the visa and work authorization needs of U.S. and global personnel, including professionals, managers and executives, treaty investors/traders, essential workers, persons of extraordinary ability, corporate trainees, and students. With I-9 compliance, Ms. Thomas assists companies in drafting employment verification compliance policies as well as with training sessions, internal audits, and representation in government audits and inspections. She is also a member of the American Immigration Lawyers Association. Ms. Thomas received her B.A., *summa cum laude*, from the University of New Mexico and her J.D., *cum laude*, from the UNM School of Law.

Tom Dean is of Counsel to Miller Stratvert P.A. in Albuquerque. He practices primarily in the areas of health care regulation, Medicare compliance, and the HIPAA Privacy Rule. He has been General Counsel to several health systems, and involved in mergers and acquisitions, joint ventures among healthcare systems, development of an ACO; analysis of business relationships with medical staff members, design of several Medicare compliance programs, review and updating of medical staff bylaws and peer review process, and negotiation of settlements with the OIG for the Centers for Medicare and Medicaid Services.

Victor P. Montoya is a Principal and the Office Litigation Manager in the Albuquerque, New Mexico, office of Jackson Lewis P.C. He is a Certified Employment and Labor Law Specialist by the New Mexico State Bar's Board of Legal Specialization. Mr. Montoya's practice focuses on advising employers and representing them in litigation regarding federal and state laws related to employment, unemployment, wage, disability, and civil rights issues, including Title VII of the Civil Rights Act, the ADA, the ADEA, the FLSA, the FMLA, USERRA, the New Mexico Human Rights Act, and the New Mexico Minimum Wage Act. Mr. Montoya advises employers regarding employment practices and policies, handbooks, hiring, terminations, trade secrets, and employment contracts. Mr. Montoya also practices alternative dispute resolution and received his mediator certification from the University of New Mexico, School of Law in 1999. While attending law school, he served as Managing Editor of the *U.C. Davis Law Review*.

Ethics-Know Your imitations

16-101 . Competence.

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation.

Committee commentary. —

Legal Knowledge and Skill

[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter, and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

[2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

[3] In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

[4] A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an unrepresented person. See also Rule 16-602 NMRA of the Rules of Professional Conduct.

Thoroughness and Preparation

[5] Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 16-102(C) NMRA of the Rules of Professional Conduct.

Retaining or Contracting With Other Lawyers

[6] Before a lawyer retains or contracts with other lawyers outside the lawyer's own firm to provide or assist in the provision of legal services to a client, the lawyer should obtain informed consent from the client and must reasonably believe that the other lawyers' services will contribute to the competent and ethical representation of the client. See also Rules 16-102 (allocation of authority), 16-104 (communication with client), 16-105(E) (fee splitting), 16-106 (confidentiality), and 16-505(A) (unauthorized practice of law) NMRA of the Rules of Professional Conduct. The reasonableness of the decision to retain or contract with other lawyers outside the lawyer's own firm will depend upon the circumstances, including the education, experience, and reputation of the nonfirm lawyers, the nature of the services assigned to the nonfirm lawyers, and the legal protections, professional conduct rules, and ethical environments of the jurisdictions in which the services will be performed, particularly relating to confidential information.

[7] When lawyers from more than one law firm are providing legal services to the client on a particular matter, the lawyers should consult with each other and the client about the scope of their respective representations and the allocation of responsibility among them. See Rule 16-102 NMRA of the Rules of Professional Conduct. When making allocations of responsibility in a matter pending before a tribunal, lawyers and parties may have additional obligations that are a matter of law beyond the scope of these rules.

Maintaining Competence

[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject. If a system of peer review has been established, the lawyer should consider making use of it in appropriate circumstances.

[Adopted by Supreme Court Order No. 08-8300-029, effective November 3, 2008; as amended by Supreme Court Order No. 13-8300-038, effective December 31, 2013; as amended by Supreme Court Order No. 15-8300-007, effective December 31, 2015.]

COMPILER'S ANNOTATIONS

The 2015 amendment, approved by Supreme Court Order No. 15-8300-007, effective December 31, 2015, revised the committee commentary to add the provisions relating to retaining or contracting with lawyers outside the lawyer's own firm to assist in the provision of legal services; in Paragraph 5, after "See", deleted "Paragraph C of Rule 16-102 NMRA" and added "Rule 16-102(C) NMRA"; added Paragraphs 6 and 7; and redesignated former Paragraph 6 as Paragraph 8.

Failure to investigate constitutes incompetent representation. — An attorney's failure to investigate the factual basis of his client's case, the legal basis for the claim or the applicable statute of limitations violated this rule and constituted incompetent representation warranting public censure pursuant to Rule 17-206(A)(4) NMRA. *In re Reid*, 1993-NMSC-055, 116 N.M. 38, 859 P.2d 1065.

Defense counsel's failure to tender proper jury instructions amounted to ineffective assistance of counsel. *State v. Talley*, 1985-NMCA-058, 103 N.M. 33, 702 P.2d 353.

Abandonment of client warrants suspension. — If an attorney abandons his client and the client's case, despite his having been paid a substantial fee, he violates this rule (former Rule 6-101 NMRA) and the violation warrants suspension. *In re Chowning*, 1983-NMSC-085, 100 N.M. 375, 671 P.2d 36.

Attorney was publicly censured and placed on probation for one year for his failure to file client's claim prior to running of statute of limitations, for his subsequent frivolous appeal, and for mishandling sale of former client's real property. *In re Markley*, 1984-NMSC-082, 101 N.M. 565, 686 P.2d 255.

Suspension warranted where conflicting interests impair independent judgment. — If a lawyer allows his independent professional judgment on his client's behalf to be impaired by his representation of conflicting interests and, through negligence and acceptance of undue influence and instructions from others, he unintentionally aids an embezzlement scheme in which his client is the victim, such conduct warrants suspension from practice of law for a 30-day period and thereafter until reinstated as provided by the rules of the supreme court. *In re Dilts*, 1979-NMSC-055, 93 N.M. 131, 597 P.2d 316.

Psychiatric condition asserted as defense. — In a disciplinary proceeding in which the attorney's psychiatric condition is asserted as a defense, in weighing the appropriateness of suspension versus disbarment, the court must consider whether it has been shown that the psychiatric condition is amenable to treatment and whether the prognosis for full rehabilitation has been established. *In re Stewart*, 1986-NMSC-043, 104 N.M. 337, 721 P.2d 405.

Attorneys' inaction and incompetence. — Where Owen represented the complainants, who were the lessees in a daycare lease dispute, Owen transferred the matter to Jackson who filed suit on behalf of the complainants against the lessor and mortgage holder; because Jackson failed to properly attend to the lawsuit, the complainants fired Jackson and rehired Owen; Jackson failed to withdraw as counsel of record or notify the court and opposing counsel of the withdrawal; Owen failed to file an entry of appearance or substitution of counsel; Jackson continued to receive notices, correspondence, and pleadings which Jackson delivered to Owen; Owen failed to communicate with the complainants; Owen and Jackson failed to respond to the lessor's and mortgage holder's pleadings and failed to attend hearings; and it was only after the district court granted the lessor's motion for summary judgment and writ of execution that Owen notified the complainants that their daycare business was being evicted, Jackson and Owen abandoned the complainants and failed to competently represent them. *In re Owen and Jackson*, 2013-NMSC-035.

An attorney's inaction and incompetence in representing a client in divorce action violated Rules 6-101 and 7-101 NMRA of the Code of Professional Responsibility (now Rules 16-101 and 16-103 NMRA of the Rules of Professional Conduct). *In re Gallegos*, 1986-NMSC-058, 104 N.M. 496, 723 P.2d 967.

One-year suspension warranted. — Attorney's actions warranted a one-year suspension since he made misrepresentations to a court, failed to return unearned fees, failed to render an accounting to a

client and acted otherwise to prejudice the administration of justice. *In re Arrieta*, 1986-NMSC-045, 104 N.M. 389, 722 P.2d 640.

Attorney's conduct involving two frivolous claims resulting in violation of Rule 16-301 NMRA and several other provisions of the Rules of Professional Conduct warranted a one-year suspension. *In re Richards*, 1999-NMSC-030, 127 N.M. 716, 986 P.2d 1117.

Attorney was suspended from practice for one year for engaging in conduct that adversely reflected upon his fitness to practice law, for neglecting a legal matter entrusted to him, for engaging in conduct involving dishonesty or misrepresentation, and for failure to give his full cooperation and assistance to counsel for the disciplinary board. *In re Laughlin*, 1986-NMSC-068, 104 N.M. 630, 725 P.2d 830.

Indefinite suspension warranted. — Sixteen violations of nine rules governing professional responsibility, involving misrepresentation, neglect, improper fee-splitting, disrespect to various tribunals, and other conduct prejudicial to the administration of justice resulted in the defendant's being suspended indefinitely from the practice of law. *In re Quintana*, 1986-NMSC-057, 104 N.M. 511, 724 P.2d 220.

Indefinite suspension was warranted because of an attorney's violation of this rule and other rules, such as Rule 16-103 NMRA, by failing to act with diligence and promptness in representing a client; Rule 16-104 NMRA, by failing to keep his client informed about the status of a matter and failing to respond to requests for information; Rule 16-116(D) NMRA, by failing to surrender papers and property to which the client was entitled at the termination of the representation; Rule 16-302 NMRA, by failing to expedite litigation consistent with the interests of his client; and Rule 16-804(C),(D) and (H) NMRA, by engaging in conduct involving dishonesty, fraud, deceit or misrepresentation, engaging in conduct prejudicial to the administration of justice, and by engaging in conduct that adversely reflects on his fitness to practice law. *In re Lally*, 1999-NMSC-003, 126 N.M. 566, 973 P.2d 243.

Indefinite suspension was warranted because of attorney's violation of this rule and other provisions, such as Rule 16-105 NMRA, by charging an excessive fee; Rule 16-302 NMRA, by failing to expedite litigation; Rule 16-303(A)(1) NMRA, by making an untrue statement of material fact to a tribunal; Rule 16-304(D) NMRA, by failing to comply with a discovery request; Rule 16-505(A) NMRA, by practicing law in a jurisdiction where doing so violates regulations; and Rule 16-804(C),(D) and (H) NMRA, by engaging in conduct involving dishonesty, deceit, and misrepresentation, by engaging in conduct prejudicial to the administration of justice, and by engaging in conduct that adversely reflects upon his fitness to practice law. *In re Righter*, 1999-NMSC-009, 126 N.M. 730, 975 P.2d 343.

Indefinite suspension was warranted because an attorney violated this rule by failing to provide competent representation. The attorney also violated Rule 16-102A NMRA, by failing to abide by a client's decisions concerning the objectives of the representation; Rule 16-103 NMRA, by failing to act with reasonable diligence and promptness in representing a client; Rule 16-104A NMRA, by failing to keep a client reasonably informed about the status of a matter and by failing to promptly comply with reasonable requests for information; Rule 16-116D NMRA, by failing to timely surrender papers and property to which a client was entitled and by failing to timely refund any advance payment of a fee that had not been earned; Rule 16-804(D) and (H) NMRA, by engaging in conduct that is prejudicial to the administration of justice and conduct that adversely reflects on his fitness to practice law; Rule 16-801(B) NMRA, by failing to respond to lawful requests for information from the office of disciplinary counsel; and Rule 16-803(D) NMRA, by failing to cooperate with disciplinary counsel in the course of the investigation. *In re Carlton*, 2000-NMSC-001, 128 N.M. 419, 993 P.2d 736.

An attorney's apparent failure to complete several cases, to take steps to insure that the interests of her clients were protected upon her withdrawal from their cases, and to promptly refund any unearned portions of fees paid in advance, as well as her lack of cooperation with the disciplinary counsel, constitute conduct violative of the professional rules warranting an indefinite suspension from the practice of law. *In re Roth*, 1987-NMSC-004, 105 N.M. 255, 731 P.2d 951; *In re Tapia*, 1990-NMSC-092, 110 N.M. 693, 799 P.2d 129.

Sixty-day suspension warranted. — Counsel's failure to appear for a deposition, to file a motion for an amended complaint, to file a motion for a redetermination on behalf of his client, or to respond to disciplinary counsel, warranted a 60-day suspension. *In re Allred*, 1987-NMSC-073, 106 N.M. 227, 741 P.2d 830.

Disbarment warranted. — Disbarment was justified because of the inadequacy of an attorney's representation of clients in violation of this rule and Rules 16-102(A), 16-103 and 16-104(A) NMRA, by his adverse business transaction with a client and misappropriation of trust account funds in violation of

Rules 16-108, 16-115 and 16-116(D) NMRA, and violation of Rule 16-801 NMRA and other rules relating to disciplinary proceedings. *In re Darnell*, 1997-NMSC-025, 123 N.M. 323, 940 P.2d 171.

Code not basis for civil liability. — Former Code of Professional Responsibility was established to discipline attorneys. It was not intended to provide a foundation for civil liability. *Garcia v. Rodey, Dickason, Sloan, Akin & Robb*, 1988-NMSC-014, 106 N.M. 757, 750 P.2d 118.

Failure to comply with the Rules of Appellate Procedure constituted a violation of this rule. *In re Dawson*, 2000-NMSC-024, 129 N.M. 369, 8 P.3d 856.

Attorney's failure to docket an appeal and lying to his client for seven years about the status of the appeal violated numerous rules and warranted indefinite suspension from practice. *In re Roberts*, 1995-NMSC-037, 119 N.M. 769, 895 P.2d 669.

Bankruptcy practice. — An attorney's failure to address a potential secured claim against his client in a bankruptcy proceeding was a violation of Rules 16-101 and 16-804 NMRA. *In re Elmore*, 1997-NMSC-020, 123 N.M. 79, 934 P.2d 273.

Rule violated. *In re Cutter*, 1994-NMSC-086, 118 N.M. 152, 879 P.2d 784.

Incompetent representation. — In a personal injury action for damages resulting from a pharmacist filling a child's prescription for Ritalin with methadone, where attorney, despite having prior knowledge that records showed a discrepancy between the number of methadone tablets prescribed and those dispensed, denied plaintiff's request for admission that records existed indicating a shortage of methadone tablets, failed to produce a report filed with the Board of Pharmacy, and failed to verify the authenticity of a forged prescription for methadone that was introduced into evidence, the attorney's actions demonstrated incompetence, because they showed a lack of thoroughness in preparing for trial. *In re Estrada*, 2006-NMSC-047, 140 N.M. 492, 143 P.3d 731.

Law reviews. — For note, "Legal Malpractice - Liability for Failure to Warn: First National Bank of Clovis v. Diane, Inc.", see 16 N.M.L. Rev. 395 (1986).

For article, "Attorney as Interpreter: A Return to Babble," 20 N.M.L. Rev. 1 (1990).

For note, "Professional Responsibility - Attorneys Are Not Liable to Their Clients' Adversaries: *Garcia v. Rodey, Dickason, Sloan, Akin & Robb, P.A.*," see 20 N.M.L. Rev. 737 (1990).

Am. Jur. 2d, A.L.R. and C.J.S. references. — 7 Am. Jur. 2d Attorneys at Law §§ 67 to 73.

Legal malpractice by permitting statutory time limitation to run against client's claim, 90 A.L.R.3d 293.

What statute of limitations governs damage action against attorney for malpractice, 2 A.L.R.4th 284.

Adequacy of defense counsel's representation of criminal client regarding argument, 6 A.L.R.4th 16.

Adequacy of defense counsel's representation of criminal client regarding speedy trial and related matters, 6 A.L.R.4th 1208.

Adequacy of defense counsel's representation of criminal client regarding hypnosis and truth tests, 9 A.L.R.4th 354.

Adequacy of defense counsel's representation of criminal client regarding guilty pleas, 10 A.L.R.4th 8.

Adequacy of defense counsel's representation of criminal client regarding post-plea remedies, 13 A.L.R.4th 533.

Adequacy of defense counsel's representation of criminal client regarding appellate and postconviction remedies, 15 A.L.R.4th 582.

Adequacy of defense counsel's representation of criminal client regarding incompetency, insanity and related issues, 17 A.L.R.4th 575.

Incompetence of counsel as ground for relief from state court civil judgment, 64 A.L.R.4th 323.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in matters involving real estate transactions as ground for disciplinary action - modern cases, 65 A.L.R.4th 24.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in tax matters as ground for disciplinary action - modern cases, 66 A.L.R.4th 314.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in estate or probate matters as ground for disciplinary action - modern cases, 66 A.L.R.4th 342.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in family law matters as ground for disciplinary action - modern cases, 67 A.L.R.4th 415.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in personal injury or property damage actions as ground for disciplinary action - modern cases, 68 A.L.R.4th 694.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in criminal matters as ground for disciplinary action - modern cases, 69 A.L.R.4th 410.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in bankruptcy matters as ground for disciplinary action - modern cases, 70 A.L.R.4th 786.

Legal malpractice in handling or defending medical malpractice claim, 78 A.L.R.4th 725.

Misconduct involving intoxication as ground for disciplinary action against attorney, 1 A.L.R.5th 874.

Legal malpractice in defense of criminal prosecution, 4 A.L.R.5th 273.

Ineffective assistance of counsel: compulsion, duress, necessity, or "hostage syndrome" defense, 8 A.L.R.5th 713.

Legal malpractice: negligence or fault of client as defense, 10 A.L.R.5th 828.

Ineffective assistance of counsel: Right of attorney to withdraw, as appointed defense counsel, due to self-avowed incompetence, 16 A.L.R.5th 118.

Admissibility and effect of evidence of professional ethics rules in legal malpractice action, 50 A.L.R.5th 301.

7 C.J.S. Attorney and Client §§ 77 to 87; 7A C.J.S. Attorney and Client §§ 254 to 262.

16-102 . Scope of representation and allocation of authority between client and lawyer.

A. **Client's decisions.** Subject to Paragraphs C and D of this rule, a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 16-104 NMRA of the Rules of Professional Conduct, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

B. **Representation not endorsement of client's views.** A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

C. **Limitation of representation.** A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

D. **Course of conduct.** A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent or misleads the tribunal. A lawyer may, however, discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

[As amended, effective March 15, 2001; as amended by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

Compiler's notes. — The old ABA Comment has been replaced by the new 2008 Committee Commentary.

Committee commentary. —

Allocation of Authority between Client and Lawyer

[1] Paragraph A confers upon the client the ultimate authority to determine the purposes to be served by legal representation, within the limits imposed by law and the lawyer's professional obligations. The decisions specified in Paragraph A, such as whether to settle a civil matter, must also be made by the client. See Rule 16-104(A)(1) NMRA of the Rules of Professional Conduct for the lawyer's duty to communicate with the client about such decisions. With respect to the means by which the client's objectives are to be pursued, the lawyer shall consult with the client as required by Rule 16-104(A)(2) NMRA of the Rules of Professional Conduct and may take such action as is impliedly authorized to carry out the representation.

[2] On occasion, however, a lawyer and a client may disagree about the means to be used to accomplish the client's objectives. Clients normally defer to the special knowledge and skill of their lawyer with respect to the means to be used to accomplish their objectives, particularly with respect to technical, legal and tactical matters. Conversely, lawyers usually defer to the client regarding such questions as the expense to be incurred and concern for third persons who might be adversely affected. Because of the varied nature of the matters about which a lawyer and client might disagree and because the actions in question may implicate the interests of a tribunal or other persons, this rule does not prescribe how such disagreements are to be resolved. Other law, however, may be applicable and should be consulted by the lawyer. The lawyer should also consult with the client and seek a mutually acceptable resolution of the disagreement. If such efforts are unavailing and the lawyer has a fundamental disagreement with the client, the lawyer may withdraw from the representation. See Rule 16-116(B)(4) NMRA of the Rules of Professional Conduct. Conversely, the client may resolve the disagreement by discharging the lawyer. See Rule 16-116(A)(3) NMRA.

[3] At the outset of a representation, the client may authorize the lawyer to take specific action on the client's behalf without further consultation. Absent a material change in circumstances and subject to Rule 16-104 NMRA of the Rules of Professional Conduct, a lawyer may rely on such an advance authorization. The client may, however, revoke such authority at any time.

[4] In a case in which the client appears to be suffering diminished capacity, the lawyer's duty to abide by the client's decisions is to be guided by reference to Rule 16-114 NMRA of the Rules of Professional Conduct.

Independence from Client's Views or Activities

[5] Legal representation should not be denied to people who are unable to afford legal services, or whose cause is controversial or the subject of popular disapproval. By the same token, representing a client does not constitute approval of the client's views or activities.

Agreements Limiting Scope of Representation

[6] The scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. When a lawyer has been retained by an insurer to represent an insured, for example, the representation may be limited to matters related to the insurance coverage. A limited representation may be appropriate because the client has limited objectives for the representation. In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives. Such limitations may exclude actions that the client thinks are too costly or that the lawyer regards as repugnant or imprudent.

[7] Although this rule affords the lawyer and client substantial latitude to limit the representation, the limitation must be reasonable under the circumstances. If, for example, a client's objective is limited to securing general information about the law the client needs in order to handle a common and typically uncomplicated legal problem, the lawyer and client may agree that the lawyer's services will be limited to a brief telephone consultation. Such a limitation, however, would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely. Although an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation, the limitation is a factor to be considered when determining the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation. See Rule 16-101 NMRA of the Rules of Professional Conduct.

[8] With regard to Paragraph C, limitations on the scope of representation may include drafting specific, discrete pleadings or other documents to be used in the course of representation without taking on the responsibility for drafting all documents needed to carry the representation to completion. For example, a lawyer may be retained by a client during the course of an appeal for the sole purpose of drafting a specific document, such as a docketing statement, memorandum in opposition, or brief. A lawyer who agrees to prepare a discrete document under a limited representation agreement must competently prepare such a document and fully advise the client with respect to that document, which includes informing the client of any significant problems that may be associated with the limited representation arrangement. However, by agreeing to prepare a specific, discrete document the lawyer does not also assume the responsibility for taking later actions or preparing subsequent documents that may be necessary to continue to pursue the representation. While limitations on the scope of representation are permitted under this rule, the lawyer must explain the benefits and risks of such an arrangement and obtain the client's informed consent to the limited representation. Upon expiration of the limited representation arrangement, the lawyer should advise the client of any impending deadlines, pending tasks, or other consequences flowing from the termination of the limited representation. See Rule 16-303 NMRA.

[9] All agreements concerning a lawyer's representation of a client must accord with the Rules of Professional Conduct and other law. See, e.g., Rules 16-101, 16-108 and 16-506 NMRA of the Rules of Professional Conduct.

[10] A lawyer providing limited-scope representation shall explain that other lawyers may communicate directly with the client, without the permission of the lawyer and outside the presence of the lawyer. The lawyer shall explain that the client may limit or halt communications with the other lawyer with notice, preferably in writing. The lawyer should explain the risks of communicating with another lawyer. The lawyer is not required to participate in communications outside the scope of the limited representation, even if the client requests such participation.

Criminal, Fraudulent and Prohibited Transactions

[11] Paragraph D prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud. This prohibition, however, does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct. Nor does the fact that a client uses advice in a course of action that is criminal or fraudulent of itself make a lawyer a party to the

course of action. There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

[12] When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is required to avoid assisting the client, for example, by drafting or delivering documents that the lawyer knows are fraudulent or by suggesting how the wrongdoing might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent. The lawyer must, therefore, withdraw from the representation of the client in the matter. See Rule 16-116(A) NMRA of the Rules of Professional Conduct. In some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like. See Rule 16-401 NMRA of the Rules of Professional Conduct.

[13] Where the client is a fiduciary, the lawyer may be charged with special obligations in dealings with a beneficiary.

[14] Paragraph D applies whether or not the defrauded party is a party to the transaction. Hence, a lawyer must not participate in a transaction to effectuate criminal or fraudulent avoidance of tax liability. Paragraph D does not preclude undertaking a criminal defense incident to a general retainer for legal services to a lawful enterprise. The last clause of Paragraph D recognizes that determining the validity or interpretation of a statute or regulation may require a course of action involving disobedience of the statute or regulation or of the interpretation placed upon it by governmental authorities.

[15] If a lawyer comes to know or reasonably should know that a client expects assistance not permitted by the Rules of Professional Conduct or other law or if the lawyer intends to act contrary to the client's instructions, the lawyer must consult with the client regarding the limitations on the lawyer's conduct. See Rule 16-104(A)(5) NMRA of the Rules of Professional Conduct.

[Adopted by Supreme Court Order No. 08-8300-029, effective November 3, 2008; as amended by Supreme Court Order No. 15-8300-007, effective December 31, 2015.]

COMPILER'S ANNOTATIONS

The 2001 amendment, effective March 15, 2001, rewrote Paragraph C which read "A lawyer may limit the objectives of the representation if the client consents after consultation".

The 2005 amendment of the Code of Professional Conduct Comment, effective January 20, 2005, added the comment to Paragraph E.

The 2008 amendment, approved by Supreme Court Order No. 08-8300-29, effective November 3, 2008, added "and allocation of authority between client and lawyer" in the title; in Paragraph A, added "Subject to Paragraphs C and D of this rule", added the reference to Rule 16-104 NMRA, and added the second sentence; in Paragraph D, changed "A lawyer shall not engage or counsel" to "A lawyer shall not counsel"; and deleted former Paragraph E which concerned consultation on limitations of assistance when the client expects assistance not permitted by the Rules of Professional Conduct.

The 2015 amendment, approved by Supreme Court Order No. 15-8300-007, effective December 31, 2015, revised the committee commentary to provide for additional duties for lawyers providing limited-scope representation, and to make technical changes to rule citations; and in the committee commentary, added Paragraph 10 and redesignated the subsequent paragraphs accordingly.

Unreasonable limitation on the scope of representation. — Where respondent agreed to represent a criminal defendant for the limited purpose of negotiating a plea agreement for a flat fee; respondent conducted no discovery or witness interviews; defendant rejected the state's plea offer; six weeks before trial, respondent sought to withdraw from the representation without discussing the matter with defendant; respondent cited a breakdown of the attorney-client relationship as the reason for the withdrawal, when in fact respondent wanted to withdraw because respondent had accepted a flat fee for negotiating a plea agreement; and after the court denied the motion, respondent told the prosecutor that respondent would not prepare for trial in order to set up a claim for ineffective assistance of counsel, respondent's conduct warranted suspension. *In re Chavez*, 2013-NMSC-008, 299 P.3d 403.

Duty to take essential steps and consult with client. — When one contracts with an attorney for legal services, it is not the client's responsibility to initiate all inquiries to the attorney to insure that essential steps are being taken. Furthermore, it is within the scope of an attorney's obligations to a client to provide the information, advice, and reassurances necessary to allay unnecessary concerns that the client may have. Where attorney does none of these things, he violates this and other rules. *In re Carrasco*, 1987-NMSC-089, 106 N.M. 294, 742 P.2d 506.

Attorney's failure to consult with his clients concerning the objectives of the representation and the means by which the objectives were to be pursued violated Paragraph A of this rule. *In re Houston*, 1999-NMSC-032, 127 N.M. 582, 985 P.2d 752.

Dual role of guardian ad litem. — The dual role of a guardian ad litem to represent the best interests of a child while also presenting the child's wishes to the court even if they conflict with the position of the guardian ad litem conforms to the requirements of the Rules of Professional Conduct. *State ex rel. Children, Youth & Families Dep't v. Esperanza M.*, 1998-NMCA-039, 124 N.M. 735, 955 P.2d 204.

Lawyers are officers of court and are always under obligation to be truthful to the court. *Woodson v. Phillips Petroleum Co.*, 1985-NMSC-018, 102 N.M. 333, 695 P.2d 483.

Public defenders are not excused from compliance with the Code of Professional Responsibility (now the Rules of Professional Conduct) even though they are paid with public funds. *State v. Martinez*, 1982-NMCA-020, 97 N.M. 540, 641 P.2d 1087.

Attorney's duty upon appeal. — An attorney representing a client on appeal should first seek to convince the client of the wisdom of the attorney's professional judgment, but, failing such persuasion, the client's contention should be presented. The manner of such presentation is solely for the attorney, subject, however, to Rule 7-102(A) NMRA (now Rules 16-102, 16-303 and 16-304 NMRA) which prohibits an attorney from knowingly advancing unwarranted claims and from knowingly making false statements of law or fact. *State v. Boyer*, 1985-NMCA-029, 103 N.M. 655, 712 P.2d 1.

Abandonment of issues on appeal. — The strict language of this rule and Rule 7-102 NMRA (now Rules 16-102, 16-303 and 16-304 NMRA) allows attorneys to abandon frivolous issues, or even non-frivolous issues, once the attorney has found one non-frivolous issue to argue with vigor on appeal. *State v. Boyer*, 1985-NMCA-029, 103 N.M. 655, 712 P.2d 1.

Abandonment of client warrants suspension. — Where an attorney abandons his client and the client's case, despite his having been paid a substantial fee, he violates this rule and the violation warrants suspension. *In re Chowning*, 1983-NMSC-085, 100 N.M. 375, 671 P.2d 36.

Six-month suspension and other penalties were warranted since attorney accepted one-half of the fee and failed to represent the client, allowing default to be entered against the client. *In re Trujillo*, 1990-NMSC-062, 110 N.M. 180, 793 P.2d 862.

Suspension warranted where conflicting interests impair independent judgment. — If a lawyer allows his independent professional judgment on his client's behalf to be impaired by his representation of conflicting interests and, through negligence and acceptance of undue influence and instructions from others, he unintentionally aids an embezzlement scheme in which his client is the victim, such conduct warrants suspension from practice of law for a 30-day period and thereafter until reinstated as provided by the rules of the supreme court. *In re Dilts*, 1979-NMSC-055, 93 N.M. 131, 597 P.2d 316.

Censure and fine for false and misleading brief. — An attorney was publicly censured and fined \$1,000 for knowingly making false, misleading and inaccurate statements in a brief to the court of appeals in violation of this rule (former Rule 7-102 NMRA). *In re Chakeres*, 1984-NMSC-088, 101 N.M. 684, 687 P.2d 741.

Restitution made only under pressure is entitled to no weight as a mitigating factor. *In re Stewart*, 1986-NMSC-043, 104 N.M. 337, 721 P.2d 405.

Misappropriation of funds. — Attorney's conversion to his own use of money received from a client to have a liquor license transferred to her name violated Rules 1-102, 6-101, 7-101 and 9-102 NMRA of the Code of Professional Responsibility (now Rules 16-102, 16-104, 16-115 and 16-804 NMRA of the Rules of Professional Conduct). *In re Gallegos*, 1986-NMSC-058, 104 N.M. 496, 723 P.2d 967.

One-year suspension warranted. — Attorney's actions warranted a one-year suspension since he made misrepresentations to a court, failed to return unearned fees, failed to render an accounting to a client and acted otherwise to prejudice the administration of justice. *In re Arrieta*, 1986-NMSC-045, 104 N.M. 389, 722 P.2d 640.

Indefinite suspension warranted. — Sixteen violations of nine rules governing professional responsibility, involving misrepresentation, neglect, improper fee-splitting, disrespect to various tribunals, and other conduct prejudicial to the administration of justice resulted in defendant's being suspended indefinitely from the practice of law. *In re Quintana*, 1986-NMSC-057, 104 N.M. 511, 724 P.2d 220.

Indefinite suspension was warranted because an attorney violated Paragraph A by failing to abide by a client's decisions concerning the objectives of the representation. The attorney also violated Rule 16-101 NMRA, by failing to provide competent representation; Rule 16-103 NMRA, by failing to act with

reasonable diligence and promptness in representing a client; Rule 16-104(A) NMRA, by failing to keep a client reasonably informed about the status of a matter and by failing to promptly comply with reasonable requests for information; Rule 16-116(D) NMRA, by failing to timely surrender papers and property to which a client was entitled and by failing to timely refund any advance payment of fee that had not been earned; Rule 16-804(D) and (H) NMRA, by engaging in conduct that is prejudicial to the administration of justice and conduct that adversely reflects on his fitness to practice law; Rule 16-801(B) NMRA, by failing to respond to lawful requests for information from the office of disciplinary counsel; and Rule 16-803(D) NMRA, by failing to cooperate with disciplinary counsel in the course of the investigation. *In re Carlton*, 2000-NMSC-001, 128 N.M. 419, 993 P.2d 736.

An attorney's apparent failure to complete several cases, to take steps to insure that the interests of her clients were protected upon her withdrawal from their cases, and to promptly refund any unearned portions of fees paid in advance, as well as her lack of cooperation with the disciplinary counsel, constitute conduct violative of the professional rules warranting an indefinite suspension from the practice of law. *In re Roth*, 1987-NMSC-004, 105 N.M. 255, 731 P.2d 951.

Disbarment warranted. — Disbarment was justified because of the inadequacy of an attorney's representation of clients in violation of Paragraph A of this rule and Rules 16-101, 16-103 and 16-104(A) NMRA, by his adverse business transaction with a client and misappropriation of trust account funds in violation of Rules 16-108, 16-115 and 16-116(D) NMRA, and violation of Rule 16-801 NMRA and other rules relating to disciplinary proceedings. *In re Darnell*, 1997-NMSC-025, 123 N.M. 323, 940 P.2d 171.

Rule violated. *In re Cutter*, 1994-NMSC-086, 118 N.M. 152, 879 P.2d 784; *In re Chavez*, 2000-NMSC-015, 129 N.M. 035, 1 P.3d 417.

Misleading the court. — In a personal injury action for damages resulting from a pharmacist filling a child's prescription for Ritalin with methadone, where attorney, who had prior knowledge that her client's records indicated that the prescription at issue had been mis-filled, who recommended that the client admit liability, who relied on representations from the pharmacist, pharmacy manager and out-of-state counsel for the pharmacy that the missing drugs could be accounted for and followed their advise to investigate other possible sources for the methadone that injured the plaintiff rather than using the attorney's independent judgment, and who proceeded to defend the case that was contrary to the evidence the attorney had found and that the attorney had not provided in discovery, the attorney misled the court. *In re Estrada*, 2006-NMSC-047, 140 N.M. 492, 143 P.3d 731.

Am. Jur. 2d, A.L.R. and C.J.S. references. — 7 Am. Jur. 2d Attorneys at Law §§ 67 to 73.

Legal malpractice in settling or failing to settle client's case, 87 A.L.R.3d 168.

Method employed in collecting debt due client as ground for disciplinary action against attorney, 93 A.L.R.3d 880.

What statute of limitations governs damage action against attorney for malpractice, 2 A.L.R.4th 284.

Adequacy of defense counsel's representation of criminal client regarding post-plea remedies, 13 A.L.R.4th 533.

Adequacy of defense counsel's representation of criminal client regarding appellate and postconviction remedies, 15 A.L.R.4th 582.

Attorney's delay in handling decedent's estate as ground for disciplinary action, 21 A.L.R.4th 75.

Disciplinary action against attorney based on communications to judge respecting merits of cause, 22 A.L.R.4th 917.

Legal malpractice liability for advising client to commit crime or unlawful act, 51 A.L.R.4th 1227.

Ratification of attorney's unauthorized compromise of action, 5 A.L.R.5th 56.

Admissibility, in prosecution of attorney for collaborating with client in criminal activities, of evidence as to attorney's duties under Code of Professional Responsibility, 111 A.L.R. Fed. 403.

16-103 . Diligence.

A lawyer shall act with reasonable diligence and promptness in representing a client.

Compiler's notes. — The old ABA Comment has been replaced by the new 2008 Committee Commentary.

Committee Commentary. —

[1] A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client. For example, a lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued. See Rule 16-102 NMRA of the Rules of Professional Conduct. The lawyer's duty to act with reasonable diligence does not require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.

[2] A lawyer's workload must be controlled so that each matter can be handled competently.

[3] Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's trustworthiness. A lawyer's duty to act with reasonable promptness, however, does not preclude the lawyer from agreeing to a reasonable request for a postponement that will not prejudice the lawyer's client.

[4] Unless the relationship is terminated as provided in Rule 16-116 NMRA of the Rules of Professional Conduct, a lawyer should carry through to conclusion all matters undertaken for a client. If a lawyer's employment is limited to a specific matter, the relationship terminates when the matter has been resolved. If a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal. Doubt about whether a client-lawyer relationship still exists should be clarified by the lawyer, preferably in writing, so that the client will not mistakenly suppose the lawyer is looking after the client's affairs when the lawyer has ceased to do so. For example, if a lawyer has handled a judicial or administrative proceeding that produced a result adverse to the client and the lawyer and the client have not agreed that the lawyer will handle the matter on appeal, the lawyer must consult with the client about the possibility of appeal before relinquishing responsibility for the matter. See Subparagraph (2) of Paragraph A of Rule 16-104 NMRA of the Rules of Professional Conduct. Whether the lawyer is obligated to prosecute the appeal for the client depends on the scope of the representation the lawyer has agreed to provide to the client. See Rule 16-102 NMRA of the Rules of Professional Conduct.

[Adopted by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

COMPILER'S ANNOTATIONS

Attorney's duty to initiate action on case. — When one contracts with an attorney for legal services, he or she is entitled to expect that the attorney will take action of some sort, and if more information is needed from the client in order to proceed, it is the attorney's responsibility to notify the client; it is not the client's responsibility to initiate all inquiries to the attorney to insure that essential steps are being taken. Failure of an attorney to do so constitutes a violation of this and other rules. *In re Carrasco*, 1987-NMSC-089, 106 N.M. 294, 742 P.2d 506.

Failure to complete cases. — An attorney's apparent failure to complete several cases, to take steps to insure that the interests of her clients were protected upon her withdrawal from their cases, and to promptly refund any unearned portions of fees paid in advance, as well as her lack of cooperation with the disciplinary counsel, constitute conduct violative of the professional rules warranting an indefinite suspension from the practice of law. *In re Roth*, 1987-NMSC-004, 105 N.M. 255, 731 P.2d 951; *In re Tapia*, 1990-NMSC-092, 110 N.M. 693, 799 P.2d 129.

An attorney who failed to pursue representation of clients and who abandoned his office and all forms of communication with his clients was subject to a one year suspension. *In re Fandey*, 1994-NMSC-118, 118 N.M. 590, 884 P.2d 481.

Attorney's failure to docket an appeal and lying to his client for seven years about the status of the appeal violated numerous rules and warranted indefinite suspension from practice. *In re Roberts*, 1995-NMSC-037, 119 N.M. 769, 895 P.2d 669.

Six-month suspension and other penalties were warranted since attorney accepted one-half of the fee and failed to represent the client, allowing default to be entered against the client. *In re Trujillo*, 1990-NMSC-062, 110 N.M. 180, 793 P.2d 862.

An attorney's inaction and incompetence in representing a client in a divorce action violated Rules 6-101 and 7-101 NMRA of the Code of Professional Responsibility (now Rules 16-101 and 16-103 NMRA of the Rules of Professional Conduct). *In re Gallegos*, 1986-NMSC-058, 104 N.M. 496, 723 P.2d 967.

Failure to respond to pleadings. — Where Owen represented the complainants, who were the lessees in a daycare lease dispute; Owen failed to communicate with the complainants, failed to respond to the lessor's and mortgage holder's pleadings, and failed to attend hearings; and it was only after the district court granted the lessor's motion for summary judgment and writ of execution that Owen notified the complainants that their daycare business was being evicted, Owen failed to diligently represent the complainants. *In re Owen and Jackson*, 2013-NMSC-035.

Attorney's failure to file an answer to a URESA action filed against his client violated Rules 6-101(A)(3) and 7-101(A)(1)-(3) NMRA of the Code of Professional Responsibility (now see Rules 16-103 and 16-302 NMRA of the Rules of Professional Conduct). *In re Gallegos*, 1986-NMSC-058, 104 N.M. 496, 723 P.2d 967.

Sixty-day suspension warranted. — Counsel's failure to appear for a deposition, to file a motion for an amended complaint, to file a motion for a redetermination on behalf of his client, or to respond to disciplinary counsel, warranted a 60-day suspension. *In re Allred*, 1987-NMSC-073, 106 N.M. 227, 741 P.2d 830.

Indefinite suspension warranted. — Indefinite suspension was warranted because of an attorney's violation of this rule and other rules, such as Rule 16-101 NMRA, by failing to provide competent representation; Rule 16-104 NMRA, by failing to keep his client informed about the status of a matter and failing to respond to requests for information; Rule 16-116(D) NMRA, by failing to surrender papers and property to which the client was entitled at the termination of the representation; Rule 16-302 NMRA, by failing to expedite litigation consistent with the interests of his client; and Rule 16-804(C), (D) and (H) NMRA, by engaging in conduct involving dishonesty, fraud, deceit or misrepresentation, engaging in conduct prejudicial to the administration of justice, and by engaging in conduct that adversely reflects on his fitness to practice law. *In re Lally*, 1999-NMSC-003, 126 N.M. 566, 973 P.2d 243.

Indefinite suspension was warranted because an attorney violated this rule by failing to act with reasonable diligence and promptness in representing a client. The attorney also violated Rule 16-101 NMRA, by failing to provide competent representation; Rule 16-102(A) NMRA, by failing to abide by a client's decisions concerning the objectives of the representation; Rule 16-104(A) NMRA, by failing to keep a client reasonably informed about the status of a matter and by failing to promptly comply with reasonable requests for information; Rule 16-116(D) NMRA, by failing to timely surrender papers and property to which a client was entitled and by failing to timely refund any advance payment of fee that had not been earned; Rule 16-804(D) and (H) NMRA, by engaging in conduct that is prejudicial to the administration of justice and conduct that adversely reflects on his fitness to practice law; Rule 16-801(B) NMRA, by failing to respond to lawful requests for information from the office of disciplinary counsel; and Rule 16-803(D) NMRA, by failing to cooperate with disciplinary counsel in the course of the investigation. *In re Carlton*, 2000-NMSC-001, 128 N.M. 419, 993 P.2d 736.

Disbarment warranted. — Disbarment was justified because of the inadequacy of an attorney's representation of clients in violation of this rule and Rules 16-101, 16-102 and 16-104(A) NMRA, by his adverse business transaction with a client and misappropriation of trust account funds in violation of Rules 16-108, 16-115 and 16-116(D) NMRA, and violation of Rule 16-801 NMRA and other rules relating to disciplinary proceedings. *In re Darnell*, 1997-NMSC-025, 123 N.M. 323, 940 P.2d 171.

Rule violated. *In re Martinez*, 1988-NMSC-033, 107 N.M. 171, 754 P.2d 842; *In re Cutter*, 1994-NMSC-086, 118 N.M. 152, 879 P.2d 784; *In re Canevaro*, 1997-NMSC-033, 123 N.M. 576, 943 P.2d 1029; *In re Chavez*, 2000-NMSC-015, 129 N.M. 035, 1 P.3d 417; *In re Dawson*, 2000-NMSC-024, 129 N.M. 369, 8 P.3d 856.

Am. Jur. 2d, A.L.R. and C.J.S. references. — Negligence, inattention, or professional incompetence of attorney in handling client's affairs in matters involving real estate transactions as ground for disciplinary action - modern cases, 65 A.L.R.4th 24.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in tax matters as ground for disciplinary action - modern cases, 66 A.L.R.4th 314.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in estate or probate matters as ground for disciplinary action - modern cases, 66 A.L.R.4th 342.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in family law matters as ground for disciplinary action - modern cases, 67 A.L.R.4th 415.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in personal injury or property damage actions as ground for disciplinary action - modern cases, 68 A.L.R.4th 694.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in criminal matters as ground for disciplinary action - modern cases, 69 A.L.R.4th 410.

Negligence, inattention, or professional incompetence of attorney in handling client's affairs in bankruptcy matters as ground for disciplinary action - modern cases, 70 A.L.R.4th 786.

Legal malpractice in handling or defending medical malpractice claim, 78 A.L.R.4th 725.

Legal malpractice in defense of criminal prosecution, 4 A.L.R.5th 273.

16-108 . Conflict of interest; current clients; specific rules.

A. **Business transactions with or adverse to client.** A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

B. **Use of information limited.** A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these rules.

C. **Client gifts.** A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.

D. **Literary or media rights.** Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

E. **Financial assistance.** A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

F. **Compensation from third party.** A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information relating to representation of a client is protected as required by Rule 16-106 NMRA of the Rules of Professional Conduct.

G. **Representation of two or more clients.** A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

H. **Prospective malpractice liability limitation.** A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

I. Proprietary interest in cause of action. A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

- (1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and
- (2) contract with a client for a reasonable contingent fee in a civil case.

J. Lawyer association. While lawyers are associated in a firm, a prohibition in the foregoing Paragraphs A through I that applies to any one of them shall apply to all of them.

[As amended by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

Compiler's notes. — The old ABA Comment has been replaced by the new 2008 Committee Commentary.

Committee Commentary. —

Business Transactions Between Client and Lawyer

[1] A lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property or financial transaction with a client, for example, a loan or sales transaction or a lawyer investment on behalf of a client. The requirements of Paragraph A must be met even when the transaction is not closely related to the subject matter of the representation, as when a lawyer drafting a will for a client learns that the client needs money for unrelated expenses and offers to make a loan to the client. The rule applies to lawyers engaged in the sale of goods or services related to the practice of law, for example, the sale of title insurance or investment services to existing clients of the lawyer's legal practice. See Rule 16-507 NMRA of the Rules of Professional Conduct. It also applies to lawyers purchasing property from estates they represent. It does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 16-105 NMRA of the Rules of Professional Conduct, although its requirements must be met when the lawyer accepts an interest in the client's business or other non-monetary property as payment of all or part of a fee. In addition, the rule does not apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in Paragraph A are unnecessary and impracticable.

[2] Subparagraph (1) of Paragraph A requires that the transaction itself be fair to the client and that its essential terms be communicated to the client, in writing, in a manner that can be reasonably understood. Subparagraph (2) of Paragraph A requires that the client also be advised, in writing, of the desirability of seeking the advice of independent legal counsel. It also requires that the client be given a reasonable opportunity to obtain such advice. Subparagraph (3) of Paragraph A requires that the lawyer obtain the client's informed consent, in a writing signed by the client, both to the essential terms of the transaction and to the lawyer's role. When necessary, the lawyer should discuss both the material risks of the proposed transaction, including any risk presented by the lawyer's involvement, and the existence of reasonably available alternatives and should explain why the advice of independent legal counsel is desirable. See Paragraph E of Terminology of the Rules of Professional Conduct (definition of informed consent).

[3] The risk to a client is greatest when the client expects the lawyer to represent the client in the transaction itself or when the lawyer's financial interest otherwise poses a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's financial interest in the transaction. Here the lawyer's role requires that the lawyer must comply, not only with the requirements of Paragraph A, but also with the requirements of Rule 16-107 NMRA of the Rules of Professional Conduct. Under that rule, the lawyer must disclose the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction, such as the risk that the lawyer will structure the transaction or give legal advice in a way that favors the lawyer's interests at the expense of the client. Moreover, the lawyer must obtain the client's informed consent. In some cases, the lawyer's interest may be such that Rule 16-

107 NMRA of the Rules of Professional Conduct will preclude the lawyer from seeking the client's consent to the transaction.

[4] If the client is independently represented in the transaction, Subparagraph (2) of Paragraph A of this rule is inapplicable, and the Subparagraph (1) of Paragraph A requirement for full disclosure is satisfied either by a written disclosure by the lawyer involved in the transaction or by the client's independent counsel. The fact that the client was independently represented in the transaction is relevant in determining whether the agreement was fair and reasonable to the client as Subparagraph (1) of Paragraph A further requires.

Use of Information Related to Representation

[5] Use of information relating to the representation to the disadvantage of the client violates the lawyer's duty of loyalty. Paragraph B applies when the information is used to benefit either the lawyer or a third person, such as another client or business associate of the lawyer. For example, if a lawyer learns that a client intends to purchase and develop several parcels of land, the lawyer may not use that information to purchase one of the parcels in competition with the client or to recommend that another client make such a purchase. The rule does not prohibit uses that do not disadvantage the client. For example, a lawyer who learns a government agency's interpretation of trade legislation during the representation of one client may properly use that information to benefit other clients. Paragraph B prohibits disadvantageous use of client information unless the client gives informed consent, except as permitted or required by these rules. See Paragraph D of Rule 16-102 NMRA, Rule 16-106 NMRA, Paragraph C of Rule 16-109 NMRA, Rule 16-303 NMRA, Paragraph B of Rule 16-401 NMRA, Rule 16-801 NMRA and Rule 16-803 NMRA of the Rules of Professional Conduct.

Gifts to Lawyers

[6] A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If a client offers the lawyer a more substantial gift, Paragraph C does not prohibit the lawyer from accepting it, although such a gift may be voidable by the client under the doctrine of undue influence, which treats client gifts as presumptively fraudulent. In any event, due to concerns about overreaching and imposition on clients, a lawyer may not suggest that a substantial gift be made to the lawyer or for the lawyer's benefit, except where the lawyer is related to the client as set forth in Paragraph C.

[7] If effectuation of a substantial gift requires preparing a legal instrument such as a will or conveyance the client should have the detached advice that another lawyer can provide. The sole exception to this rule is where the client is a relative of the donee.

[8] This rule does not prohibit a lawyer from seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position. Nevertheless, such appointments will be subject to the general conflict of interest provision in Rule 16-107 NMRA of the Rules of Professional Conduct when there is a significant risk that the lawyer's interest in obtaining the appointment will materially limit the lawyer's independent professional judgment in advising the client concerning the choice of an executor or other fiduciary. In obtaining the client's informed consent to the conflict, the lawyer should advise the client concerning the nature and extent of the lawyer's financial interest in the appointment, as well as the availability of alternative candidates for the position.

Literary Rights

[9] An agreement by which a lawyer acquires literary or media rights concerning the conduct of the representation creates a conflict between the interests of the client and the personal interests of the lawyer. Measures suitable in the representation of the client may detract from the publication value of an account of the representation. Paragraph D does not prohibit a lawyer representing a client in a transaction concerning literary property from agreeing that the lawyer's fee shall consist of a share in ownership in the property, if the arrangement conforms to Rule 16-105 NMRA of the Rules of Professional Conduct and Paragraphs A and I of this rule.

Financial Assistance

[10] Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. These dangers do not warrant a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are

virtually indistinguishable from contingent fees and help ensure access to the courts. Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

Person Paying for a Lawyer's Services

[11] Lawyers are frequently asked to represent a client under circumstances in which a third person will compensate the lawyer, in whole or in part. The third person might be a relative or friend, an indemnitor (such as a liability insurance company) or a co-client (such as a corporation sued along with one or more of its employees). Because third-party payers frequently have interests that differ from those of the client, including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless the lawyer determines that there will be no interference with the lawyer's independent professional judgment and there is informed consent from the client. See also Paragraph C of Rule 16-504 NMRA of the Rules of Professional Conduct (prohibiting interference with a lawyer's professional judgment by one who recommends, employs or pays the lawyer to render legal services for another).

[12] Sometimes, it will be sufficient for the lawyer to obtain the client's informed consent regarding the fact of the payment and the identity of the third-party payer. If, however, the fee arrangement creates a conflict of interest for the lawyer, then the lawyer must comply with Rule 16-107 NMRA of the Rules of Professional Conduct. The lawyer must also conform to the requirements of Rule 16-106 NMRA of the Rules of Professional Conduct concerning confidentiality. Under Paragraph A of Rule 16-107 NMRA of the Rules of Professional Conduct, a conflict of interest exists if there is significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in the fee arrangement or by the lawyer's responsibilities to the third-party payer (for example, when the third-party payer is a co-client). Under Paragraph B of Rule 16-107 NMRA of the Rules of Professional Conduct, the lawyer may accept or continue the representation with the informed consent of each affected client, unless the conflict is non-consentable under that paragraph. Under Paragraph B of Rule 16-107 NMRA of the Rules of Professional Conduct, the informed consent must be confirmed in writing.

Aggregate Settlements

[13] Differences in willingness to make or accept an offer of settlement are among the risks of common representation of multiple clients by a single lawyer. Under Rule 16-107 NMRA of the Rules of Professional Conduct, this is one of the risks that should be discussed before undertaking the representation, as part of the process of obtaining the clients' informed consent. In addition, Paragraph A of Rule 16-102 NMRA of the Rules of Professional Conduct protects each client's right to have the final say in deciding whether to accept or reject an offer of settlement and in deciding whether to enter a guilty or nolo contendere plea in a criminal case. The rule stated in this paragraph is a corollary of both of those rules and provides that, before any settlement offer or plea bargain is made or accepted on behalf of multiple clients, the lawyer must inform each of them about all the material terms of the settlement, including what the other clients will receive or pay if the settlement or plea offer is accepted. See also Paragraph E of Terminology of the Rules of Professional Conduct (definition of informed consent). Lawyers representing a class of plaintiffs or defendants, or those proceeding derivatively, may not have a full client-lawyer relationship with each member of the class; nevertheless, such lawyers must comply with applicable rules regulating notification of class members and other procedural requirements designed to ensure adequate protection of the entire class.

Limiting Liability and Settling Malpractice Claims

[14] Agreements prospectively limiting a lawyer's liability for malpractice are prohibited unless the client is independently represented in making the agreement because they are likely to undermine competent and diligent representation. Also, many clients are unable to evaluate the desirability of making such an agreement before a dispute has arisen, particularly if they are then represented by the lawyer seeking the agreement. This paragraph does not, however, prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement. Nor does this paragraph limit the ability of lawyers to practice in the form of a limited-liability entity, where permitted by law, provided that each lawyer remains personally liable to the client for his or her own conduct and the firm complies with any conditions required by law, such as provisions requiring client notification or maintenance of adequate liability insurance. Nor does it prohibit an agreement in accordance with Rule 16-102 NMRA of

the Rules of Professional Conduct that defines the scope of the representation, although a definition of scope that makes the obligations of representation illusory will amount to an attempt to limit liability.

[15] Agreements settling a claim or a potential claim for malpractice are not prohibited by this rule. Nevertheless, in view of the danger that a lawyer will take unfair advantage of an unrepresented client or former client, the lawyer must first advise such a person in writing of the appropriateness of independent representation in connection with such a settlement. In addition, the lawyer must give the client or former client a reasonable opportunity to find and consult independent counsel.

Acquiring Proprietary Interest in Litigation

[16] Paragraph I states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. Like Paragraph E, the general rule has its basis in common law champerty and maintenance and is designed to avoid giving the lawyer too great an interest in the representation. In addition, when the lawyer acquires an ownership interest in the subject of the representation, it will be more difficult for a client to discharge the lawyer if the client so desires. The rule is subject to specific exceptions developed in decisional law and continued in these rules. The exception for certain advances of the costs of litigation is set forth in Paragraph E. In addition, Paragraph I sets forth exceptions for liens authorized by law to secure the lawyer's fees or expenses and contracts for reasonable contingent fees. The law of each jurisdiction determines which liens are authorized by law. These may include liens granted by statute, liens originating in common law and liens acquired by contract with the client. When a lawyer acquires by contract a security interest in property other than that recovered through the lawyer's efforts in the litigation, such an acquisition is a business or financial transaction with a client and is governed by the requirements of Paragraph A. Contracts for contingent fees in civil cases are governed by Rule 16-105 NMRA of the Rules of Professional Conduct.

Imputation of Prohibitions

[17] Under Paragraph J, a prohibition on conduct by an individual lawyer in Paragraphs A through I also applies to all lawyers associated in a firm with the personally prohibited lawyer. For example, one lawyer in a firm may not enter into a business transaction with a client of another member of the firm without complying with Paragraph A, even if the first lawyer is not personally involved in the representation of the client. The prohibition set forth in Paragraph J is personal and is not applied to associated lawyers.

[Adopted by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

COMPILER'S ANNOTATIONS

The 2008 amendment, approved by Supreme Court Order No. 08-8300-29, effective November 3, 2008, in the title of the rule, changed the phrase "prohibited transactions" to "current clients; specific rules"; in Subparagraph (2) of Paragraph A, changed "the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction" to the current language; in Subparagraph (3) of Paragraph A, changed "the client consents in writing thereto" to the current language; in Paragraph B, deleted "Unless otherwise required by these rules, a" at the beginning of the sentence and changed "consents after consultation" to "gives informed consent, except as permitted or required by these rules"; in Paragraph C, replaced the former language of the rule which prohibited a lawyer from preparing an instrument which would give the lawyer or a person related to the lawyer a gift from a client by the current language; in Subparagraph (1) of Paragraph E, changed "provided the client remain ultimately liable for such costs and expense" to "the repayment of which may be contingent on the outcome of the matter"; in Subparagraph (1) of Paragraph F, changed "consents after consultation" to "gives informed consent"; in Paragraph G, changed "consents after consultation, including" to "gives informed consent, in writing signed by the client. The lawyer's"; in Subparagraph (1) of Paragraph H, changed "permitted by law" to "the client"; in Subparagraph (2) of Paragraph H, changed "settle a claim for which liability" to "settle a claim or potential claim for such liability" and changed "without first advising that person in writing that independent representation is appropriate" to the current language which prohibits a settlement unless the person is advised in writing of the desirability of seeking independent legal advice; deleted former Paragraph I which prohibited representation adverse to the representation by a related lawyer; relettered former Paragraph J as Paragraph I; and added a new Paragraph J.

Relation of attorney and client is one of highest trust and confidence, requiring the attorney to observe the utmost good faith towards his client, and not to allow his private interests to conflict with those of his client. Very strict and rigid rules have always been enforced under which an attorney could not maintain a purchase from his client unless he was able to clearly show that he had made a full communication to his client of all that he knew of advantage to the client regarding the subject of the

negotiations. *Van Orman v. Nelson*, 1967-NMSC-069, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

Information which attorney must convey to client. — An attorney has an affirmative duty to fully inform a client, not only of the attorney's interest in the transaction, but also how such interest might affect the attorney's personal judgment and that the client is free to seek outside legal advice regarding the transaction. *In re D'Angelo*, 1986-NMSC-052, 105 N.M. 391, 733 P.2d 360.

Duty no less than real estate broker. — The duty owed by an attorney to his client is certainly no less exacting than that owed by a real estate broker to his principal. *Van Orman v. Nelson*, 1969-NMSC-035, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

Property ownership between clients and attorney. — If the attorney had an interest in a client corporation and its real property, he violated this rule by failing to comply with the requirements for entering into a business transaction with a client since he failed to obtain the client's written consent to the alleged transaction. Of a more serious nature was the action taken by the attorney when he learned the property had been placed for sale since he resorted to issuing false and unauthorized deeds to protect an asserted interest in a client's property which is antithetical to a lawyer's duties to the client and the legal system. *In re Schmidt*, 118 N.M. 213, 880 P.2d 310 (1994).

Advances from attorney's own funds. — If costs are advanced, the advance must come from the attorney's own funds; and where an attorney who advanced funds from a trust account in which the attorney had commingled personal and clients trust was saved from disbursing funds that belonged to other clients, it was not proper for him to make advances from the fund. *In re Cannain*, 1997-NMSC-001, 122 N.M. 710, 930 P.2d 1162.

No conflict with statute. — The statute which makes an attorney jointly liable with the client for the services of a court reporter (36-2-13.1 NMSA 1978) does not conflict with Subparagraph E(1) of this rule. *Trambley v. Wyman*, 1998-NMCA-035, 125 N.M. 13, 956 P.2d 144, *cert. denied*, 124 N.M. 589, 953 P.2d 1087 (1998).

Contracts between client and attorney will be closely scrutinized by the courts and when a client challenges the fairness of such a contract the attorney has the burden of showing not only that he used no undue influence but that in every particular he acted honestly and in good faith. *Van Orman v. Nelson*, 1967-NMSC-069, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

Factors in determining fairness. — Inadequacy of consideration is but one factor in determining whether a transaction between attorney and client is fair; others include a showing that the attorney made a full and frank disclosure of all relevant information that he had and that the client had independent advice before completing the transaction. *Van Orman v. Nelson*, 1967-NMSC-069, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

Agreement voidable. — The trial court's conclusion that an agreement was voidable may clearly be sustained upon the ground that the attorney failed to fully disclose all facts relating to the sale of the house which he was consummating, particularly with respect to the purchase price; furthermore, the client had no independent advice before signing the agreement and deed. *Van Orman v. Nelson*, 1967-NMSC-069, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

If the court finds that the transactions between the attorney and his client were not made in the best of faith and were not made without an advantage to the attorney or disadvantage to his client, that said transactions were not fair and not equitable and the client was not fully informed of her rights and interests, the attorney's actions are incompatible with the high fidelity he owed to his client as a member of the legal profession. *Van Orman v. Nelson*, 1967-NMSC-069, 78 N.M. 11, 427 P.2d 896, *rev'd on other grounds*, 1969-NMSC-035, 80 N.M. 119, 452 P.2d 188.

Exchange of service agreement not standard commercial transaction. — An attorney was required to disclose in writing the terms of an arrangement with his client, whereby the attorney received construction work from the client at a reduced rate and his payments were often deferred, since the agreement was not a standard commercial transaction excepted from this rule. *Fowler Bros. v. Young*, 91 F.3d 1367 (10th Cir. 1996).

Constitutional rights violation requires "actual" conflict. — A conflict of interest violation of these rules will not in itself constitute a violation of constitutional rights because under case law an "actual" conflict must be established. *United States v. Gallegos*, 39 F.3d 276 (10th Cir. 1994).

Disclosure provision of this rule does not place an attorney in the position of a trustee. *Fowler Bros. v. Young*, 91 F.3d 1367 (10th Cir. 1996).

Disbarment warranted. — Disbarment was justified because of the inadequacy of an attorney's representation of clients in violation of Rules 16-101, 16-102(A), 16-103 and 16-104(A) NMRA, by his business transaction and trust account violations of this rule and Rules 16-115 and 16-116(D) NMRA, and violations of Rule 16-801 NMRA and other rules relating to disciplinary proceedings. *In re Darnell*, 1997-NMSC-025, 123 N.M. 323, 940 P.2d 171.

Contingency arrangement. — Attorney who took case on a contingency arrangement was sanctioned for fees and costs in the amount of \$26,769.80 for failing to settle a case at the request of the client or withdraw as attorney in the case. *Vesco v. Snedecker*, 236 F. Supp. 2d 1272 (D.N.M. 2002).

Law reviews. — For article, "Ethics and the Settlement of Civil Rights Cases: Can Attorneys Keep Their Virtue and Their Fees?", see 16 N.M.L. Rev. 283 (1986).

Am. Jur. 2d, A.L.R. and C.J.S. references. — 7 Am. Jur. 2d Attorneys at Law §§ 121, 199, 200, 263.

Fee collection practices as ground for disciplinary action, 91 A.L.R.3d 583.

Liability insurance coverage as extending to liability for punitive or exemplary damages, 16 A.L.R.4th 11.

Propriety of attorney acting as both counsel and class member or representative, 37 A.L.R.4th 751.

Liability of professional corporation of lawyers, or individual members thereof, for malpractice or other tort of another member, 39 A.L.R.4th 556.

Liability of attorney, acting for client, for malicious prosecution, 46 A.L.R.4th 249.

Attorney's assertion of retaining lien as violation of ethical code or rules governing professional conduct, 69 A.L.R.4th 974.

Attorney's retaining lien: what items of client's property or funds are not subject to lien, 70 A.L.R.4th 827.

7 C.J.S. Attorney and Client §§ 77 to 87.

16-113 . Organization as client.

A. **Generally.** A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

B. **Acting in best interest of organization.** If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to a higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

C. **Authority to reveal information.** Except as provided in Paragraph D of this rule, if:

(1) despite the lawyer's efforts in accordance with Paragraph B the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law; and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 16-106 NMRA of the Rules of Professional Conduct permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

D. **Exception to authority to reveal information.** Paragraph C of this rule shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

E. **Notice of discharge or withdrawal.** A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraphs B or C of this rule, or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

F. **Identity of client.** In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

G. **Personal representation of officer or employee.** A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 16-107 NMRA of the Rules of Professional Conduct. If the organization's consent to the dual representation is required by Rule 16-107 NMRA of the Rules of Professional Conduct, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

[As amended by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

Compiler's notes. — The old ABA Comment has been replaced by the new 2008 Committee Commentary.

Committee Commentary. —
The Entity as the Client

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. Officers, directors, employees and shareholders are the constituents of the corporate organizational client. The duties defined in this Committee Commentary apply equally to unincorporated associations. "Other constituents" as used in this commentary means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations.

[2] When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 16-106 NMRA of the Rules of Professional Conduct. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 16-106 NMRA of the Rules of Professional Conduct. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 16-106 NMRA of the Rules of Professional Conduct.

[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph B makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Paragraph F of Terminology of the Rules of Professional Conduct, knowledge can be inferred from circumstances and a lawyer cannot ignore the obvious.

[4] In determining how to proceed under Paragraph B, the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated by Rule 16-113 NMRA of the Rules of Professional Conduct to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[5] Paragraph B also makes clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

Relation to Other Rules

[6] The authority and responsibility provided in this rule are concurrent with the authority and responsibility provided in other rules. In particular, this rule does not limit or expand the lawyer's responsibility under Rules 16-108, 16-116, 16-303 or 16-401 NMRA of the Rules of Professional Conduct. Paragraph C of this rule supplements Paragraph B of Rule 16-106 NMRA of the Rules of Professional

Conduct by providing an additional basis upon which the lawyer may reveal information relating to the representation, but does not modify, restrict, or limit the provisions of Subparagraphs (1) through (6) of Paragraph B of Rule 16-106 NMRA of the Rules of Professional Conduct. Under Paragraph C the lawyer may reveal such information only when the organization's highest authority insists upon or fails to address threatened or ongoing action that is clearly a violation of law, and then only to the extent the lawyer reasonably believes necessary to prevent reasonably certain substantial injury to the organization. It is not necessary that the lawyer's services be used in furtherance of the violation, but it is required that the matter be related to the lawyer's representation of the organization. If the lawyer's services are being used by an organization to further a crime or fraud by the organization, Subparagraphs (2) and (3) of Paragraph B of Rule 16-106 NMRA of the Rules of Professional Conduct may permit the lawyer to disclose confidential information. In such circumstances Paragraph D of Rule 16-102 NMRA of the Rules of Professional Conduct may also be applicable, in which event, withdrawal from the representation under Subparagraph (1) of Paragraph A of Rule 16-116 NMRA of the Rules of Professional Conduct may be required.

[7] Paragraph D makes clear that the authority of a lawyer to disclose information relating to a representation in circumstances described in Paragraph C does not apply with respect to information relating to a lawyer's engagement by an organization to investigate an alleged violation of law or to defend the organization or an officer, employee or other person associated with the organization against a claim arising out of an alleged violation of law. This is necessary in order to enable organizational clients to enjoy the full benefits of legal counsel in conducting an investigation or defending against a claim.

[8] A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraph B or C, or who withdraws in circumstances that require or permit the lawyer to take action under either of these paragraphs, must proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

Government Agency

[9] The duty defined in this rule applies to governmental organizations. Defining precisely the identity of the client and prescribing the resulting obligations of such lawyers may be more difficult in the government context and is a matter beyond the scope of these rules. See Scope of the Rules of Professional Conduct. Although in some circumstances the client may be a specific agency, it may also be a branch of government, such as the executive branch, or the government as a whole. For example, if the action or failure to act involves the head of a bureau, either the department of which the bureau is a part or the relevant branch of government may be the client for purposes of this rule. Moreover, in a matter involving the conduct of government officials, a government lawyer may have authority under applicable law to question such conduct more extensively than that of a lawyer for a private organization in similar circumstances. Thus, when the client is a governmental organization, a different balance may be appropriate between maintaining confidentiality and assuring that the wrongful act is prevented or rectified, for public business is involved. In addition, duties of lawyers employed by the government or lawyers in military service may be defined by statutes and regulation. This rule does not limit that authority. See Scope of the Rules of Professional Conduct.

Clarifying the Lawyer's Role

[10] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual and that discussions between the lawyer for the organization and the individual may not be privileged.

[11] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Dual Representation

[12] Paragraph G recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

Derivative Actions

[13] Under generally prevailing law, the shareholders or members of a corporation may bring suit to compel the directors to perform their legal obligations in the supervision of the organization. Members of unincorporated associations have essentially the same right. Such an action may be brought nominally by the organization, but usually is, in fact, a legal controversy over management of the organization.

[14] The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 16-107 NMRA of the Rules of Professional Conduct governs who should represent the directors and the organization.

[Adopted by Supreme Court Order No. 08-8300-29, effective November 3, 2008.]

COMPILER'S ANNOTATIONS

The 2008 amendment, approved by Supreme Court Order No. 08-8300-29, effective November 3, 2008, in Paragraph B, added the last sentence which requires a lawyer for an organization to report matters that are not in the best interest of the organization to the highest authority who can act on behalf of the organization; and deleted the former list of factors which the lawyer should consider in determining how to proceed and measures to be taken to minimize disruption of the organization and the risk of revealing information to persons outside the organization; deleted former Paragraph C which permitted the lawyer to resign from an organization when the highest authority in the organization insists on an act or refusal to act that is in violation of law and that is likely to injure the organization; added new Paragraphs C, D and E; relettered former Paragraph D as Paragraph F; in Paragraph F, changed "it is apparent" to "the lawyer knows or reasonably should know"; and relettered former Paragraph E as Paragraph G.



IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

Opinion Number: 2016-NMSC-023

Filing Date: June 16, 2016

Docket No. S-1-SC-34920

**IN THE MATTER OF
JASON S. MONTCLARE, ESQUIRE**

**An Attorney Licensed to
Practice Before the Courts
of the State of New Mexico**

PUBLIC CENSURE

Jane Gagne
Albuquerque, NM

for Disciplinary Board

Jason S. Montclare
Alamogordo, NM

Respondent

OPINION AND PUBLIC CENSURE

DANIELS, Chief Justice.

{1} Attorney Jason S. Montclare accepted a flat fee from a client in the form of real property and transferred a half interest in that property to his legal assistant before he had fully earned it, making him unable to return the unearned portion when he was later discharged before completion of the case. Montclare's actions violated Rule 16-105 NMRA, Rule 16-108 NMRA, and Rule 16-115 NMRA of our Rules of Professional Conduct. We write to issue a public censure and to clarify the rules pertaining to nonmonetary flat fees.

I. BACKGROUND

{2} Montclare agreed to represent Wolfgang Bohm, the complainant, in a child support enforcement action brought by the State of New Mexico Human Services Department (State) in which Bohm had been incarcerated for failure to appear. On April 12, 2013, Bohm

retained Montclare's services to obtain his release from jail and resolve the underlying child support action in exchange for a flat fee consisting of real property located at 101 Round Mountain, Bent, New Mexico. Bohm had transferred the property to Montclare on the preceding day by special warranty deed, which Montclare immediately recorded with the office of the county clerk.

{3} Montclare commenced work on Bohm's case and filed a motion for his immediate release from custody. On May 8, 2013, the State stipulated to Bohm's release without communicating with Montclare. Bohm was released from jail the next day and asked Montclare to return the property. Montclare refused, maintaining that he had earned it, and instead deeded half of the property to his office manager Tracy Perry as payment for her services.

{4} The Office of Disciplinary Counsel of the New Mexico Supreme Court Disciplinary Board brought an action against Montclare on November 26, 2013. Before any hearing, Montclare and Perry agreed to transfer the property back to Bohm, but they were unable to reach an agreement as to how Montclare would compensate Perry for her interest. The Hearing Committee of the Disciplinary Board held a hearing on the merits on April 15, 2014. On June 3, 2014, the Hearing Committee issued its proposed conclusion that Montclare had violated Rule 16-105(A) by charging an unreasonable fee, Rule 16-108(A) by acquiring ownership of client property without complying with the requirements pertaining to conflicts of interest, and Rule 16-115(A) and (E) by failing to hold client property separate from his own. The Hearing Committee recommended that Montclare be suspended from the practice of law for six months followed by one year of supervised probation. Additionally, the Hearing Committee recommended that Montclare be ordered to make restitution to Bohm by deeding the entire property back to him or by paying him its appraised value.

{5} On June 24, 2014, counsel for the Disciplinary Board notified Montclare that the transfer of the property from Bohm to Montclare was not valid because the property was still in the name of Bohm's deceased mother at the time, and consequently the deed from Montclare to Perry might be void because Montclare did not have a valid property interest to transfer. Nevertheless, the Disciplinary Board asked that Montclare and Perry execute special warranty deeds and quitclaim deeds transferring any interest they might have in the property back to Bohm to resolve any possible cloud on the title that may have resulted from the invalid transfers. On September 10, 2014, disciplinary counsel filed a specification of charges against Montclare, alleging that by deeding a half interest in the property to Perry he had violated Rule 16-504 NMRA by improperly splitting fees with a nonlawyer.

{6} On September 16, 2014, a Panel of the Disciplinary Board approved the Hearing Committee's proposed findings of fact and conclusions of law on the earlier charges after briefing but without hearing oral argument. The Panel adopted the Hearing Committee's recommendation of a six-month suspension followed by one year of supervised probation and also recommended that Montclare be required to take any necessary steps to restore clear title to the property to Bohm or, if clear title could not be restored, to pay Bohm the fair

market value of the property.

{7} Montclare requested review of the Panel's decision by this Court on October 2, 2014, arguing that disciplinary counsel had not proved he had the mental state that merited suspension and asking that the case be remanded to the Hearing Committee for reconsideration in light of the invalidity of the transfer that was discovered after the hearing. On October 17, 2014, Montclare also moved the Panel for a new hearing on the same basis. Disciplinary counsel responded that the Panel no longer had jurisdiction over the proceedings because Montclare had already requested review by this Court. The Panel did not rule on the motion for a new hearing.

{8} We heard argument in this case on February 4, 2015, but ordered the matter held in abeyance subject to Montclare commencing fee arbitration with Bohm and making arrangements to clear title to the property. Disciplinary counsel suggested to Montclare that the additional allegations concerning fee-splitting could be resolved by consenting to discipline.

{9} On February 9, 2015, Montclare entered into a conditional agreement in which he admitted to violating Rule 16-504(A) by sharing legal fees with a nonlawyer and consented to a formal reprimand. The Panel approved the consent agreement on March 19, 2015. Montclare then sought to withdraw from the consent agreement, and on April 3, 2015, he petitioned this Court for a hearing in the matter. This Court denied the petition.

{10} During this period, Bohm was attempting to sell the property but was unable to close the sale because he did not yet have clear title. Montclare subsequently quitclaimed his interest in the property to Bohm and attempted to reach an agreement with Perry to purchase her half interest in the property so that he could deed it back to Bohm, but he did not have the funds to pay the price Perry requested. Despite repeated extensions of time and admonitions from disciplinary counsel to make arrangements to purchase Perry's interest, Montclare still failed to do so.

{11} On September 25, 2015, disciplinary counsel moved this Court for an order to show cause as to why Montclare should not be held in contempt for violating the February 4, 2015, order by failing to take action to clear title to the property. The pending sale of the property was terminated due to the cloud on the title, and Bohm refused to participate in fee arbitration.

{12} After oral argument, we declined to hold Montclare in contempt but adopted the findings and conclusions of the Disciplinary Board Panel regarding the underlying violations of our Rules of Professional Conduct. We ordered that Montclare receive a public censure and be suspended from the practice of law for a period of six months, which suspension would be deferred on the condition that he purchase Perry's interest in the property on or before February 8, 2016, so as to return clear title to Bohm. The order specified that upon Montclare's delivery of full payment to Perry, disciplinary counsel would make

arrangements to obtain and deliver a quitclaim deed from Perry renouncing her interest in the property. Montclare was also ordered to attend an ethics CLE and pay the costs of the disciplinary proceedings. This opinion serves as his public censure and shall be published in the State Bar of New Mexico Bar Bulletin.

II. DISCUSSION

{13} In reviewing disciplinary proceedings, we defer to the Hearing Committee on factual matters but review legal conclusions and recommendations for discipline de novo. *In re Yalkut*, 2008-NMSC-009, ¶ 16, 143 N.M. 387, 176 P.3d 1119.

{14} “A lawyer shall not make an agreement for, charge or collect an unreasonable fee.” Rule 16-105(A). “[N]on-refundable unearned fees are unreasonable.” *Yalkut*, 2008-NMSC-009, ¶ 26. A flat fee for future legal services is not prohibited, but it cannot be considered as earned when paid and must be held in trust until earned. *See id.* Additionally, “lawyers must inform their new clients of the basis upon which they will compute the amount of fee earned . . . and maintain records that will enable them to determine the ongoing status of the fee, even when the fee arrangement is for a flat fee.” *Id.* (omission in original) (internal quotation marks and citation omitted). An attorney who is discharged is only entitled to recover the reasonable value of services rendered prior to the discharge, even if the agreement was for a flat fee and the discharge is without cause. *Guest v. Allstate Ins. Co.*, 2010-NMSC-047, ¶¶ 49, 51, 149 N.M. 74, 244 P.3d 342. Upon termination, an attorney must refund to the client “any advance payment of fee or expense that has not been earned or incurred.” Rule 16-116(D) NMRA.

{15} Montclare did present billing records to the Hearing Committee showing the time he spent on the case and calculating the fee he maintained he had earned. The Committee found that these calculations were not credible and consequently that Montclare had not earned the full value of the property. We defer to these findings and conclude that, because Montclare did not earn the full value of the property before transferring an interest to Perry and thereby making it nonrefundable, the property was an unreasonable fee in violation of Rule 16-105(A).

{16} We clarify that the acceptance of a flat fee in the form of real property is not in itself contrary to our Rules of Professional Conduct. An attorney may accept a nonmonetary fee, but regardless of the form it takes any fee must be reasonable and must be refundable until it is fully earned.

{17} Additionally, an attorney must minimize any potential conflict of interest with a client by ensuring that

- (1) the [terms of a nonmonetary fee agreement] are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

- (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
- (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

Rule 16-108(A).

{18} Montclare argued that it was Bohm's idea to use the property to pay for legal services and that he was doing Bohm a favor by accepting the offered real estate because other attorneys had declined the case and Bohm would otherwise have been without representation. Regardless of the truth or accuracy of Montclare's assertions, they do not relieve him of his responsibilities to properly advise his client and to ensure that the terms of any transaction are fair and fully disclosed. Attorneys often contract with clients in difficult situations because it is precisely those circumstances that give rise to the need for an attorney. But our Rules of Professional Conduct prevent attorneys from taking advantage of any such desperation to the detriment of the client. Rule 16-108 "was promulgated to ensure that transactions between clients and attorneys remain fair and reasonable and to ensure that attorneys do not exercise an unfair advantage over their clients." *Guest v. Allstate Ins. Co.*, 2009-NMCA-037, ¶ 23, 145 N.M. 797, 205 P.3d 844, *reversed on other grounds by Guest v. Allstate Ins. Co.*, 2010-NMSC-047, ¶ 72. By agreeing to accept Bohm's property without advising him to seek independent counsel, without obtaining his informed consent, or without ensuring that the terms of the transaction were fair and reasonable to Bohm, Montclare violated Rule 16-108(A).

{19} Finally, after agreeing to accept the property as a fee, Montclare failed to properly safeguard it until he had earned its full value. Any retainer or flat fee not yet earned must be safely kept and held in trust for the client, separately from the lawyer's own property. Rule 16-115. Money that belongs to a client must be deposited in a separate trust account and withdrawn only as fees are earned or expenses are incurred. Rule 16-115(A), (C). Our rules are not so specific regarding nonmonetary property, but it must be identified as belonging to the client, safeguarded, and promptly returned when the client is so entitled. Rule 16-115(A), (D). One way to accomplish this when a fee takes the form of real property would be to have the deed held in escrow by a neutral, third party until the attorney has earned the full value of the property. But it would not necessarily be an ethical violation to transfer the title into the attorney's name and record the transfer, even though the attorney is not yet entitled to ownership of the property, because in the absence of a third-party escrow these steps might be necessary to properly safeguard both attorney and client interests in the title. There would have been no violation if Montclare had transferred and recorded the deed but had safely kept it and had promptly transferred it back to Bohm when asked. When Montclare instead refused to return the property and transferred a half interest to Perry, making him unable to return it to Bohm without securing Perry's cooperation, Montclare

violated Rule 16-115(A), (D).

III. CONCLUSION

{20} We issue this public censure as a consequence of Montclare's actions in accepting a flat fee and transferring a portion of that fee to a third party before he had earned it so that he was unable to refund the unearned portion when requested as is required by our Rules of Professional Conduct. Because Montclare has since made the required payments and filed the necessary documents to transfer all interest in the property back to his former client, we do not impose the previously deferred six-month suspension.

{21} **IT IS SO ORDERED.**

CHARLES W. DANIELS, Chief Justice

WE CONCUR:

PETRA JIMENEZ MAES, Justice

EDWARD L. CHÁVEZ, Justice

BARBARA J. VIGIL, Justice

JUDITH K. NAKAMURA, Justice

AMERICAN BAR ASSOCIATION
ADOPTED BY THE HOUSE OF DELEGATES

AUGUST 9-10, 2010

RECOMMENDATION

RESOLVED, That the American Bar Association acknowledges and supports United States Government efforts to combat money laundering and terrorist financing;

FURTHER RESOLVED, That the American Bar Association observes that voluntary, risk-based, and updated guidance would assist legal professionals to avoid money laundering and terrorist financing risks when providing services to clients;

FURTHER RESOLVED, That the American Bar Association adopts the Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing (“Good Practices Guidance”); and

FURTHER RESOLVED, That the American Bar Association encourages state, local, and specialty bar associations to embrace the Good Practices Guidance and to educate legal professionals and law students regarding the risks addressed by the Guidance.

VOLUNTARY GOOD PRACTICES GUIDANCE FOR LAWYERS TO DETECT AND COMBAT MONEY LAUNDERING AND TERRORIST FINANCING

A collaborative effort of representatives of the American Bar Association (“ABA”) Task Force on Gatekeeper Regulation and the Profession, the ABA Section of Real Property, Trust and Estate Law, the ABA Section of International Law, the ABA Section of Business Law, the ABA Section of Taxation, the ABA Criminal Justice Section, the American College of Trust and Estate Counsel, the American College of Real Estate Lawyers, the American College of Mortgage Attorneys, and the American College of Commercial Finance Lawyers.

The Task Force on Gatekeeper Regulation and the Profession, the ABA Section of Real Property, Trust and Estate Law, the ABA Section of International Law, the ABA Section of Business Law, the ABA Section of Taxation, the ABA Criminal Justice Section, the ABA Law Practice Management Section, the American College of Trust and Estate Counsel, the American College of Real Estate Lawyers, the American College of Mortgage Attorneys, and the American College of Commercial Finance Lawyers have formally endorsed or approved this paper.

April 23, 2010

**VOLUNTARY GOOD PRACTICES GUIDANCE
FOR LAWYERS TO DETECT AND COMBAT
MONEY LAUNDERING AND TERRORIST FINANCING**

TABLE OF CONTENTS

Overview	4
What is Money Laundering?	4
What is Terrorist Financing?	6
What is the Risk-Based Approach?	7
What is Client Due Diligence?	8
Who is Covered by the Lawyer Guidance?	11
What specified activities are covered by the Lawyer Guidance?	12
1. Buying and Selling of Real Estate	12
2. Managing of client money, securities or other assets	12
3. Management of bank, savings or securities accounts	13
4. Organization of contributions for the creation, operation or management of companies	13
5. Creation, operation, or management of legal persons or arrangements, and buying and selling of business entities	14
What are the risk categories?	15
1. Country/Geographic Risk	15
2. Client Risk	17
2.1 Politically Exposed Persons	17
2.2 Unusual Activity	18
2.3 Masking of Beneficial Ownership	18
2.4 Cash Intensive Businesses	19
2.5 Cash Intensive Businesses—Mitigation of Risk	19
2.6 Charities and NPOs	19
2.7 Financial Intermediaries Not Subject to Adequate AML/CFT Laws	20
2.8 Clients with Certain Criminal Convictions	20
2.9 Clients with No Address/Multiple Addresses	20
2.10 Unexplained Change in Instructions	20
2.11 Structures With No Legal Purpose	21
3. Service Risk	21
3.1 “Touching the Money” Test	21
3.2 Concealment of Beneficial Ownership	22
3.3 Performing Services Outside Area of Expertise	23
3.4 Accelerated Real Estate Transfers	23
3.5 Cash Payments; Payments From Other Sources	24
3.6 Inadequate Consideration	24
3.7 Estate Administration—Convictions for Proceeds	25

	Generating Crimes	
3.8	Extraordinary Legal Fees	25
3.9	Source of Funds/Wealth	25
3.10	Out of Character Transactions	26
3.11	Shell Companies	26
3.12	Hard to Identify Trust Beneficiaries	26
3.13	Anonymity	27
3.14	Trust Services	27
4.	Risk Variables that May Affect Risk	28
4.1	Nature of Client Relationship	28
4.2	Existing Regulation	29
4.3	Reputation and Publicly Available Information	29
4.4	Regularity/Duration of Relationship	30
4.5	Familiarity with Country/Laws	30
4.6	Duration/Magnitude of Lawyer-Client Relationship	30
4.7	Local Counsel	30
4.8	Geographic Disparity	31
4.9	“One Shot” Transaction	31
4.10	Technological Developments Favoring Anonymity	31
4.11	Client Origination/Referral Source	32
4.12	Structure of Client/Transaction	32
4.13	Pension Funds	32
5.	Controls for Higher Risk Clients	32
5.1	General Training	33
5.2	Specific Training	33
5.3	Enhanced Due Diligence	33
5.4	Peer/Managerial Oversight	33
5.5	Evolving Evaluation of Services	33
5.6	On-Going/Evolving Evaluation of Clients	34
5.7	Overlap	34
6.	Basic Protocol for Client Intake and Assessment	34
6.1	Standard Level of CDD	35
6.2	Reduced CDD	36
6.3	Enhanced CDD	36
6.4	Timing	37
	What if Client Presents an Unacceptable Risk?	37
	Education and Continuing Legal Education Efforts	37
	Appendix A	38
	Appendix B	40

STATEMENT FROM UNITED STATES DEPARTMENT OF TREASURY

The Treasury Department welcomes this Good Practices paper as a useful step in protecting the legal profession as well as the broader financial system from the risks of money laundering and terrorist financing. Treasury looks forward to continuing engagement with the ABA to facilitate implementation of effective policies and procedures to protect against money laundering and terrorist financing.

**VOLUNTARY GOOD PRACTICES GUIDANCE
FOR LAWYERS TO DETECT AND COMBAT
MONEY LAUNDERING AND TERRORIST FINANCING**

In 1989, the major industrialized nations formed an intergovernmental body known as the Financial Action Task Force on Money Laundering (“FATF”) to coordinate efforts to prevent money laundering in both the international financial system and the domestic financial systems of the member entities. FATF first issued a comprehensive plan, known as the Forty Recommendations, for combating money laundering that was intended to present the basic framework for anti-money laundering (“AML”) efforts and be of universal application.¹ The Forty Recommendations are a set of international standards and are not a binding international convention, but many countries (including the United States) have committed to implementing them.

A decade after the creation of FATF, FATF sought to enlist the support of so-called “gatekeepers” to combat money laundering and terrorist financing. “Gatekeepers” include certain designated non-financial businesses and professions (“DNFBPs”) such as lawyers, notaries, trust and company service providers (“TCSPs”), real estate agents, accountants, and auditors who assist with transactions involving the movement of money in the domestic and international financial systems. This effort is known as the “Gatekeeper Initiative.”

A month after the September 11, 2001 terrorist attacks in the United States, FATF expanded its mandate to address terrorist financing and issued the Special Recommendations on Terrorist Financing. The Special Recommendations, originally comprised of eight recommendations, are intended to supplement the Forty Recommendations and are designed to combat the funding of terrorist acts and terrorist organizations. A ninth special recommendation was added in October 2004 to address concerns with cash couriers, thereby transforming the Special Recommendations into what have become known as the Nine Special Recommendations. The Forty Recommendations and the Nine Special Recommendations are sometimes referred to as the “40+9 Recommendations.” In sum, the 40+9 Recommendations, together with their interpretative notes, constitute the international standards for combating money laundering and terrorist financing.

The 40+9 Recommendations encourage countries to develop a risk-based approach to prevent money laundering and to combat the financing of terrorism (“CFT”). The theoretical and practical underpinning of the risk-based approach is to ensure that the limited resources (both governmental and private sector) available to fight money laundering and terrorist financing are employed and allocated in the most efficient

¹ The acronyms used in this paper are based on linguistic naming conventions used by FATF. Annex 2 (Glossary of Terminology) attached to the Lawyer Guidance (as defined below) contains a glossary of many of the terms used in the Lawyer Guidance. Appendix B attached to this Guidance contains a glossary of many of the acronyms used in this Guidance.

manner possible so that the activities posing the greatest risks receive the most attention and are targeted with the greatest funding. In this manner, the risk-based approach differs fundamentally from a rules-based approach. Under a rules-based approach, a person would be required to comply with particular laws, rules, or regulations irrespective of the underlying quantum or degree of risk.

In June 2007, FATF collaborated with representatives of the international banking and securities industries to formulate risk-based guidance for financial institutions. Known as the “Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing—High Level Principles and Procedures” (“Financial Institution Guidance”), this document was the first risk-based guidance paper issued by FATF for a specific industry sector.

Shortly after the issuance of the Financial Institution Guidance, FATF met with representatives of the DNFBP sectors, including lawyers, to determine if they would be willing to engage in a similar collaborative effort to develop risk-based guidance for their businesses and professions. The DNFBPs agreed to do so, and following such efforts FATF ultimately issued separate risk-based guidance papers in 2008 for every DNFBP sector, including lawyers.

During the negotiations with FATF over the guidance for lawyers, representatives of the legal profession emphasized to FATF the importance of ensuring that any risk-based approach developed did not undermine the attorney-client privilege or the duty of client confidentiality or otherwise impede the delivery of legal services generally. After over a year of intense debate and discussion, in October 2008 FATF issued risk-based guidance for the legal profession entitled “RBA Guidance for Legal Professionals” (“Lawyer Guidance”).²

The Lawyer Guidance contains 126 separately numbered paragraphs and organizationally tracks the Financial Institutions Guidance that served as a template for the DNFBP guidance papers. The Lawyer Guidance is a complex document that addresses different audiences (e.g., private sector and public authorities), undertakes to identify the AML and CFT issues specific to the legal profession, and outlines the risk factors that lawyers need to consider in developing a risk-based system.

The Lawyer Guidance is “high level” guidance intended to provide a broad framework for implementing a risk-based approach for the legal profession. It does not offer detailed direction on the application of this approach to specific factual situations, nor does it take into account the practical realities of the practice of law in an increasingly complex environment or attempt to address jurisdictional variations among the FATF member countries. For those reasons, the Lawyer Guidance urges the legal profession

² RBA GUIDANCE FOR LEGAL PROFESSIONALS (“LAWYER GUIDANCE”), adopted October 23, 2008, available at <http://www.fatf-gafi.org/dataoecd/5/58/41584211.pdf>. FATF Recommendations 12 (customer due diligence), 16 (suspicious transaction reports), and 24 (monitoring) and the related Interpretative Notes specifically deal with lawyers.

generally, or in different countries, to develop “good practice in the design and implementation of an effective risk-based approach.”³

Accordingly, the purpose of this paper is to assist members of the legal profession in the United States in designing and implementing effective risk-based approaches consistent with the broad contours of the Lawyer Guidance. It is not intended to be, nor should it be construed as, a statement of the standard of care governing the activities of lawyers in implementing a risk-based approach to combat money laundering and terrorist financing. Rather, given the vast differences in practices, firms, and lawyers throughout the United States, this paper seeks only to serve as a resource that lawyers can use in developing their own voluntary risk-based approaches. At the same time, this paper is not intended to be an academic exercise. The federal government is under pressure from FATF and others (including development agencies, the Organisation for Economic Co-Operation and Development, the International Monetary Fund, The World Bank, and the United Nations) to adopt legislation implementing some or all of the provisions of the Recommendations relating to the legal profession. An overarching purpose of this paper is to encourage lawyers to develop and implement voluntary, but effective, risk-based approaches consistent with the Lawyer Guidance, thereby negating the need for federal regulation of the legal profession.

To assist practitioners in understanding the practical implications of a particular provision in the Lawyer Guidance, this paper provides various “Practice Pointers.” These Practice Pointers are intended to offer insight into the Lawyer Guidance provision in question, especially from the perspective of a practitioner.

This paper represents a collaborative effort by representatives of the following organizations, all of which have formally endorsed or approved this paper:

- American Bar Association (“ABA”) Task Force on Gatekeeper Regulation and the Profession;
- ABA Section of Real Property, Trust and Estate Law;
- ABA Section of International Law;
- ABA Section of Business Law;
- ABA Section of Taxation;
- ABA Criminal Justice Section;
- ABA Law Practice Management Section;
- American College of Trust and Estate Counsel;
- American College of Real Estate Lawyers;
- American College of Mortgage Attorneys; and
- American College of Commercial Finance Lawyers.

This paper will be revised and updated on an as-needed basis in response to evolving developments.

³ LAWYER GUIDANCE ¶ 6.

OVERVIEW

The first section of this paper will provide an overview of the mechanics of money laundering and terrorist financing so that practitioners can better understand and achieve the goals of the United States' and FATF's AML/CFT efforts. The sections that follow will then describe the risk-based approach and recommended client due diligence, identify those lawyers who are subject to the Lawyer Guidance, specify the activities that are addressed by the Lawyer Guidance, list and analyze the risk categories and risk variables, and conclude with a suggested protocol for client intake and assessment and a discussion of the importance of on-going education and continuing legal education efforts in this area.

The “practice pointers” appearing throughout the text, which take the form of hypothetical fact patterns to highlight specific issues or points, are designed to provide practical guidance and insights to practitioners. They may also elaborate on a statement or concept contained in the Lawyer Guidance.

What is Money Laundering?

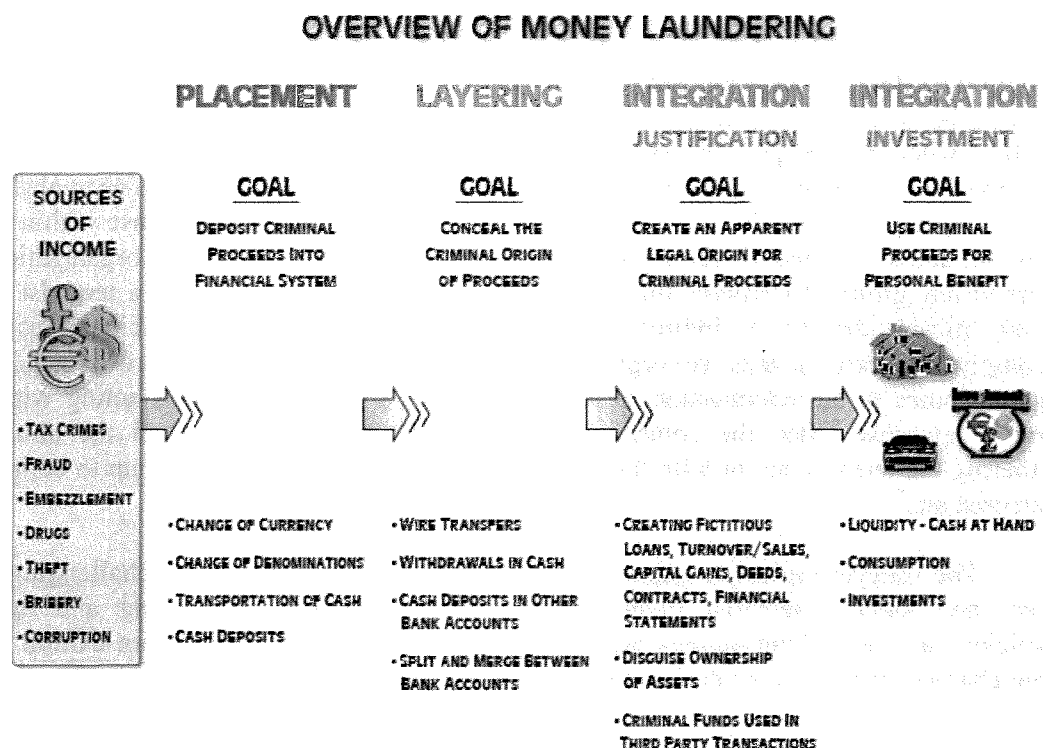
Money laundering “is the criminal practice of filtering ill-gotten gains, or ‘dirty’ money, through a series of transactions; in this way the funds are ‘cleaned’ so that they appear to be proceeds from legal activities.”⁴ Money laundering was made a federal crime in the U.S. under the Money Laundering Control Act of 1986 and is addressed under 18 U.S.C. § 1956 (laundering of monetary instruments) and § 1957 (engaging in monetary transactions in property derived from specified unlawful activity). Money laundering involves three distinct stages: the placement stage, the layering stage, and the integration stage.⁵ The placement stage is the stage at which funds from illegal activity, or funds intended to support illegal activity, are first introduced into the financial system. The layering stage involves further disguising and distancing the illicit funds from their illegal source through the use of a series of frequently complex financial transactions. This stage may include the creation of tiered entities and complicated entity structures designed to conceal the source of the illicit funds. The integration phase of money laundering results in the illicit funds, now laundered, returning to “a status of expendability in the hands of the organized crime group that generated them.”⁶

⁴ BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL, Federal Financial Institutions Examination Council at 7 (2007), available at <http://www.occ.treas.gov/handbook/bsa-amlintro-overview.pdf>.

⁵ See http://www.fatf-gafi.org/document/29/0,3343,en_32250379_32235720_33659613_1_1_1_1,00,-html# (explaining three stages of money laundering).

⁶ See http://www.fincen.gov/news_room/aml_history.html. (explaining three stages of money laundering).

Practice pointer: The following diagram provides an overview of the three phases of money laundering. See MONEY LAUNDERING AWARENESS HANDBOOK FOR TAX EXAMINERS AND TAX AUDITORS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, available at www.oecd.org/dataoecd/61/17/43841099.pdf:



* * * * *

A 2008 federal district court case also illustrates a money laundering scheme whereby the defendant was convicted of, among other things, conspiring to commit money laundering. Factually, the defendant led a scheme that involved manipulating documents associated with real estate sales and closings to obtain excess mortgage loan proceeds generated from the property sales. The defendant recruited unsuspecting investors to purchase low income, dilapidated, and depressed properties at prices artificially inflated above legitimate fair-market values (placement phase). The mortgages were financed with fraudulent loans facilitated, brokered, and closed by the defendant and his conspirators (layering phase). The conspirators provided the down payments on the properties, paid kick backs to the loan applicants, and opened bank accounts to disguise the true nature, location, source, ownership, and control of the

⁷ For a more complete description of this case, see the press release issued by the U.S. Department of Justice at www.usdoj.gov/usao/ohs/Press/03-26-08-Day.pdf.

proceeds and profits from the transactions (integration phase).⁷

What is Terrorist Financing?

Terrorist financing includes the financing of terrorists, terrorist acts, and terrorist organizations. FATF defines a “terrorist” basically as anyone who commits, participates in, organizes, or contributes to the commission of terrorist acts. FATF defines “terrorist acts” as including any act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act. The definition also includes acts that constitute an offense within the scope of, and as defined in, certain specified treaties.⁸ Finally, a “terrorist organization” refers to any group of terrorists that: (a) commits, or attempts to commit, a terrorist act by any means, directly or indirectly, unlawfully and willfully, (b) participates as an accomplice in terrorist acts, (c) organizes or directs others to commit terrorist acts, or (d) contributes to the commission of terrorist acts by a group of persons acting with a common purpose when the contribution is made intentionally and with the aim of furthering the terrorist act or with the knowledge of the intention of the group to commit a terrorist act.⁹

The Lawyer Guidance acknowledges that it is significantly more challenging to detect and identify terrorist financing than potential money laundering and other suspicious activity. Transactions facilitating terrorist financing often do not exhibit the same characteristics as conventional money laundering. For example, terrorist financing

⁸ See http://www.fatf-gafi.org/document/53/0,3343,en_32250379_32236947_34261877_1_1_1_1,00.html#INSRII.

⁹ See <http://www.fatf-gafi.org/dataoecd/16/54/40339628.pdf> (contains definitions used in this paragraph). For purposes of the definition of “terrorist organization,” it does not matter whether the terrorist act actually occurs. Prohibitions on terrorism and terrorist financing also are mandated by the United Nations and federal law. United Nations Security Council Resolution (“UNSCR”) 1267 (and its progeny) calls on Member States to ban travel for, freeze the funds and financial resources of, and impose an arms embargo on members of the Taliban and Al Qaeda. See <http://www.un.org/sc/committees/1267/>. The United States implements UNSCR 1267 pursuant to the United Nations Participation Act (“UNPA”), 22 U.S.C. § 287c, and the International Emergency Economic Powers Act (“IEEPA”), 50 U.S.C. § 1701 *et seq.* The U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”) administers the regulations promulgated pursuant to IEEPA and the UNPA. In particular, pursuant to OFAC’s regulations, U.S. persons (including lawyers) are prohibited from engaging in transactions (including the exchange of services) with certain terrorists, those they own or control and those who are acting on their behalf. These persons (individuals and entities) are identified on the SDN List (as defined in text accompanying footnote 9 below). OFAC’s terrorism regulations are implemented pursuant to the IEEPA, the UNPA, and the Anti-terrorism and Effective Death Penalty Act of 1996, 18 U.S.C. § 2332d, among others. OFAC administers the following sanctions programs specifically targeting terrorists, those they own or control, and those who provide material support to terrorists: The Global Terrorism Sanctions Regulations, 31 C.F.R. 594; Terrorism Sanctions Regulations, 31 C.F.R. 595; the Terrorism List Government Sanctions Regulations, 31 C.F.R. 596; and the Foreign Terrorist Organizations Sanctions Regulations, 31 C.F.R. 597.

may involve low dollar value transactions and the appearance of innocence (such as purportedly charitable activities), and can involve a variety of sources (such as business, criminal activity, self-funded, and state sponsors of terrorism). The Lawyer Guidance thus does not comprehensively address the application of the risk-based approach to terrorist financing.¹⁰

Practice pointer: A common method of terrorist financing identified to date has been the movement of funds donated to cross-border (i.e., between the United States and another jurisdiction, not between two states) non-profit organizations. For example, a not for profit organization (“NPO”) in the United States may appear, from all outwardly signs, to be operating legitimately, but through multiple transfers and manipulations of funds, may in fact be funneling funds offshore to an organization with hidden terrorist ties. Alternatively, the terrorist group may actually run the NPO. An examination of available public source information, including the charity’s tax return, Form 990 PF, the charity’s website, corporate formation documents, and other due diligence methods may disclose how funds are ultimately used. However, the terrorist link may not be evident from a review of the charity’s tax return. The practitioner should thus inquire of the charity what due diligence procedures it has in place and to identify the recipient of the funds. If funds are paid to foreign charities or to private charities, then the charity is supposed to monitor and keep records of how the funds are used. As part of the client due diligence (as defined below), the practitioner should ask for these records and in appropriate circumstances check the list of Specially Designated Nationals and Blocked Persons (“SDN List”) maintained by OFAC.¹¹

What is the Risk-Based Approach?

The risk-based approach is grounded in the premise that the limited resources (both governmental and private sector) available to combat money laundering and terrorist financing should be employed and allocated in the most efficient manner possible so that the sources of the greatest risks receive the most attention. A risk-based approach is intended to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified, thereby facilitating an efficient allocation of this limited pool of resources.

The proportionate nature of the risk-based approach means that higher risk areas should be subject to enhanced procedures, such as enhanced client due diligence (“CDD”) and enhanced transaction monitoring. By contrast, simplified, modified, or

¹⁰ LAWYER GUIDANCE ¶¶ 40-44. For a detailed discussion of terrorist financing, see MONEY LAUNDERING & TERRORIST FINANCING RISK ASSESSMENT STRATEGIES, Financial Action Task Force (issued June 18, 2008), <http://www.fatf-gafi.org/dataoecd/46/24/40978997.pdf>.

¹¹ See Section 2.6 and accompanying footnote for further discussion of charities and NPOs.

reduced controls may apply in lower risk areas (for purposes of this Guidance, “reduced” shall hereafter include “simplified” and “modified”). In no case does FATF suggest that the risk may ever be so low as to eliminate any form or level of CDD.

An effective risk-based approach involves identifying and categorizing money laundering and terrorist financing risks and establishing reasonable controls based on the risks identified. This paper will identify the risk categories and offer voluntary good practices designed to assist lawyers in detecting money laundering while satisfying their professional obligations.

Practice pointer: For example, a general practitioner in rural Montana would have no reason to engage in extensive due diligence or know your client measures (as discussed below) if a long term client called the lawyer and asked her to form a limited liability company for the purpose of buying a ranch. However, if that same lawyer received a call from a new and unknown client saying that the client had just won several million dollars at poker in Nevada and needed the lawyer to form a limited liability company to buy a ranch, then a risk based approach would suggest that in this latter case, more extensive due diligence and know your client measures would be appropriate.

What is Client Due Diligence?

The 40+9 Recommendations require that lawyers perform CDD when they perform or carry out specified activities.¹² CDD is intended to assist lawyers in forming a reasonable belief that they have appropriate awareness of the true identity of each client¹³ and the true nature of the matter they have been engaged to undertake. CDD is not intended to place the lawyer in an adversarial relationship with the client; rather, the purpose is to make sure the lawyer knows the true identity and business goals of the client.

CDD should be performed at client intake, but it also should be periodically performed during the course of the engagement. The level of required CDD varies depending on the risk profile of the client. For some clients, “basic” CDD may be appropriate. For clients posing a higher risk, “enhanced” CDD may be necessary. At the other end of the spectrum, reduced CDD may be sufficient. The relative levels of CDD are described in greater detail below.

The three (3) steps required to be taken in “basic” CDD are as follows:

¹² See Recommendation 12.

¹³ LAWYER GUIDANCE ¶ 114.

- Identify and appropriately verify the identity of each client on a timely basis.¹⁴
- Identify the beneficial owner,¹⁵ and take reasonable measures to verify the identity of the beneficial owner of the client such that the lawyer is reasonably satisfied that the lawyer knows who the beneficial owner is. Clients generally should be subject to the full range of CDD measures, including the requirement to identify the beneficial owner in accordance with Lawyer Guidance ¶ 114. The purpose of identifying beneficial ownership is to ascertain those natural persons who exercise effective control over a client, whether by means of ownership, voting shares, contract rights, or otherwise. Lawyers may use a risk-based approach when determining the extent to which they are required to identify the beneficial owner, depending on the type of client, suspicious behavior that might suggest someone is seeking to conceal the true party in interest, the difficulty of ascertaining the identity, the business relationship and transaction, and other appropriate factors, including the geographic location of the client.

The issue of whether a lawyer must, in all cases, identify the beneficial owners of a client was a highly controversial issue in the drafting of the Lawyer Guidance. Although FATF initially sought to adopt a rules-based approach that would require lawyers to always identify the beneficial owners of a client, after strong opposition from representatives of the legal profession, FATF ultimately agreed that this analysis would be subject to a risk-based approach. Consequently, depending on the risks presented by the client, it may be appropriate to identify the beneficial owners of a client. Lawyers should do so only when, from a risk-based standpoint, such an analysis is warranted. It is impractical in some instances for a lawyer to identify the beneficial owners of a client. The cost, time, and effort to undertake such an analysis is typically disproportionate to advancing the goals of detecting and preventing money laundering and terrorist financing unless other factors are present.

Practice pointer: For example, if a lawyer is dealing with a syndication of investors or financiers or an entity that has a large number of owners but is not publicly traded, ascertaining the client's beneficial owners would be extremely time consuming. Unless other facts put the lawyer on notice that something unusual or suspicious were transpiring, the

¹⁴ See Section 6 for a more detailed discussion of this step.

¹⁵ The Lawyer Guidance defines “beneficial owner” as follows: “*Beneficial owner* refers to the natural person(s) who ultimately owns or controls a client and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” See LAWYER GUIDANCE Annex 2.

process of determining all the beneficial owners of the client would be disproportionate to the level of risk.

- Obtain information to understand the client's circumstances and business depending on the nature, scope, and timing of the services to be provided. This information may be obtained from clients in the normal course of the lawyers' acceptance of the retention and receipt of instructions from the client.

Who is covered by the Lawyer Guidance?

The Lawyer Guidance covers “legal professionals,” which includes lawyers and notaries.¹⁶ The Lawyer Guidance is principally focused on transactional lawyers, especially those creating entities and those handling funds, but not all lawyers are subject to the Lawyer Guidance. For instance, in-house lawyers are not covered by the Lawyer Guidance.¹⁷ Several other exclusions are described below.

Importantly, the Lawyer Guidance is limited to those lawyers who “prepare for and carry out specified activities.” The Lawyer Guidance does not define “prepare for and carry out,” but it does define “specified activities” as described below. Thus, even if the lawyer is subject to the Lawyer Guidance, CDD may not be required because of the particular nature of the proposed engagement.

Local and special counsel engagements present unique and challenging issues. Local counsel may be engaged by the primary transaction counsel to assist on a discrete local law issue peripheral to an overall transaction and may have little or no direct involvement with the client. At the other extreme, local counsel may be intimately involved with the transaction, including drafting and negotiating the applicable transactional documents. The Lawyer Guidance recognizes that lawyers providing advice or services (such as a local law enforceability opinion) peripheral to the overall transaction who are not preparing for or carrying out the transaction may not be required to observe the applicable CDD and record-keeping obligations.¹⁸ In short, those lawyers would not be covered by the Lawyer Guidance. Section 4.7 below explores the issue of local and special counsel in greater detail.

A special situation arises for a lawyer who is serving as a trustee. FATF has issued not only Lawyer Guidance, but also risk-based guidance for trust and company service providers, another category of DNFBPs (“TCSP Guidance”).¹⁹ This would appear to create uncertainty as to which guidance a lawyer acting as a trustee is to follow. Generally speaking, a lawyer acting as a trustee need only follow the Lawyer Guidance; the primary exception is if the lawyer is offering the trustee services through a separate entity, such as a trust company. In this latter case, the lawyer should refer to the TCSP Guidance rather than the Lawyer Guidance. The TCSP Guidance imposes obligations on

¹⁶ Legal professionals include notaries, but the Lawyer Guidance does not cover those common law notaries who perform merely administrative acts such as witnessing or authenticating documents (such as deeds and mortgages).

¹⁷ LAWYER GUIDANCE ¶ 8 fn. 2.

¹⁸ LAWYER GUIDANCE ¶ 13. The record-keeping obligations are designed to ensure that documents, data, or information collected under the CDD process is kept up-to-date and relevant by undertaking reviews of existing records, particularly for higher risk categories of clients.

¹⁹ RBA GUIDANCE FOR TRUST AND COMPANY SERVICE PROVIDERS (TCSPs), Financial Action Task Force (issued June 17, 2008). http://www.fatf-gafi.org/newsEvents/0.3382.en_32250379_32235720_1_1_1_3_1.00.html

TCSPs that differ from those imposed on lawyers, thereby underscoring the importance of knowing which guidance applies.

What specified activities are covered by the Lawyer Guidance?

The “specified activities” (collectively, “Specified Activities” or, individually, “Specified Activity”) consist of the following five (5) categories: (a) buying and selling of real estate, (b) managing of client money, securities or other assets, (c) management of bank, savings or securities accounts, (d) organization of contributions for the creation, operation, or management of companies, and (e) creation, operation, or management of legal persons or arrangements, and buying and selling of business entities.²⁰

1. Buying and Selling of Real Estate. The Lawyer Guidance does not define “buying and selling of real estate.” The Specified Activity of buying and selling of real estate appears to apply to both residential and commercial purchase and sale transactions. No dollar limits or thresholds apply to this Specified Activity. However, this Specified Activity does not appear to encompass a number of real estate-related transactions, such as leasing transactions, the preparation of condominium documentation, or the negotiation of easement agreements that do not involve the immediate exchange of funds. Less clear is whether the financing of a purchase or sale of real estate constitutes a Specified Activity, which is discussed in more detail below. However, since financing and re-financing involve the movement of funds, practitioners should assume that these activities would constitute Specified Activities.

Practice pointer: A lawyer who prepares for and carries out the sale of real estate would need to perform the basic CDD and record-keeping requirements envisioned by the 40 +9 Recommendations. But that same lawyer who is engaged by a client to draft and negotiate leases for a shopping center or office complex is not preparing for or carrying out a transaction involving the buying and selling of real estate and need not perform CDD.

2. Managing of client money, securities or other assets. The Lawyer Guidance does not define “managing of client money, securities or other assets.” Here, as well as under items 3 and 4 below, the lawyer would in all cases be handling the client’s funds and, as emphasized above, FATF is particularly focused on the potential risk in situations where the lawyer is actually handling funds. In any situation where the lawyer controls the use, application, or disposition of funds or has signatory authority over the client’s financial account, the risk must be addressed at some level. Recognize,

²⁰ LAWYER GUIDANCE ¶ 12. The wording used in this paragraph, although syntactically challenging, tracks the precise language of the Lawyer Guidance. Earlier drafts of the Lawyer Guidance used the phrase “regulated activities” when referring to the Specified Activities. FATF replaced the “regulated activities” formulation with the “Specified Activities” formulation to avoid conveying the impression that the Lawyer Guidance “regulated” the legal profession.

however, that in almost all cases the funds in the lawyer's control will have been transferred to the lawyer through a financial institution that has performed its own required due diligence and, in some cases, the lawyer should be able to rely on that in lieu of conducting the lawyer's own due diligence. In other cases, however, the financial institution may have simply satisfied itself that the money is flowing into the trust account of a reputable lawyer or law firm. Nonetheless, any time lawyers "touch the money" they should satisfy themselves as to the bona fides of the sources and ownership of the funds in some manner and should inquire of any involved financial institution as to any CDD performed by such institution.

Practice pointer: Lawyers should consider using third party escrow agents to avoid responsibility generally.

3. Management of bank, savings or securities accounts. The Lawyer Guidance does not define "management of bank, savings or securities accounts." In addition to the risks identified in item 2 above, a lawyer or a law firm must be particularly cognizant of the funds that move through the firm's trust account or client account. In this particular situation, the Lawyer Guidance would extend to trial lawyers who frequently hold funds in the firm's trust account.

Practice pointer: Lawyers should exercise caution to avoid situations where they are essentially providing banking services for their clients as opposed to merely holding client money for a legitimate transaction. For example, in a real estate sale, if the lawyer is being asked to make payments not just to mainstream lending institutions, but to more obscure recipients including private individuals whose identities are difficult to verify, the lawyer should exercise caution or treat this as a higher risk situation.²¹

4. Organization of contributions for the creation, operation, or management of companies. The Lawyer Guidance does not define "organization of contributions for the creation, operation, or management of companies."

Practice pointers:

- An example of this Specified Activity is when a lawyer prepares for or carries out a transaction where investors contribute capital to a legal entity. This category does not appear to cover financing or refinancing transactions because the funds are not being contributed to the company.

²¹ This discussion is derived from Section 11.2.3 of the Anti-Money Laundering Practice Note prepared by the Law Society of England and Wales (issued February 22, 2008). See <http://www.lawsociety.org.uk/productsandservices/practicenotes/aml/463.article>.

- In addition to the risks identified in item 2 above relating to handling a client's funds, note that an expansive interpretation of this "specified activity" would conceivably cover financing and refinancing transactions.

5. Creation, operation, or management of legal persons or arrangements, and buying and selling of business entities. The Lawyer Guidance does not define "creation, operation, or management of legal persons or arrangements, and buying and selling of business entities."²² It is under item 5 that the widest range of transactional lawyers fall within the "specified activities." This category of Specified Activities appears to include most of the routine work that is done by real estate lawyers, corporate and business lawyers, and trust and estates lawyers. As in all cases, lawyers must evaluate the risks to determine the extent of CDD required. Even lawyers who do nothing more than prepare for or carry out the task of forming legal entities are likely to be subject to the Lawyer Guidance under this criterion.

Practice pointer: The following is an example of the creation of business entities used for money laundering. Mr. S headed an organization importing narcotics into country A from country B. Mr. S employed a lawyer to establish a web of off-shore corporate entities through which Mr. S could launder proceeds of a narcotics importing operation. These entities were incorporated in Country C where there was lax scrutiny of ownership, records, and finances. A local management company in Country D administered these companies. These entities were used to camouflage movement of illicit funds, acquisition of assets, and financing criminal activities. Mr. S was the holder of 100% of the bearer share capital (i.e., bearer shares are negotiable instruments that accord ownership in a corporation to the person who possess the bearer share certificate) of these off-shore entities. In Country A, a distinct group of entities without any apparent association to Mr. S transferred large amounts of money to Country D where it was deposited in, or transited through, Mr. S's offshore companies. This same web network was found to have been used to transfer large amounts of money to a person in Country E who was later found to be responsible for drug shipments destined for Country A.²³

²² See THE MISUSE OF CORPORATE VEHICLES, INCLUDING TRUST AND COMPANY SERVICE PROVIDERS, Financial Action Task Force (issued October 13, 2006), <http://www.fatf-gafi.org/dataoecd/30/46/37627377.pdf>.

²³ See Case 20, REPORT ON MONEY LAUNDERING TYPOLOGIES 2003-2004, Financial Action Task Force, <http://www.fatf-gafi.org/dataoecd/19/11/33624379.PDF>.

In July 2009, the Uniform Law Commissioners adopted a uniform act known as the Uniform Law Enforcement Access to Entity Information Act that would in certain circumstances ensure transparency and disclosures to law enforcement authorities of the ownership of various legal entities. Representatives of the U.S. Department of Treasury participated in drafting the uniform act. Legislation is also currently pending in Congress dealing with this issue.

Practice pointer: Lawyers engaged in the performance of these legal tasks should satisfy themselves that, at a minimum, they have performed the basic CDD measures described previously (unless the client is otherwise exempt as described in this paper).

What are the risk categories?

The Lawyer Guidance identifies three major risk categories with regard to legal engagements: (a) country/geographic risk, (b) service risk, and (c) client risk. Lawyers need to determine their exposure to each of these risk categories. The relative weight to be given to each risk category in assessing the overall risk of money laundering and terrorist financing will vary from one lawyer or firm to another because of the size, sophistication, location, and nature and scope of services offered by the lawyer or the firm. Based on their individual practices and judgments, lawyers will need to assess independently the weight to be given to each risk factor. These risk factors are subject to variables that may increase or decrease the perceived risk posed by a particular client or type of work. This section will discuss the risk factors and Section 4 will highlight in detail the risk variables that affect each of the risk factors.

Practice pointer: The risk profile of a lawyer or firm whose practice is limited to domestic clients and transactions differs from the risk profile of a lawyer or firm that engages in international and cross-border transactions. The risk factors are intended to attune the lawyer to these differences so as to enable the lawyer to design and implement a risk-based approach that is tailored to that specific, and unique, practice profile.

1. Country/Geographic Risk

The Lawyer Guidance notes the absence of a universally adopted listing of countries or geographic areas that are deemed to present a lower or higher risk. The client's domicile, the location of the transaction, and the source of the funding are but a few sources from which a money laundering risk can arise.

The Lawyer Guidance does, however, identify the profile of those countries that in FATF's view pose a higher risk of money laundering. These higher risk countries include those that are subject to sanctions, embargoes, or similar measures issued by

certain bodies, such as the United Nations and those identified by credible sources as having significant levels of corruption or other criminal activity or a location from which funds or support are provided to terrorist organizations. Countries are also considered to pose a higher risk of money laundering when credible sources identify those countries as generally lacking appropriate AML/CFT laws, regulations, and other measures. The Lawyer Guidance defines “credible sources” as information that is produced by well-known bodies that generally are regarded as reputable and that make such information publicly and widely available. Examples of credible sources include FATF, the International Monetary Fund, The World Bank, FinCEN, OFAC, and the U.S. Department of State.²⁴

Practice pointers:

- Most U.S. lawyers deal only with clients and parties located exclusively within the United States. The country/geographic risk should thus not present a meaningful risk in most transactions.
- In assessing the country risk, a lawyer needs to take into account the client’s domicile, the location of the transaction, and the source of the funding.
- A lawyer representing a client who is involved in acquiring a non-U.S. business that has operations in, or has business with, a country subject to a United Nations embargo or a U.S. government sanctions program (e.g., Zimbabwe, Sudan, and Iran) should understand that the transaction represents a higher risk based on the geographic location and activities of the business being acquired. The lawyer also should determine during the initial client intake efforts whether the lawyer, as a U.S. person, is authorized to participate in the representation because U.S. sanctions programs generally prohibit U.S. persons from engaging in most transactions with persons in Zimbabwe, Sudan, and Iran.
- Transparency International, a global civil society organization formed to fight corruption, has developed a jurisdiction-specific corruption perceptions index that ranks countries based on the degree to which corruption is perceived to exist among public officials and politicians. *See* http://www.transparency.org/policy_research/surveys_indices/cpi/2007/faq#general1. This website may be a useful resource in assessing the level of corruption in a specific country. Another useful resource is the individual Country Reports prepared

²⁴ The U.S. Department of State’s International Narcotics Strategy Control Report, Volume II Money Laundering and Financial Crimes, provides an annual report on money laundering risks posed on a country-by-country basis. *See* <http://www.state.gov/p/inl/rls/nrcrpt/2009/vol2/index.htm>.

annually by The World Bank. These reports are available at <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,,menuPK:115635~pagePK:64020917~piPK:64021009~theSitePK:40941,00.html#CountryReports>.

2. Client Risk

A critical component to the development and implementation of an overall risk-based framework is determining the potential money laundering or terrorist financing risk posed by a client. Clients range from individuals, partnerships and limited liability companies with dozens of partners or members to multi-national corporations. Given this spectrum of clients, a lawyer will be challenged to determine whether a particular client poses a higher risk and, if so, the level of that risk and whether the application of any mitigating factors influences that assessment. The Lawyer Guidance identifies various categories of higher risk clients. If a client falls into one of these categories, the lawyer is then required to apply a set of risk variables that may mitigate or exacerbate the risk assessment the lawyer is required to make to determine the necessary level of CDD.

The Lawyer Guidance identifies nearly a dozen categories of potentially higher risk clients.²⁵ Lawyers need to determine whether any of their clients fall into one or more of these categories and therefore warrant an evaluation of any mitigating circumstances and increased risk assessment. These categories are as follows:

- 2.1 Politically Exposed Persons. Politically exposed persons (“PEPs”) are individuals who are or have been entrusted with prominent functions in a foreign country. Examples include heads of state or of government, senior politicians, senior government, judicial, or military officials, senior executives of state owned corporations, or important political party officials. PEPs do not include middle ranking or more junior individuals in the foregoing categories. If a lawyer is advising a client that is a PEP or is beneficially owned by the PEP, the lawyer would have to perform a higher and more exacting form of CDD known as “enhanced CDD.” The extent and nature of the enhanced CDD will depend on the relevant factors, such as the PEP’s home country, the type of work the PEP is instructing the lawyer to perform or carry out, and the scrutiny to which the PEP is subjected in the PEP’s home country.

Practice pointers:

- It is important to note that PEPs are high level political officials in *foreign* countries. For example, a senior U.S. government official would not be a PEP vis-à-vis a U.S. lawyer. By contrast, a U.S. lawyer representing a high level

²⁵ LAWYER GUIDANCE ¶ 109.

government official of a foreign country would be representing a PEP for purposes of the Lawyer Guidance.

- FATF identified a typology where a senior politician and a senior official were involved in high level corruption. An intermediary received a payment of USD 50 million from Company A. The intermediary then transferred the money into two accounts held off-shore; the funds were then moved to company accounts that were also held offshore. The beneficial owners of these company accounts were discovered to be a former head of the secret service in Country B and a state secretary for the Ministry of Defence in Country C.²⁶

- 2.2 Unusual Activity. Clients conducting their relationship or requesting services in unusual or unconventional circumstances (as evaluated in light of all the circumstances of the representation).²⁷

Practice pointer: This broad category, which is viewed through the prism of the overall representation, includes a client's inexplicable demand to close a purchase or sale in an extremely short period of time or the client's refusal to provide the lawyer with any details about the client. Similarly, a client who insists that a lawyer who does not usually handle cross-border transactions assume responsibility in an international business transaction should raise suspicions.

- 2.3 Masking of Beneficial Ownership. Where the structure or nature of the client entity or relationship makes it difficult to identify in a timely manner the true beneficial owner or controlling interests, such as the unexplained or seemingly unnecessary use of legal persons or legal arrangements, nominee shares or bearer shares.²⁸

Practice pointer: This might be typified by a client, particularly a new client, who insists on the formation of a complex, multi-tiered entity (such as a limited liability partnership, corporation, or limited liability company) involving other entities and a notable absence of

²⁶ See Case 15, REPORT ON MONEY LAUNDERING TYPOLOGIES 2003-2004, Financial Action Task Force, <http://www.fatf-gafi.org/dataoecd/19/11/33624379.PDF>.

²⁷ *Id.* (third bullet).

²⁸ *Id.* (fourth bullet).

any individuals and offers only the briefest of explanations or no justification for or explanation as to the purpose or the ownership structure of the new entity.

- 2.4 Cash Intensive Businesses. Clients that are cash (and cash equivalent) intensive businesses, such as: (a) money services businesses (e.g., remittance houses, currency exchange houses, or other businesses offering money transfer facilities), (b) casinos, betting and other gambling related activities, and (c) businesses that while not normally cash intensive, generate substantial amounts of cash.²⁹

Practice pointer: Lawyers need to be especially sensitive to cash intensive businesses, such as residential rental operations. Money launderers have been known to use bars, restaurants, car washes, and parking lots – all legitimate enterprises, but cash intensive. Indeed, money launderers have sought to launder funds through collection plates at churches.

- 2.5 Cash Intensive Businesses—Mitigation of Risk. Where clients are cash intensive businesses that are already themselves subject to and regulated for a full range of AML/CFT requirements consistent with the 40+9 Recommendations, this may mitigate the client risks to the lawyer.³⁰
- 2.6 Charities and NPOs. Charities and other NPOs that are not subject to monitoring or supervision (especially those operating on a “cross-border” basis) by designated competent authorities or self-regulatory organizations (“SROs”) are potentially higher risk clients.³¹

Practice pointer: A lawyer should carefully scrutinize a charity that has raised funds domestically and then disbursed them abroad, no matter what may appear on the surface to be its charitable cause or mission. When dealing with a charity/NPO, a lawyer may consider it appropriate to assess whether the policies and procedures of the charity/NPO comply with the guidelines set forth in U.S. DEPARTMENT OF THE TREASURY ANTI-TERRORIST FINANCING GUIDELINES: VOLUNTARY BEST PRACTICES FOR U.S. BASED CHARITIES, <http://www.ustreas.gov-press-releases-reports->

²⁹ *Id.* (fifth bullet).

³⁰ *Id.* (sixth bullet).

³¹ *Id.* (seventh bullet). For a discussion of voluntary best practices for U.S. based charities, see U.S. DEPARTMENT OF THE TREASURY ANTI-TERRORIST FINANCING GUIDELINES: VOLUNTARY BEST PRACTICES FOR U.S. BASED CHARITIES, <http://www.ustreas.gov-press-releases-reports-0929%20finalrevised.pdf>.

0929%20finalrevised.pdf.

- 2.7 Financial Intermediaries Not Subject to Adequate AML/CFT Laws. Clients using financial intermediaries, financial institutions or legal professionals that are not subject to adequate AML/CFT laws and measures and that are not adequately supervised by competent authorities or SROs are potentially higher risk clients.³²

Practice pointer: Almost all domestic U.S. financial institutions are covered by AML/CFT rules that apply to them. Perhaps the greatest risks here are (i) a transaction with an unregulated financial institution or (ii) a transaction involving a foreign financial institution not subject to AML/CFT rules.

- 2.8 Clients with Certain Criminal Convictions. Clients having convictions for proceeds generating crimes who instruct the lawyer (who has actual knowledge of such convictions) to undertake specified activities on their behalf are potentially higher risk clients.³³

Practice pointer: Lawyers who deal with clients knowing that they have been convicted of financial crimes (such as embezzlement) present a potentially higher client risk to the lawyer.

- 2.9 Clients with No Address/Multiple Addresses. Clients who have no address, or multiple addresses without legitimate reasons.³⁴

Practice pointer: This risk factor informs the issue of the client's true identity. A client with no address or multiple addresses without a legitimate explanation is a higher risk to the lawyer. A higher risk situation may also arise where a client operates seemingly unrelated and different businesses at the same address.

- 2.10 Unexplained Change in Instructions. Clients who change their settlement or execution instructions without appropriate explanation are potentially higher risk clients.³⁵

³² *Id.* (eighth bullet).

³³ *Id.* (ninth bullet).

³⁴ *Id.* (tenth bullet).

³⁵ *Id.* (eleventh bullet).

Practice pointer: The most likely instructions to raise concerns are those given in connection with the receipt of funds (source of funds) or the delivery of funds (the recipient of funds), including those involving last minute and unexplained changes in the flow of funds or instructions directing that the funds be sent to a person or entity unrelated to the transaction.

- 2.11 Structures With No Legal Purpose. The use of legal persons and arrangements without any apparent legal or legitimate tax, business, economic or other reason are potentially higher risk situations.³⁶

Practice pointer: This high risk factor requires the lawyer to determine whether there is any apparent legal or legitimate tax, business, economic or other reason for the use of a particular legal entity or transaction structure. Obviously, a lawyer cannot knowingly facilitate criminal activity by creating deal structures whose only purpose is to mask money laundering or terrorist financing. The lawyer needs to evaluate whether the use of particular entities or deal structures advances a legal or legitimate tax, business, economic or other reason. A client who is unwilling to explain the rationale for the use of particular entities or deal structures would require the lawyer to intensify his or her CDD.

3. Service Risk

FATF has determined that some services are at higher risk for money laundering and terrorist financing. Typically those services involve the movement of funds and/or the concealment of beneficial ownership.

- 3.1 “Touching the Money” Test. Services where lawyers, acting as financial intermediaries, actually handle the receipt and transmission of funds through accounts the lawyers actually control in the act of closing or facilitating a transaction.³⁷ Without knowing the sources and destination of the funds, a lawyer may unwittingly aid money laundering or terrorist financing activities.

Practice pointers:

- This service risk factor is the classic “touch the money”

³⁶ *Id.* (twelfth bullet).

³⁷ LAWYER GUIDANCE ¶ 110 (first bullet).

factor. If a lawyer handles (or “touches”) money in performing or carrying out a Specified Activity or if cash moves through the lawyer’s client account, that lawyer is exposed to a higher risk of being unknowingly involved in money laundering or terrorist financing activity. For example, a real estate lawyer who represents a seller of commercial real estate may also function as an escrow agent who holds the earnest money deposit in an escrow account and conducts closing by receiving and transmitting the closing funds through the lawyer’s escrow account.

- Trust and estate lawyers frequently “touch the money,” for example, in the process of funding a trust or in administering an estate. Risk thus exists at the point of funding the trust and thereafter in the administration of the trust.
- The lawyer should be aware of not only the source of funds transferred to a trust but the use of the funds by the trustee. The lawyer should be alert to the purpose of the trust, the reasons behind any unusual structures, and the use of jurisdictions that have minimal compliance with AML/CFT regulation.

3.2 Concealment of Beneficial Ownership. Services to conceal improperly beneficial ownership from competent authorities.³⁸

Practice pointer: Anonymity, or the lack of transparency, is disfavored by criminal enforcement authorities. However, there may be legitimate reasons to keep confidential the beneficial ownership of an entity from the public because of business competitive reasons. For example, a developer may desire to acquire multiple tracts of land. If the developer discloses the identity of its beneficial owners, landowners may force the developer (with perceived “deep pockets”) to pay a higher price for the tracts being sold. By keeping the identity of its beneficial owners out of the public record, the developer may be able to acquire the tracts at fair market value without paying a premium. Non-business reasons for confidentiality may apply as well. For instance, a wealthy investor may desire anonymity to enhance personal safety (e.g., avoid kidnappings). Lawyers should be mindful, though, that law enforcement authorities may have a legitimate need to know the identity of the true beneficial owner in

³⁸ *Id.* (second bullet).

appropriate circumstances, such as bona fide criminal investigations.

- 3.3 Performing Services Outside Area of Expertise. Services requested by the client for which the client knows the lawyer does not have expertise excepting where the lawyer is referring the request to an appropriately trained professional for advice.³⁹

Practice pointer: A lawyer regularly represents a client in commercial real estate transactions. The client asks the lawyer to handle the creation of various off-shore trusts. The client is aware that the lawyer has no training in creating these types of trusts. The lawyer should inquire why the client would like the lawyer, and not that lawyer's colleagues who are experienced in trusts, to handle this work.

- 3.4 Accelerated Real Estate Transfers. Transfer of real estate between parties in a time period that is unusually short for similar transactions with no apparent legal, tax, business, economic or other legitimate reason.⁴⁰

Practice pointers:

- Accelerated, or frequent, transfers or “flips” of real property may be accomplished for specific tax or other business reasons. But real property transfers made in an unusually short time frame in comparison to similar deals and with no apparent legal, tax, business, economic or other legitimate reason represent a higher risk to the lawyer. For example, a client asks the lawyer to handle the transfer of a residence from the client to a new entity controlled by the client. The client then directs the lawyer to convey the property immediately from the new entity to yet another new entity controlled by the client. The lawyer needs to understand the legal, tax, business, economic, or other legitimate reason for the serial transactions within a compressed time period.
- In a 2008 report, FinCEN noted that a bank reported a series of transactions occurring within a one-month period in which the same property was bought and sold among related

³⁹ *Id.* (third bullet).

⁴⁰ *Id.* (fourth bullet).

individuals. As a result of this flipping of the property, the bank granted a loan re-finance of over \$600,000 to an individual who did not hold title to the property at the time the loan closed. The bank indicated in the suspicious activity report narrative that it was not able to definitively determine the motive for these transactions, but surmised that they may have been conducted to promote money laundering or tax evasion.⁴¹

- 3.5 Cash Payments; Payments From Other Sources. Payments received from unassociated or unknown third parties and payments for fees in cash where this would not be a typical method of payment.⁴²

Practice pointer: If a client offers to pay in cash, the lawyer is dealing with a higher risk situation. For payments from third parties, the lawyer should always understand the reason for that arrangement. The lawyer should be aware of the requirement that each person engaged in a trade or business who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction or in two or more related transactions, must file Form 8300 with the Internal Revenue Service.

- 3.6 Inadequate Consideration. Transactions where it is readily apparent to the lawyer that there is inadequate consideration, such as when the client does not identify legitimate reasons for the amount of the consideration.⁴³

Practice pointer: In assessing the adequacy of consideration, a lawyer is not required to undertake a rigorous analysis of the economics of the transaction. Rather, the lawyer simply needs to understand whether the stated consideration is reasonably related to the value of the transaction after factoring in the known relevant criteria. For instance, a client proposes to sell a parcel of land valued at \$1 million to a third party for \$20,000. On its face, the disparity between the value of the land and the stated consideration should prompt the lawyer to inquire into the justification for the disparity in consideration. Inadequate consideration is typically not

⁴¹ SUSPECTED MONEY LAUNDERING IN THE RESIDENTIAL REAL ESTATE INDUSTRY: AN ASSESSMENT BASED UPON SUSPICIOUS ACTIVITY REPORT FILING ANALYSIS, APRIL 2008, http://www.fincen.gov/news_room/rp/files/MLR_Real_Estate_Industry_SAR_web.pdf.

⁴² *Id.* (fifth bullet).

⁴³ *Id.* (sixth bullet).

a risk factor in the practice of estate planning where clients are routinely making gifts to spouses, children, other family members and charities.

- 3.7 Estate Administration—Convictions for Proceeds Generating Crimes. Administrative arrangements concerning estates where the decedent was known to the lawyer to be a person who had been convicted of proceeds generating crimes.⁴⁴

Practice pointer: If the decedent was involved or even reputed to have been involved in criminal activity, then the lawyer is dealing with a higher risk situation. A lawyer should assume a higher level of risk if the decedent was involved in any of the following businesses: casinos, bars, strip clubs, or dealers in pornography. Although these businesses are not necessarily illegal, they involve sufficient indicia of criminal elements being associated with such businesses that the assumption of higher risk is warranted.

- 3.8 Extraordinary Legal Fees. Clients who offer to pay extraordinary fees for services which would not ordinarily warrant such a premium. Bona fide and appropriate contingency fee arrangements, where a lawyer may receive a significant premium for a successful representation, should not be considered a risk factor.⁴⁵

Practice pointer: If the client offers to pay the lawyer a percent of the proceeds for a sale where the client wants the closing to be quick and anonymous, a lawyer should view this as a higher risk situation.

- 3.9 Source of Funds/Wealth. The source of funds and the source of wealth. The source of funds is the activity that generates the funds for a client, while the source of wealth describes the activities that have generated the total net worth of a client.⁴⁶

Practice pointer: Most clients can quickly inform a lawyer of how they made or acquired their wealth. A lawyer can usually verify easily such representations by references, a review of the clients'

⁴⁴ *Id.* (seventh bullet).

⁴⁵ *Id.* (eighth bullet).

⁴⁶ *Id.* (ninth bullet).

income tax returns (but only to the extent the client has provided the lawyer with this information), or Internet research. A higher risk situation may arise if the client is unable or unwilling to identify the source of wealth.

- 3.10 Out of Character Transactions. Unusually high levels of assets or unusually large transactions compared to what might reasonably be expected of clients with a similar profile may indicate that a client not otherwise seen as higher risk should be treated as such. Conversely, low levels of assets or low value transactions involving a client that would otherwise appear to be higher risk might allow the lawyer to treat the client as lower risk.⁴⁷

Practice pointer: This risk factor focuses on transactions that appear out of character for a particular client because of the size of the transactions or assets. For example, a lawyer represents a client who typically buys tracts of land for development, and the average size of these transactions is approximately \$500,000. The client/developer asks the lawyer to handle the acquisition of an operating business unrelated to the client's real estate development business for a purchase price of \$6 million. In this case, the lawyer should inquire into the client's historical acquisition practices and why this client now appears to be engaged in transactions that are out of character.

- 3.11 Shell Companies. Shell companies, companies with ownership through nominee shareholding and control through nominee and corporate directors.⁴⁸

Practice pointer: These are the kinds of structures typically used to conceal beneficial ownership. The risk is higher when such entities are being utilized.

- 3.12 Hard to Identify Trust Beneficiaries. Situations where it is difficult to identify the beneficiaries of trusts; this might include a discretionary trust that gives the trustee discretionary power to name the beneficiary within a class of beneficiaries and distribute accordingly the assets held in trust, and when a trust is set up for the purpose of managing shares in

⁴⁷ *Id.* (tenth bullet).

⁴⁸ *Id.* (eleventh bullet).

a company that can make it more difficult to determine the ownership of the company managed by the trust.⁴⁹

Practice pointer: Typically trust beneficiaries are obvious. In any situation where they are not, the risk is higher. Sometimes trusts are used to conceal beneficial ownership, but there is no reason that the beneficial owners should not be disclosed to the lawyer so the lawyer can make an assessment of the risk based on that knowledge.

- 3.13 Anonymity. Services that deliberately have provided or purposely depend upon more anonymity in the client identity or participants than is normal under the circumstances and in the experience of the lawyer.⁵⁰

Practice pointer: As described in a previous Practice Pointer, a developer assembling multiple parcels may have a legitimate need to anonymity and, in that case, anonymity is not by itself a higher risk factor.

- 3.14 Trust Services. Firms that, as a separate business, offer TCSP services should look to the TCSP Guidance, even if those firms are owned or operated by lawyers. Lawyers, however, who offer TCSP services should look to the Lawyer Guidance, but those lawyers should also consider the customer or service risks related to TCSPs, such as the following: (a) unexplained use of express trusts, (b) unexplained delegation of authority by the client through the use of powers of attorney, mixed boards and representative offices, (c) in the case of express trusts, an unexplained relationship between a settlor and beneficiaries with a vested right, other beneficiaries and persons who are the object of a power, (d) in the case of an express trust, an unexplained (where explanation is warranted) nature of classes of beneficiaries and classes within an expression of wishes.⁵¹

Practice pointers:

- In the usual case a trust lawyer will know immediately if the trust arrangement has odd or unusual characteristics. Even then, some of these features may be easily explained by the

⁴⁹ *Id.* (twelfth bullet).

⁵⁰ *Id.* (thirteenth bullet).

⁵¹ *Id.* (fourteenth bullet).

client, but such factors may be a sign of a higher risk situation.

- In performing trustee services the lawyer will almost certainly be “touching the money” and so that service risk is higher.

4. Risk Variables that May Affect Risk

The Lawyer Guidance recognizes that vast and profound differences exist within lawyers and the nature of their practices, types of clients, size of firms, scale, and expertise. All lawyers and law firms are not the same. For that reason, when creating a reasonable risk-based approach and evaluating the resources that can be reasonably allocated to implement and manage it, due consideration must be given to these factors. The Lawyer Guidance notes that a sole practitioner would not be expected to devote an equivalent level of resources as a large law firm. Instead, the sole practitioner would need to develop appropriate systems and controls and a risk-based approach proportionate to the scope and nature of the practitioner’s practice.

A lawyer needs to consider whether the client and the proposed work would be unusual, risky, or suspicious. This significant factor must always be considered in the context of the lawyer’s practice. The risk-based approach and its concept of proportionality dictates that the presence or absence of one or more of these variables may require a lawyer to perform enhanced due diligence or lead the lawyer to conclude that standard CDD can be reduced. As noted earlier, in no case does FATF suggest that the risk may ever be so low as to eliminate any form or level of CDD. This approach is best viewed as a sliding scale where one or more of the following variable factors may increase or decrease the perceived risk posed by a particular client or type of work.

- 4.1 Nature of Client Relationship. The nature of the client relationship and the client’s need for the lawyer to provide specified activities.⁵²

Practice pointers:

- If the lawyer has been regularly representing the client for several years in performing and carrying out one or more Specified Activities, the client’s request that the lawyer perform the same or similar work for another similar transaction suggests that the risk of money laundering or terrorist financing is low. In this situation, it would be disproportionate to perform standard CDD; rather, reduced CDD would be warranted and the focus should be on the transaction involved.

⁵² LAWYER GUIDANCE ¶ 112 (first bullet).

- Reduced CDD may simply entail confirming the on-going accuracy of the client information.
- The type of client influences the scope, level, and intensity of the CDD. Lawyers should thus determine the type of entity involved, such as whether the client is a natural person or a legal entity. If the client is a legal entity, is the client privately held or publicly traded? Is the client subject to AML/CFT regulations or other form of governmental oversight and regulation? If the client is a legal entity, who is acting on behalf of the client in directing the performance of the Specified Activities?

4.2 Existing Regulation. The level of regulation or other oversight or governance regime to which a client is subject.⁵³

Practice pointer: A client that is a financial institution or legal professional regulated in a country with a satisfactory AML/CFT regime poses less risk of money laundering than a client in an industry that has money laundering risks and yet is unregulated for money laundering purposes.

4.3 Reputation and Publicly Available Information. The reputation and publicly available information about a client. Clients that are transparent and well known in the public domain and have operated for a number of years without being convicted of proceeds generating crimes may have low susceptibility to money laundering.⁵⁴

Practice pointer: A client has been operating a family owned business in the same location for several generations. The client has an excellent reputation in the community and is active in various community organizations. In this example, the client can be viewed as having a low susceptibility to money laundering. By contrast, a client has just relocated to a distant geographic location and has not had an opportunity to establish the client's reputation. The client is publicity shy and there appears to be no publicly available information about the client. The lawyer does not know the criminal background of the client. In that situation, the lawyer should perform standard CDD unless other risk factors suggest that

⁵³ *Id.* (second bullet).

⁵⁴ *Id.* (third bullet).

enhanced CDD should be performed.

- 4.4 Regularity/Duration of Relationship. The regularity or duration of the relationship.⁵⁵

Practice pointer: The regularity and duration of the attorney-client relationship influences the level of CDD. A lawyer who has been regularly representing a client for several decades would have no need to perform standard or enhanced CDD. Reduced CDD would be warranted in that situation. By contrast, a lawyer who has represented a client for several decades but only deals with the client once or twice every five years should perform standard CDD given the lack of regular, on-going interaction with the client.

- 4.5 Familiarity with Country/Laws. The familiarity of the lawyer with a country, including knowledge of local laws, regulations and rules, as well as the structure and extent of regulatory oversight, as the result of a legal professional's own activities within the country.⁵⁶

Practice pointer: This likely is only going to be an issue for lawyers who practice cross-border work. Even then this requested service may not be a higher risk situation. For example, in dealing with a country that has stringent AML/CFT laws (such as the United Kingdom), the risk might be lower than when dealing with Liechtenstein. In dealing with Liechtenstein or another small financial center jurisdiction, the frequency of the transactions and the knowledge about the reputation of one's professional counterpart can affect the risk assessment.

- 4.6 Duration/Magnitude of Lawyer-Client Relationship. The proportionality between the magnitude or volume and longevity of the client's business and its use of the lawyer for its legal requirements, including the nature of professional services sought.⁵⁷ This factor focuses on the duration and magnitude of the lawyer-client relationship.
- 4.7 Local Counsel. Subject to other factors (including the nature of the services and the source and nature of the client relationship), providing limited legal services in the capacity of a local or special counsel may be

⁵⁵ *Id.* (fourth bullet).

⁵⁶ *Id.* (fifth bullet).

⁵⁷ *Id.* (sixth bullet).

considered a low risk factor. This may also, in any event, mean that the lawyer is not “preparing for” or “carrying out” a transaction for a regulated activity specified in Recommendation 12.⁵⁸

Practice pointer: The local or special counsel’s experience and relationship with referring counsel can have a significant impact on risk. If the referring counsel is well known and has a good reputation for ethics and professionalism, the risk is lower than if the referring counsel is not known or does not enjoy a good reputation.

- 4.8 Geographic Disparity. Significant and unexplained geographic distance between the lawyer and the location of the client where there is no nexus to the type of work being undertaken.⁵⁹

Practice pointer: If a California client asks a Florida lawyer to form a Nevada limited liability company or corporation, the client’s request may call for a higher risk assessment.

- 4.9 “One Shot” Transaction. Where a prospective client has instructed the lawyer to undertake a single transaction-based service (as opposed to an ongoing advisory relationship) and one or more other risk factors are present.⁶⁰

Practice pointer: If the entire scope of representation of a new client is to form a limited liability company for the client to receive the proceeds of a sale, the narrowness of the representation may pose a higher risk factor.

- 4.10 Technological Developments Favoring Anonymity. Risks that may arise from the use of new or developing technologies that permit non-face to face relationships and could favour or promote anonymity. However, due to the prevalence of electronic communication between lawyers and clients in the delivery of legal services, non-face to face interaction between lawyers and clients should not, standing alone, be considered a high risk factor. For example, non-face to face, cross-border work for an existing client is not necessarily high risk work for certain organisations

⁵⁸ *Id.* (seventh bullet).

⁵⁹ *Id.* (eighth bullet).

⁶⁰ *Id.* (ninth bullet).

(such as regional, national or international law firms or other firms, regardless of size, that specialize in that type of work).⁶¹

Practice pointer: It is not unusual for lawyers and clients, who have never met in person, to deal and interact with each other via e-mail and voicemail messages. This should not, standing alone, constitute a high risk factor.

- 4.11 Client Origination/Referral Source. The nature of the referral or origination of the client relationship.⁶²

Practice pointer: A prospective client may contact a legal professional in an unsolicited manner or without common or customary methods of introduction or referrals, which may increase risk. By contrast, where a prospective client has been referred from another trusted source subject to an AML/CFT regime that is in line with the FATF standards, the referral may be considered a mitigating risk factor.

- 4.12 Structure of Client/Transaction. The structure of a client or transaction.⁶³

Practice pointer: Structures with no apparent legal, tax, business, economic or other legitimate reason may increase risk. Legal professionals often design structures (even if complex) for legitimate legal, tax, business, economic or other legitimate reasons. In those cases, the structure used is not a high risk factor.

- 4.13 Pension Funds. Trusts that are pensions may be considered lower risk.⁶⁴

5. Controls for Higher Risk Clients

An assessment of the applicable risk factors may lead to the conclusion that the client may be higher risk. The Lawyer Guidance does not prohibit a lawyer from representing a higher risk client; instead, the Lawyer Guidance directs the lawyer to implement appropriate measures and controls to mitigate the potential money laundering

⁶¹ *Id.* (tenth bullet).

⁶² *Id.* (eleventh bullet).

⁶³ *Id.* (twelfth bullet).

⁶⁴ *Id.* (thirteenth bullet).

and terrorist financing risks of that client. Lawyers and appropriate staff need to be trained to identify and detect changes in client activity by reference to risk-based criteria. The measures and controls for higher risk clients may include the following:

- 5.1 General Training. It is paramount that general training be made available to lawyers and appropriate staff on money laundering methods and risks relevant to lawyers.⁶⁵
- 5.2 Specific Training. Targeted training for increased awareness by the lawyers providing Specified Activities to higher risk clients or to lawyers undertaking higher risk work. The key is to ensure that those lawyers who will be exposed to the higher risk work be specifically trained so that they are attuned to the applicable risks.⁶⁶
- 5.3 Enhanced Due Diligence. Enhanced levels of CDD for higher risk situations (see section 6.3 below for a more detailed discussion).⁶⁷
- 5.4 Peer/Managerial Oversight. Enhanced or additional review and/or consultation by the lawyer or within a firm at the establishment of a relationship. Peer or managerial review and oversight are important measures to take when dealing with higher risk clients. Additional review may detect other risk factors or may reveal factors that mitigate the risk. In larger firms, various management levels or committees may review these types of engagements with close scrutiny. At smaller firms, these types of formal controls may not be feasible or practical, but the lawyer should nonetheless seek additional review when exploring an engagement with a higher risk client.⁶⁸
- 5.5 Evolving Evaluation of Services. Periodic review of the services offered by the lawyer and/or firm to determine whether the risk of money laundering and terrorist financing occurring has increased. Services offered by a lawyer may, over time, become more susceptible to money laundering and terrorist financing. Lawyers should periodically review their services to see if the risks of money laundering and terrorist financing occurring have increased.⁶⁹

Practice pointer: If a lawyer's practice evolves from domestic

⁶⁵ LAWYER GUIDANCE ¶ 113 (first bullet).

⁶⁶ *Id.* (second bullet).

⁶⁷ *Id.* (third bullet).

⁶⁸ *Id.* (fourth bullet).

⁶⁹ *Id.* (fifth bullet).

work to international work, the service risk may possibly increase. Similarly, if a lawyer's practice results in an increased use of the firm's trust account (client account), service risk may increase. Another example of increased risk is when a lawyer's client base involves over time the increasing use of more entities or more tiered entity structures.

5.6 On-Going/Evolving Evaluation of Clients. Reviewing client relationships from time to time to determine whether the risk of money laundering and terrorist financing occurring has increased. Clients may enter into new businesses or affiliate with other investors, all of which may increase the risk of money laundering and terrorist financing. Lawyers should be attuned to their client relationships to detect whether the risk of money laundering and terrorist financing occurring has increased.⁷⁰

5.7 Overlap. The same measures and controls may often address more than one of the risk criteria identified, and it is not necessarily expected that a legal professional establish specific controls targeting each risk criterion. Lawyers may adopt measures and controls that address multiple risk factors. For that reason, lawyers are not required to mechanically apply a specific measure or control to each risk criterion.⁷¹

6. Basic Protocol for Client Intake and Assessment

The fundamental starting point for implementing a risk-based approach is for the lawyer to make an overall risk assessment of the client. Most lawyers perform elements of that assessment as part of their established client intake and conflicts review system. The protocols outlined in this Section 6 and in Appendix A attached hereto are designed to supplement, not supplant, that system. The complexity of that system will vary depending on the practice profile of the lawyer and the firm.

In making an overall risk assessment of the client, the lawyer needs to take into account any appropriate risk variables (and any mitigating factors) before making a final determination to accept the engagement. The lawyer's risk assessment, which is made on an individualized basis for each client, will then dictate the overall approach to CDD requirements and appropriate verification. The lawyer determines which CDD requirements are appropriate for each client based on the overall risk assessment and the lawyer's familiarity with the client. These CDD requirements may include the following:

⁷⁰ *Id.* (sixth bullet).

⁷¹ *Id.* (seventh bullet).

6.1 Standard Level of CDD. A standard level of CDD is generally applied to all clients. Standard level CDD includes the following elements:

6.1.1 Identifying the client and verifying that client's identity using reliable, independent source documents, data, or information. The lawyer needs to document its findings.

- Basic Identification. Client identification may entail a review of the client's driver's license or other governmentally-issued photographic identification, the verification of the client's address, and a check of the client's financial and business references.
- OFAC Scan. A basic part of the verification process includes performing an "OFAC scan" to determine whether the client's name appears on the SDN List or business with the client is otherwise prohibited. The SDN List identifies a list of persons (individuals and entities) with whom U.S. persons may not engage in the exchange of most goods, services, or technology. U.S. persons are also prohibited from engaging in the exchange of most goods, services, or technology with (a) persons owned 50% or more by persons on the SDN list; and (b) persons in or the governments of Cuba,⁷² Sudan, and Iran. Helpful information on performing OFAC scans and dealing with the results of that effort are set forth in OFAC's website: <http://www.treas.gov/offices/enforcement/ofac/>.

6.1.2 Identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner of the client such that the lawyer is reasonably satisfied that the lawyer knows who the beneficial owner is.

Practice pointer: The verification of the identity of beneficial ownership is risk-based. Lawyers should evaluate the risks of not verifying the identity of the beneficial owners of a client. Law firms should consider developing or revising their intake forms to capture this information.

6.1.3 Obtaining information on the purpose and intended nature of the business relationship.

⁷² For purposes of the Cuban Assets Control Regulations, Cuban nationals located outside of the United States are also prohibited parties.

6.1.4 Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken periodically throughout the course of that relationship to ensure that the transactions being conducted are consistent with the lawyer's knowledge of the client, its business and risk profile, including, where necessary, the source of funds.

Practice pointer: Client due diligence is not a static analysis. The attorney-client relationship often evolves over time, and the lawyer needs to be sensitive to changes that may occur during the course of the relationship.

- 6.2 Reduced CDD. A lawyer can apply a reduced level of CDD in recognized lower risk scenarios, such as: (a) publicly listed companies (and their majority owned subsidiaries), (b) financial institutions subject to an AML/CFT regime consistent with the FATF Recommendations (all U.S. banks are subject to an AML/CFT regime), and (c) government authorities and state run enterprises (other than those from sanctioned countries). Reduced CDD may simply include obtaining information on the purpose and intended nature of the new matter or business relationship, which information is necessary to perform the engagement.

Practice pointer: Lawyers do not need to perform standard CDD for clients that are publicly listed companies. These companies present a recognized lower risk profile than other clients. The lawyers will need to know the purpose and nature of the new matter or business relationship.

- 6.3 Enhanced CDD. An enhanced level of CDD is required for those clients that are reasonably determined by the lawyer to be of higher risk. An assessment of higher risk may be based on a number of factors, such as the client's business activity, ownership structure, particular service offered including work involving higher risk countries or defined by applicable law or regulation as posing higher risk, such as the risks outlined in paragraphs 108-109 of the Lawyer Guidance (geographic risk and customer risk). Enhanced CDD means a more in depth, systematic inquiry into the client and its ownership and business activities.

Practice pointer: Higher risk clients require enhanced CDD. The lawyer needs to ensure that the client and its ownership and business activities comply with applicable law and that no criminal activity is involved.

- 6.4 **Timing.** The overall risk assessment should be performed as part of the client intake and conflict review process, meaning that the lawyer should refrain from performing the work until the completion of the risk assessment process. In those situations where the verification process may be time consuming, the lawyer may determine to cease work on a matter if the overall risk assessment is not completed within a defined time period after the work begins.

What if Client Presents an Unacceptable Risk?

Not every risk-based approach analysis of a potential client will inexorably lead to the conclusion that, with appropriate controls, the lawyer can accept and proceed with the proposed engagement. It may be possible that the lawyer's analysis will lead the lawyer to reject the engagement or to withdraw from the representation. Rule 1.16 of the ABA Model Rules of Professional Conduct governs declining or terminating the lawyer-client relationship. When faced with a situation where the lawyer is compelled to decline or terminate the relationship, the lawyer should comply with the requirements of the applicable rules of professional conduct, including Model Rule 1.16 or its equivalent. For example, a lawyer may withdraw from representing a client if, among other things, the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent or the client has used the lawyer's services to perpetrate a crime or fraud.

Education and Continuing Legal Education Efforts

The Lawyer Guidance places a premium on on-going educational efforts to enhance awareness of money laundering and terrorist financing risks.⁷³ Once the lawyer or law firm has assimilated the basics of the risk-based approach, a decision needs to be made about how to implement policies and procedures firm wide. At a minimum the lawyer or law firm needs to implement an AML/CFT policy and procedures for client intake and the periodic review of clients' activities. The lawyer or law firm should designate a compliance officer. All lawyers in the firm will need a certain level of training and education as will paralegals and key administrative staff. The policies, procedures, and education should be set, endorsed, and reviewed by the firm's senior management.

The firm should designate one or more lawyers whose task will be to remain current on developments in this area. These lawyers will need to make determinations about ongoing education in the firm as well as periodic revisions to policies and procedures.

⁷³ LAWYER GUIDANCE ¶¶ 33, 97, 102, and 121.

Appendix A
Basic Client Intake

Upon the intake of a new client, a lawyer may wish to take some or all of the measures discussed below to help the lawyer assess the risk of money laundering and terrorist financing the potential representation of the client may entail. The degree and scope of this assessment will vary based upon, among other factors, the particulars of the proposed representation and the nature and identity of the client. This Appendix A is intended only to highlight some of the key elements of the assessment lawyers should consider and is not intended to be, nor should it be construed as, a mandatory checklist for client intake that is to be used or applied in all circumstances or a rote or mechanical fashion.

1. **Client Identity.** Once the lawyer has gained an understanding of the representation being sought and the client's objective, the lawyer will need to verify the identity of the client by obtaining some basic information that will enable the lawyer to "know the client" and, if applicable, its beneficial ownership.

1.1 **Natural Person as Client.** In the case of an individual client, depending upon the nature of the representation and level of initial concern the lawyer may have regarding the intentions or background of the client, the lawyer may need to obtain some or all of the following information: the client's name, employment background, place of birth, prior residential addresses, current residential address, business address, phone numbers, date of birth, marital status, names of prior or current spouses and/or names of children, dates of birth and social security numbers of any such spouses and/or children, the name and contact information of any other lawyers with whom the client regularly deals, the name and contact information of the client's certified public accountant, prior criminal convictions, pending lawsuits, and status of tax filings with governmental authorities. The lawyer may also wish to retain a copy of the client's driver's license or another federally issued form of photo identification and/or request that the client submit a summary of his or her personal and business history. This could help the lawyer to determine and/or verify the source of the funds to be involved in the transaction(s) in question.

1.2 **Entity as Client.** If the client is an entity rather than an individual (and dependent on other risk factors, such as whether the client is publicly traded), depending upon the nature of the representation and level of initial concern the lawyer may have regarding the intentions or background of the client, the lawyer should seek to obtain the names of any subsidiary/parent/nominee entities, and should obtain information on one or more of the following: the primary directors, officers, trustees, partners, managers, and/or people serving in another fiduciary capacity in connection with this entity and the entity's federal employment identification number. The lawyer should also consider whether it is necessary to obtain some of the basic information on the fiduciaries of the entity as described above. Depending on other risk factors, if not disclosed by partners, members, or shareholders of the entity when the above information

is provided, the lawyer may also need to determine beneficial ownership, as discussed in more detail in the main body of this guidance.

2. **Client Due Diligence.** In addition to the basic information discussed above, depending on risk factors and the level of disclosures made by the client, the lawyer may find it advisable to request letters of introduction or letters of reference from other professionals that have past experience with the client, such as other transactional lawyers, bankers, and certified public accountants

2.1 **OFAC List.** It would also be prudent for the lawyer to check the Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons list at <http://www.treas.gov/offices/enforcement/ofac/sdn/tl1sdn.pdf> for the name of the client, the client's spouse, the client's beneficial owners, and/or other related persons, and any relevant business entities.⁷⁴

2.2 **Other Searches.** Another suggested due diligence measure is the conducting of an Internet search (for example, a Google search (www.google.com)) of the client's name, the client's spouse and/or other related persons, and any relevant business entities. Although the accuracy of the Internet should not be relied upon, search results may provide the lawyer with valuable information that is not readily available elsewhere. For example, an Internet search might yield a link to an article that indicates a potential client's connections to a business entity involved in a pending or previous criminal proceeding. If so, the lawyer can then determine whether and to what extent to check available court records to verify this information.

2.3 **Background Checks.** Depending on the risk profile of the client, background checks can also prove to be useful in evaluating the potential risk involved in accepting the representation of a new client. For instance, Accurint (www accurint.com) is a service that provides information on a client's past and current addresses, any bankruptcies, liens, judgments and UCC filings against it, and any business entities and job titles associated with the client's name. It also provides information on the client's business associates as well as driver's licenses issued to the client, and possibly information regarding any criminal record, sexual offenses, concealed weapons permits, associates, relatives, and properties of the client.

3. **Periodic Update.** Depending on a current evaluation of risk factors, the lawyer may wish to repeat some or all of these steps on an annual or other appropriate periodic basis to ensure that the status of the client has not changed.

⁷⁴ In circumstances where the client's business or the proposed engagement warrants (such as where the client is engaged in the export business), it may also be prudent for the lawyer to check the Denied Persons List at <http://www.bis.doc.gov/dpl/Default.shtm>.

Appendix B
Glossary of Terms

Set forth below is a list of certain acronyms used in this Guidance.

ABA	American Bar Association
AML	Anti-money laundering
CDD	Client Due Diligence
CFT	Combating the financing of terrorism
DNFBPs	Designated Non-Financial Businesses and Professions
FATF	Financial Action Task Force
NPO	Not for profit organization
OFAC	Office of Foreign Assets Control
PEP	Politically Exposed Person
RBA	Risk Based Approach
SDN List	List of Specially Designated Nationals and Blocked Persons
SRO	Self-regulatory organization
TCSPs	Trust and company service providers

REPORT

I. Executive Summary

The American Bar Association's Task Force on Gatekeeper Regulation and the Profession ("Task Force") was formed over eight years ago to address certain issues arising from increased interest among U.S. government and foreign regulatory officials in combating money laundering and terrorist financing and enlisting the assistance of certain professionals, including lawyers, in this effort ("Gatekeeper Initiative"). The American Bar Association participated in a project by the Financial Action Task Force on Money Laundering ("FATF")¹ to develop risk-based guidance to client due diligence in the delivery of legal services. This project culminated in the issuance by FATF on October 23, 2008 of risk based guidance for the legal profession. Known as "RBA Guidance for Legal Professionals" ("Lawyer Guidance"), this document directed the legal profession to implement the Lawyer Guidance.

FATF, Congress, and federal regulators have exerted considerable pressure on the legal profession to proactively address the vulnerabilities facing the legal profession to money laundering and terrorist financing. Since the issuance of the Lawyer Guidance, the Task Force has collaborated with several ABA sections and specialty bar associations to develop voluntary risk based guidance for the U.S. legal profession. This effort culminated in the development of a paper entitled "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing" ("Good Practices Guidance"). The Good Practices Guidance, dated April 23, 2010, is designed to implement the Lawyer Guidance by providing practical and understandable guidance to the legal profession for the development of a risk based approach to client due diligence.

The following groups have endorsed the Good Practices Guidance: the Task Force; the ABA Section of Real Property, Trust, and Estate Law; the ABA Business Law Section, the ABA International Law Section; the ABA Criminal Justice Section; the ABA Law Practice Management Section; the American College of Trust and Estate Counsel; the American College of Real Estate Lawyers; the American College of Mortgage Attorneys; and the American College of Commercial Finance Lawyers.

The adoption by the ABA of the Good Practices Guidance will respond to requests by FATF, Congress, and federal regulators for guidance to the legal profession, which may serve to preclude the imposition of a rules-based federal regulatory approach on the legal profession. A rules-based approach would invariably trigger significant issues with regard to the attorney-client privilege, the duty of client confidentiality, the attorney-client relationship, and the delivery of legal services more generally.

¹ The Financial Action Task Force ("FATF") is an inter-governmental body comprised of 35 members whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is therefore a 'policy-making body' that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The FATF has published 40 + 9 Recommendations in order to meet this objective.

II. Background on the Gatekeeper Initiative.

The Gatekeeper Initiative originates from the Moscow Communiqué issued at the 1999 meeting of the G-8 Finance Ministers. It calls on countries to consider various means to address money laundering through the efforts of professional gatekeepers of the international financial system, including lawyers, accountants, company formation agents, and others.

In recent years, the fight against money laundering has gained importance in the priorities of many countries. Moved by the FATF, the leading global organization in the fight against money laundering, governments from countries that comprise the principal financial centers have worked collaboratively to identify money laundering typologies, develop recommendations on best practices to combat money laundering, criminalize money laundering around the world, and encourage cooperation among national law enforcement and regulation agencies. Following the Moscow Communiqué, FATF created a working group that identified several professions as “gatekeepers” with respect to money laundering. On May 31, 2002, FATF published a consultation paper entitled “Review of the FATF 40 Recommendations” in which FATF identified several areas where possible changes could be made to FATF’s anti-money laundering (“AML”) framework. The broad topics covered concern customer due diligence and suspicious transaction reporting (“STR”), beneficial ownership and control of corporate vehicles, and the application of AML obligations to non-financial businesses and professions, including the legal profession.

In the United States, the Money Laundering and Financial Crime Strategy Act of 1998 obligates the U.S. Departments of Justice and Treasury to issue an annual “National Money Laundering Strategy Report,” outlining a plan of action to enhance U.S. AML efforts. The report for 2000 tasked the Justice Department with reviewing the professional responsibilities of lawyers and making recommendations “ranging from enhanced professional education, standards, or rules, or legislation, as may be needed.” A similar theme was set forth in the report for 2001. An inter-agency working group was established, including the Department of Justice (“DOJ”), the Department of Treasury (“Treasury”), the Securities and Exchange Commission, and Treasury’s Financial Crimes and Enforcement Network (“FinCEN”). This inter-agency group is charged with developing a U.S. position on the Gatekeeper Initiative.

III. Gatekeeper Task Force.

A. Background.

The cataclysmic terrorist attacks on the United States on September 11, 2001 triggered responses from FATF and the ABA. A month after these terrorist attacks, FATF expanded its mandate to address terrorist financing and issued the Special Recommendations on Terrorist Financing. The Special Recommendations, originally comprised of eight recommendations intended to complement the Forty Recommendations, are designed to combat the funding of terrorist acts and terrorist organizations. A ninth special recommendation was added in October 2004 to address the concerns with cash couriers, thereby constituting the Nine Special Recommendations.

The Forty Recommendations and the Nine Special Recommendations are sometimes collectively referred to as the 40+9 Recommendations.

In February 2002, ABA President Robert E. Hirshon created the Task Force to address the Gatekeeper Initiative. The mission of the Task Force is to respond to initiatives by DOJ, Treasury, the Congress, FATF, and others that will affect the attorney-client relationship in the context of AML enforcement. The Task Force (a) reviews and evaluates ABA policies and rules regarding the ability of attorneys to disclose client activity and information, and works to develop positions on the Gatekeeper issue, (b) develops educational programs for legal professionals and law students, and (c) organizes resource materials to allow lawyers to comply with their AML responsibilities. At the time the Task Force was established, the principal focus of the Task Force with regard to federal AML policy was whether the federal government would impose a mandatory STR requirement on lawyers, i.e., filing with federal government regulators or law enforcement personnel reports on suspicious activity by clients, and being prohibited from informing clients that such a report had been filed (the so-called “no tipping off” rule). This would have made lawyers subject to reporting obligations that are similar to what banks and other financial institutions have for reporting suspicious financing transactions to FinCEN.

B. Efforts.

In response to concerns with the imposition of the STR requirement on the U.S. legal profession, in February 2002, the ABA Criminal Justice Section proposed a recommendation before the ABA House of Delegates that stated “That the American Bar Association urges the United States government to seek to protect and uphold the attorney/client relationship, including the attorney/client privilege, in dealing with international money laundering.”

1. **Resolution 104.** In February 2003, the Task Force submitted a Recommendation and Report to the House of Delegates on the Gatekeeper Initiative. The Section of Real Property, Probate and Trust Law (now the Section of Real Property, Trust and Estate Law), the Criminal Justice Section, the Section of Litigation, and the Section of International Law joined in this submission. The Recommendation supported the enactment of reasonable and balanced initiatives to detect and prevent money laundering and terrorist financing. At the same time, the Recommendation opposed any law or regulation that would compel lawyers to disclose privileged or confidential information to government officials based on “suspicious” activity of the client, or otherwise compromise the attorney-client relationship or independence of the bar. The Recommendation also noted that the Model Rules of Professional Responsibility would continue to be reviewed as they relate to the obligations of lawyers to maintain client confidences, and urged bar associations and law schools to undertake educational efforts on money laundering risks and concerns.

The Report accompanying this Recommendation explained the appropriate role of lawyers in U.S. government efforts to combat money laundering; analyzed the legal and

ethical problems arising from any mandatory reporting obligation to the U.S. government to reveal client information that involves a “suspicion” of possible money laundering or other criminal activity; and discussed existing legal and ethical requirements that minimize the risk that lawyers will be involved in money laundering activities. The Recommendation, dated February 10-11, 2003, is now known as Resolution 104.

2. **Resolution 300.** In 2008, two developments emerged that prompted the Task Force to submit a Report and Recommendation to the House of Delegates at the 2008 annual meeting in New York City. First, in May 2008, federal legislation was proposed to require those who form unincorporated business entities, trusts, partnerships, and other organizational structures to document, verify, and make available to law enforcement authorities the record and beneficial ownership of these business entities. This legislation would impose significant and difficult burdens on company formation agents (including lawyers in some circumstances), state authorities, and others to comply with this legislation. Second, in 2008 FATF was in the process of developing the risk-based Lawyer Guidance.

In response to these two developments, the Task Force Report and Recommendation provided that states, and not the federal government, should retain the authority to regulate those who form these unincorporated business entities. The Report and Recommendation noted that amendments to certain uniform and model laws relating to the formation of these business entities were currently under review to address concerns raised by law enforcement officials and policy makers. The Recommendation opposed federal legislation as premature, in order to provide the states with the opportunity to develop a uniform solution to address the issue of beneficial ownership when forming entities under state law.

The Report and Recommendation also urged U.S. lawyers to develop voluntary risk-based guidance for client due diligence, and directed the ABA to develop this voluntary guidance for one or more of its constituent sections and to engage with the federal government and other interested parties in this process. The Report and Recommendation cautioned that, absent this voluntary guidance, it is possible that federal regulators and lawmakers could impose a rules-based approach on the legal profession, thereby triggering significant issues with regard to the attorney-client privilege, the duty of client confidentiality, the attorney-client relationship, and the delivery of legal services more generally. The Recommendation, dated August 11-12, 2008, is now known as Resolution 300.

Since the adoption of Resolution 300, the Task Force has developed the Good Practices Guidance, obtained endorsements of the Good Practices Guidance by various ABA sections and specialty bar associations, participated in lawyer educational programs on AML risks and compliance more generally; maintained a dialogue with the federal government and FATF concerning the imposition of STR and other AML requirements on the legal profession; and interacted with other U.S. and non-U.S. bar associations, law societies, and legal professional organizations concerning government policy and the

work of FATF regarding the role of the legal profession in preventing money laundering and terrorist financing.

IV. Risk-Based Approach and Good Practices Guidance.

The risk-based approach is grounded in the premise that the limited resources (both governmental and private sector) available to combat money laundering and terrorist financing should be employed and allocated in the most efficient manner possible so that the sources of the greatest risks receive the most attention. A risk-based approach is intended to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified, thereby facilitating an efficient allocation of this limited pool of resources.

The proportionate nature of the risk-based approach means that higher risk areas should be subject to enhanced risk-based procedures, such as enhanced client due diligence (“CDD”) and enhanced transaction monitoring. By contrast, simplified, modified, or reduced risk management procedures may apply in lower risk areas (for purposes of this Guidance, “reduced” shall hereafter include “simplified” and “modified”). An effective risk-based approach involves identifying and categorizing money laundering and terrorist financing risks and establishing reasonable controls based on the risks identified.

FATF has been active in developing risk-based guidance for financial institutions and designated non-financial businesses and professions (“DNFBPs”), including legal professionals. In June 2007, FATF adopted Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures, which includes guidance for public authorities and guidance for financial institutions (“Financial Institution Guidance”). This effort was the culmination of extensive consultation between private and public sector members of an Electronic Advisory Group (“EAG”) established by FATF.

In addition to financial institutions, the FATF Recommendations also cover a number of DNFBPs. At its June 2007 meeting, the FATF’s Working Group on Evaluation and Implementation (“WGEI”) endorsed a proposal to convene a meeting of the representatives from the DNFBPs to assess the possibility of developing guidance on the risk-based approach for their sectors, using the same structure and style as the Financial Institution Guidance.

Three months later, in September 2007, FATF convened a meeting in London attended by members of organizations that represent lawyers, notaries, trust and company service providers (“TCSPs”), accountants, casinos, real estate agents and dealers in precious metals and dealers in precious stones. The Gatekeeper Task Force representatives attended this meeting. This private sector group expressed an interest in contributing to Lawyer Guidance on implementing a risk-based approach for their sectors. The guidance for the DNFBPs would follow the principles of the risk-based approach already established by FATF, and would highlight risk factors specific to the

DNFBPs, as well as suggest mitigation strategies that fit with the particular activities and businesses of the DNFBPs. The FATF established another EAG to facilitate the work. The U.S. government, through the Treasury Department, was supportive of the FATF effort and its outreach to the private sector.

The private sector group met again in December 2007 in Bern, Switzerland and was joined by a number of specialist public sector members, including representatives from the Gatekeeper Task Force and the American College of Trust and Estate Counsel. Separate working groups comprising public and private sectors members were established, and private sector chairs were appointed. The EAG met in Paris in April 2008, in London in June 2008, and in Ottawa in September 2008 to advance discussions on developing guidance for legal professionals. After further international consultation with both public and private sectors, FATF adopted the Lawyer Guidance at its October 2008 plenary in Rio de Janeiro.² Guidance for each of the other DNFBP sectors was published separately.

The Lawyer Guidance, dated April 23, 2010, contains 126 separately numbered paragraphs and organizationally tracks the Financial Institutions Guidance developed by FATF for the financial institutions industry that served as a template for the Lawyer Guidance. The Lawyer Guidance is a complex document that addresses different audiences (e.g., private sector and public authorities), undertakes to identify the AML and anti-terrorist financing, or counter financing of terrorism (“CFT”), issues specific to the legal profession, and outlines the risk factors that lawyers need to consider in developing a risk-based system.

The Lawyer Guidance is “high level” guidance intended to provide a broad framework for implementing a risk-based approach for the legal profession. It does not offer detailed direction on the application of this approach to specific factual situations, nor does it take into account the practical realities of the practice of law in an increasingly complex environment or attempt to address jurisdictional variations among the FATF member countries. For those reasons, the Lawyer Guidance urges the legal profession generally, or in different countries, to develop “good practice in the design and implementation of an effective risk-based approach.”³

In response to the Lawyer Guidance, the Gatekeeper Task Force and representatives from other ABA sections and specialty bar associations developed the Good Practices Guidance. The goal of the Good Practices Guidance is to assist members of the legal profession in the United States in designing and implementing effective risk-based approaches consistent with the broad contours of the Lawyer Guidance. The Good Practices Guidance is not intended to be, nor should it be construed as, a statement of the standard of care governing the activities of lawyers in implementing a risk-based

² For a detailed analysis of the development of the Lawyer Guidance, see Kevin L. Shepherd, *Guardians at the Gate: The Gatekeeper Initiative and the Risk-Based Approach for Transactional Lawyers*, 43 REAL PROPERTY, TRUST & ESTATE L. J. 607 (2009).

³ Financial Action Task Force, *RBA Guidance for Legal Professionals* (2008), <http://www.fatf-gafi.org/dataoecd/5/58/41584211.pdf>, para. 6.

approach to combat money laundering and terrorist financing. Rather, given the vast differences in practices, firms, and lawyers throughout the United States, the Good Practices Guidance seeks only to serve as a resource that lawyers can use in developing their own voluntary risk-based approaches. At the same time, the Good Practices Guidance is not intended to be an academic exercise. The federal government is under pressure from FATF and others (including development agencies, the Organisation for Economic Co-Operation and Development, the International Monetary Fund, The World Bank, and the United Nations) to adopt legislation implementing some or all of the provisions of the Lawyer Guidance. An overarching purpose of the Good Practices Guidance is to encourage and empower lawyers to develop and implement voluntary, but effective, risk-based approaches consistent with the Lawyer Guidance, thereby negating the need for federal regulation of the legal profession.

The first section of the Good Practices Guidance provides an overview of the mechanics of money laundering and terrorist financing so that practitioners can better understand and achieve the goals of the United States' and FATF's AML/CFT efforts. The sections that follow then describe the risk-based approach and recommended client due diligence, identify those lawyers who are subject to the Lawyer Guidance, specify the activities that are addressed by the Lawyer Guidance, list and analyze the risk categories and risk variables, and conclude with a suggested protocol for client intake and assessment and a discussion of the importance of on-going education and continuing legal education efforts in this area.

The "practice pointers" appearing throughout the text, which take the form of hypothetical fact patterns to highlight specific issues or points, are designed to provide practical guidance and insights to practitioners. They may also elaborate on a statement or concept contained in the Lawyer Guidance.

Federal regulators have reviewed the Good Practices Guidance and have expressed their support of it. These regulators view the Good Practices Guidance as a significant step in implementing an effective risk-based approach for legal professionals in the United States. Federal legislators have encouraged the ABA to issue guidance to its members prohibiting the use of any financial account to accept suspect funds involving politically exposed persons ("PEPs")⁴, conceal PEP activity, facilitate suspect transactions involving PEPs, or circumvent AML or PEP controls at U.S. financial institutions.⁵ The Good Practices Guidance is an effort to address these concerns.

The Task Force understands through discussions with U.S. Treasury Department representatives (including a meeting held on March 22, 2010 in Washington, D.C.) that it would be helpful for the ABA to exhibit leadership in the development of non-

⁴ A politically exposed person is an individual who has been entrusted with a prominent public or governmental function, or is closely related to such a person. By virtue of this position and the influence it holds, a politically exposed person present a higher risk for potential involvement in bribery and corruption.

⁵ KEEPING FOREIGN CORRUPTION OUT OF THE UNITED STATES: FOUR CASE HISTORIES, MAJORITY AND MINORITY STAFF REPORT, U.S. SENATE SUBCOMMITTEE ON INVESTIGATIONS, Feb. 4, 2010, at p. 7.

governmentally imposed risk-based guidance for U.S. lawyers, such as the Good Practices Guidance. The Task Force's efforts in this area, coupled with on-going dialogue with Treasury Department representatives in the development and implementation of such guidance, would obviate the need for Congress to enact legislation designed to impose a rules-based system on U.S. lawyers. A copy of the Good Practices Guidance is attached hereto.

Respectfully submitted,

Edward J. Krauland, Chair
Task Force on Gatekeeper Regulation and the Profession

August 2010

GENERAL INFORMATION FORM

Submitting Entity: Task Force on Gatekeeper Regulation and the Profession, Section of Real Property, Trust and Estate Law, and Section of Business Law

Submitted By: Kevin Shepherd & Edward Krauland

1. Summary of Recommendation(s). The Financial Action Task Force (“FATF”) is an inter-governmental body that assists countries in developing anti-money laundering and counter-terrorist financing laws and policies. The FATF has published 40 Recommendations that member countries, including the United States, are to implement in an effort to combat money laundering. The FATF issued 9 Special Recommendation after the September 11 terrorist attacks that largely focused on terrorist financing risks. Following up on Recommendations 12 and 16, on October 23, 2008, the FATF published “Risk-Based Approach Guidance for Legal Professionals”, to provide guidance to the lawyers around the world on due diligence efforts that can be undertaken to avoid money laundering and terrorist financing risks in the practice of law. This Recommendation seeks ABA House of Delegates adoption of a voluntary “Good Practices” guidance paper, developed by ABA members along with practitioners in other bar associations and professional organizations, that would (a) assist the legal profession in the United States with understanding anti-money laundering and terrorist financing risks in certain areas of legal practice, and (b) provide practical guidance on what steps lawyers can take to avoid these risks.
2. Approval by Submitting Entity. The ABA Section of Real Property, Trust and Estate Law, along with the ABA Task Force on Gatekeeper Regulation and the Profession prepared this Recommendation and Report and have approved it. Other Sections that have reviewed the voluntary “Good Practices” guidance paper and have approved it in principle are the Sections of Business Law, Criminal Justice, International Law, Law Practice Management, and Taxation which reviewed the guidance paper during their respective spring meetings.
3. Has this or a similar recommendation been submitted to the ABA House of Delegates or Board of Governors previously? The ABA Gatekeeper Task Force submitted a Recommendation at the annual meeting of the ABA in August 2008. In relevant part, that Recommendation urged the ABA Gatekeeper Task Force to work with others to develop appropriate guidance on voluntary risk-based guidance for the legal profession to address money laundering and terrorist financing risks when taking on and representing clients. That Recommendation (No. 300) was approved by the House of Delegates. At the mid-year meeting of the ABA in February 2003, the ABA Gatekeeper Task Force also sponsored a Recommendation that opposed the imposition of mandatory “suspicious transaction reporting” requirements on lawyers as part of the U.S. anti-money laundering laws. The Recommendation (No. 104) was approved.

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption? No other Association policies, other than that identified in response to question 3, are known to be relevant to this Recommendation. This Recommendation would be consistent the policies described in response to question 3.

5. What urgency exists which requires action at this meeting of the House? The U.S. government, most notably the U.S. Department of the Treasury, is actively involved in the efforts of the Financial Action Task Force (“FATF”), as well as its own constituent agencies, to ensure that certain “designated non-financial businesses and professions (‘DNFBPs’), including lawyers, take appropriate steps to avoid money laundering and terrorist financing risks and activities. The U.S. government will be subject to a “mutual evaluation” by the FATF on this and other aspects of the FATF 40+9 Recommendations in the near future. In addition, various legislative efforts have been proposed over time, including as recently as the current and prior congressional sessions, to impose federal regulation on lawyers in the area of anti-money laundering and counter-terrorist financing compliance. In connection with, and apart from, the hearings relating to these legislative proposals, U.S. legislators and their staffs have inquired about ABA efforts to develop and approve good practice guidelines. Moreover, other governments and international organizations have raised the issue of U.S. adherence to FATF standards (such as Recommendations 12 and 16 relating to lawyers) as a measure of whether there exists a level playing field, since other countries in the world also are to adhere to the DNFBP standards. The ABA Gatekeeper Task Force, consistent with existing ABA policy, has been engaged on all these efforts, interacting with various U.S. government officials, members of Congress, the FATF, and representatives of other bar associations. As part of the effort to work collaboratively with members of Congress; to support representatives of the Department of the Treasury in the current mutual evaluation process; and to address appropriate concerns of U.S. law enforcement without new federal mandates being imposed on the legal profession, it is important that action be taken to approve the voluntary “Good Practices” guidance as soon as possible.

6. Status of Legislation. (If applicable.) S.569, the Incorporation Transparency and Law Enforcement Assistance Act, contains certain provisions that could impose additional anti-money laundering and counter-terrorist financing requirements on company “formation agents”, which could include lawyers. This legislation is scheduled for mark up by the Senate Committee on Homeland Security and Governmental Affairs on June 23, 2010. The Treasury Department has proposed substitute language.

7. Cost to the Association. (Both direct and indirect costs.) None expected at this time. There may be certain travel requirements that will arise in the future, but

we do not anticipate that costs associated with such travel would exceed \$5,000 per year.

8. Disclosure of Interest. (If applicable.) None.
9. Referrals. (List entities to which the recommendation has been referred, the date of referral and the response of each entity if known.) See response to question 2.
10. Contact Person. (Prior to the meeting. Please include name, address, telephone number and email address.) Kevin Shepherd, Venable LLP, Suite 900, 750 East Pratt Street, Baltimore, MD, 21202; telephone number -- 410.244.7772; email – klshepherd@venable.com; Edward Krauland, Steptoe & Johnson LLP, 1330 Connecticut Avenue, NW, Washington, D.C. 20036; telephone number -- 202-429-8083; email – ekrauland@steptoe.com
11. Contact Person. (Who will present the report to the House. Please include email address and cell phone number.) Kevin Shepherd, Venable LLP, 750 East Pratt Street, Baltimore, MD, 21202; email – klshepherd@venable.com; telephone number -- 410.244.7772; cell -- 443.889.7712; Edward Krauland, Steptoe & Johnson LLP, 1330 Connecticut Avenue, NW, Washington, DC 20036; email – skrauland@steptoe.com; telephone number – 202-429-8083.

EXECUTIVE SUMMARY

1. Summary of the Recommendation: The Recommendation addresses certain international and U.S. government policy and legal initiatives relating to combating money laundering and terrorist financing in the legal profession. Efforts have been under way for nearly a decade now that possibly could impose federal regulation on the legal profession in the area of anti-money laundering counter-terrorist financing compliance. This is being driven by concerns that the legal profession, and other “designated non-financial businesses and professions,” are vulnerable to money laundering and terrorist financing risks. This concern has manifested itself in such areas as tax evasion and abuse of corporate vehicles for improper purposes. The Recommendation seeks adoption of a voluntary “Good Practices” guidance document for the legal profession in the United States, which will educate lawyers about money laundering and terrorist financing risks in certain areas of legal practice and provide guidance on how those risks can be minimized through voluntary risk-based due diligence steps. This voluntary, profession-initiated effort would help members in efforts to comply with existing laws, avoid money laundering and terrorist financing risks in delivering legal services to clients, and reduce the need for new federal mandates on the legal profession. Absent such voluntary and self-initiated efforts, legislation or federal agency action could impose regulations on lawyers in the United States, which could conflict with ethical obligations, interfere with and undermine the attorney-client relationship, and adversely affect the delivery of legal services to clients. The notion of voluntary guidance for the legal profession, through the efforts of the American Bar Association in conjunction with others (such as state and specialty bars), was approved by Recommendation 300 at the 2008 ABA annual meeting.

2. Summary of the Issue that the recommendation Addresses: See answer to item 1. The Recommendation proposes the adoption of voluntary guidance to the legal profession in the United States that would (a) educate lawyers about money laundering and terrorist financing risks, (b) offer practical assistance to lawyers to avoid such risks through risk-based due diligence steps that can be undertaken, and (c) thereby address concerns of U.S. regulators and legislators in a manner that negates the need for new federal mandates.

3. Please Explain How the Proposed Policy Position will Address the Issue. The Recommendation offers a voluntary, self-initiated approach to assisting lawyers to avoid money laundering risks. The “Good Practices” guidance would be in keeping with the tradition of the U.S. legal profession to address important issues impacting the practice of law through self-initiated, proactive action. It would demonstrate to U.S. policy makers, regulators, and legislators, as well as the Financial Action Task Force, that new federal legislation or Treasury Department regulation (for example, through the Bank Secrecy Act or the USA PATRIOT Act) vis-à-vis the legal profession is not necessary to address money laundering and terrorist financing concerns that may exist in the formation of legal entities, real estate transactions, banking, or the sale and purchase of legal entities.

4. Summary of Minority Views There are no known minority views.

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Red Flags in Financial Statements

UNITED STATES SECURITIES
AND EXCHANGE COMMISSION,

Plaintiff,

v.

DAVID T. LEBOE,
DALE G. RASMUSSEN,

Defendants.

Civil Action No. HO-06-1020

COMPLAINT

SUMMARY

2. The Commission requests that this Court order Leboe and Rasmussen each to pay disgorgement and a civil penalty, and enjoin each of them from violating the federal securities laws cited herein.

3. The Court has jurisdiction over this action pursuant to Sections 21(d), 21(e), and

27 of the Securities and Exchange Act of 1934 (“Exchange Act”) [15 U.S.C. §§ 78u(d) and (e) and 78aa].

4. Venue lies in this District pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because certain acts or transactions constituting the violations occurred in this District.

5. In connection with the acts, practices, and courses of business alleged herein, Leboe and Rasmussen, directly or indirectly, made use of the means and instruments of transportation and communication in interstate commerce, and of the mails and of the facilities of a national securities exchange.

DEFENDANTS

6. David T. Leboe, 38, resides in Houston, Texas. Leboe joined Enron in December 1997 and, until March 2001, worked as an accountant in an Enron business unit known as Enron North America (“ENA”). During the relevant time period, Leboe was licensed in Texas as a Certified Public Accountant.

7. Dale G. Rasmussen, 46, resides in Portland, Oregon. During the relevant time period, Rasmussen was a senior counsel in ENA’s West Power Origination Legal Group. Rasmussen is licensed to practice law in the State of Oregon.

ENTITIES INVOLVED

8. Enron Corp. is an Oregon corporation with its principal place of business in Houston, Texas. During the relevant time period, Enron’s common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. During the time that defendants and others engaged in the conduct alleged herein, Enron raised millions in the public debt and equity markets. Among other operations, Enron was

the nation's largest natural gas and electric marketer. Enron rose to number seven on the *Fortune* 500 list of companies. By December 2, 2001, when it filed for bankruptcy, Enron's stock price had dropped in less than a year from more than \$80 per share to less than \$1.

9. ENA, the largest and most profitable business unit within Enron Wholesale Services ("Wholesale"), was Enron's largest and fastest growing business segment in 2000 and 2001. ENA included Enron's wholesale merchant energy business related to natural gas and power across North America, including trading, marketing and new asset development activities in that region. In its segment disclosures, ENA's results were reported within the Wholesale segment.

FACTUAL ALLEGATIONS

10. During the second and third quarters of 2000, Leboe and Rasmussen, and others, worked on a project known as Coyote Springs 2 ("CS2") that involved the sale of a power plant development project in Oregon originally scheduled for completion in June 2002. CS2 was part of the Coyote Springs Cogeneration Project, located in the city of Boardman, Oregon, designed by Portland General Electric ("PGE") to support the construction and operation of two power plants. The first power plant, Coyote Springs Unit 1, was constructed by PGE and placed into commercial operation in November 1995. The CS2 project was co-developed by ENA and PGE. PGE already owned the project site and necessary permits for constructing and operating CS2.

11. During the spring of 2000, ENA's West Power Origination group was negotiating the sale of an interest in the CS2 project to Avista Power ("Avista"). The original deal consisted of an equity interest in a power plant, an engineering construction contract to build a power generation facility, and a turbine to be placed in the plant. Under the agreement, National Energy

Production Corporation (“NEPCO”), a wholly-owned subsidiary of Enron, was to be the engineering procurement and construction (“EPC”) contractor for the CS2 facility. In conformity with the relevant accounting rules, revenues from such a construction contract could only be recognized over time, on a percentage of completion basis, as the construction progressed.

12. ENA managers, under enormous pressure to hit very aggressive earnings targets, subsequently came up with a scheme to improperly recognize an immediate gain based on the appreciation in price of the turbine generator that was to be installed at the CS2 power plant. The scheme involved the unbundling of the original deal into two separate transactions: (1) the sale of the turbine, and (2) the sale of CS2 equity and the execution of the construction contract. ENA would “sell” the turbine to Avista, recognize a gain, and then a short time later enter into a contract with Avista to build the CS2 plant using the turbine previously sold by ENA to Avista.

13. Enron determined that in order to make the two transactions “appear” separate, even though the turbine was essential to the power generation project, there needed to be a two week gap in executing the two transactions. Avista was willing to accommodate ENA in its desire to conduct the turbine sale separately as long as the economics of the deal remained the same. However, Avista was uncomfortable assuming the risk that the second transaction, the equity sale/construction contract, would not close after the intervening two weeks. Avista had no desire to own a turbine generator except as part of a functioning power plant and, if the second part of the deal failed to close, Avista would have been left holding a very expensive turbine with no associated use for it.

14. To ease Avista’s discomfort, ENA offered to provide Avista with a put option on the turbine that would require ENA to repurchase the turbine in the event that the second leg of

the CS2 transaction fell through. When Enron's accountants concluded that ENA could not provide the put and still treat the turbine transaction as a true sale, ENA asked LJM2, the partnership controlled by Enron's CFO, Andrew Fastow, to enter into a put option on the turbine with Avista.

15. On July 7, 2000, Avista entered into an agreement with LJM2 which gave Avista the right to put the turbine to LJM2 at the original sale price. The option expiration date was two weeks from the date of the turbine sale – the same day the CS2 equity sale and construction contract were expected to close.

16. The option premium paid to LJM2 was \$3,540,000, of which \$357,000 was characterized as LJM2's "use of balance sheet" fee. As additional evidence that the put arrangement was a sham, ENA negotiated the put option pricing directly with LJM2, even though Avista was the "purchaser" of the option on the turbine.

17. In a verbal side agreement, LJM2, recognizing that there was virtually no chance that Avista would ever exercise the put option, agreed if the option was not exercised to keep only the \$357,000 fee and to refund the remaining \$3,183,000 to ENA. Because Avista was only agreeing to the bifurcated sale as an accommodation to ENA, Avista did not want to pay for the put option. Thus, ENA funded the put option premium by reducing the turbine sale price by an amount equal to the option premium.

18. In addition to the put option, ENA gave Avista further comfort that it would not be stuck with the turbine if the second leg of the CS2 deal did not close. In a verbal agreement, ENA committed to repurchase the turbine from Avista at the original sale price prior to any exercise by Avista of the put option. In the unlikely event that Avista chose to exercise the put

option, ENA and LJM2 had a verbal agreement that ENA would repurchase the turbine from LJM2. ENA did not disclose to Enron's outside auditors, Arthur Andersen, the existence of the put option, LJM2's involvement, or the undocumented verbal side agreements.

19. Essentially, ENA, through a related party, LJM2, provided Avista with the right to cancel the turbine sale contingent on completion of the second leg of the CS2 deal. The put option and verbal agreements were structured so that if the put option was exercised, ENA would ultimately end up with the turbine. Further, both ENA and Avista understood that the turbine and its installation was a key component of the CS2 power plant construction project. Generally Accepted Accounting Principles ("GAAP") does not allow an entity to bifurcate a construction contract to recognize sales and profits from construction materials separate from the construction contract taken as a whole. Thus, ENA never should have treated the turbine transaction as a sale separate and apart from the rest of the CS2 deal, and thus, the income recognized from the turbine sale was recorded improperly in the third quarter of 2000.

20. Leboe was the lead accountant for ENA on the CS2 transaction. He was aware that the sole purpose of unbundling the deal was to accelerate earnings and book a profit from the turbine sale. He worked with others to come up with a reasonable timeframe after the turbine sale in which ENA could then sell the CS2 equity and enter into the construction contract with Avista and still recognize the earnings from the sale of the turbine up front. Ultimately, it was decided that two weeks would be a reasonable timeframe in order to permit treatment of the two transactions separately. Leboe knew or was reckless in not knowing that it was improper to bifurcate a construction contract to recognize sales and profits from construction materials separate from the construction contract taken as a whole.

21. In addition, during Leboe's communications with Arthur Andersen on this topic, he did not disclose to Arthur Andersen the existence of the put option agreement between Avista and LJM2. In fact, he actively sought to keep that information from Arthur Andersen and reminded others to do the same in a series of contemporaneous emails. For example, an email from Leboe to Rasmussen, copying others, stated: "Thanks for the legal doc's. With respect to the turbine sale, I was surprised to see documentation relating to LJM2/GE Put Option and LJM2/GE/Avista Consent to Assignment included in the record. My preference would be for these transaction records to be maintained separately. *AA's knowledge of the LJM2 transaction could query gain treatment.* I will provide minimal, piecemeal documentation to AA focusing only on the transaction between Avista and Enron. In connection with their third quarter review, should you receive any calls from AA directly with respect to CS2, please do not discuss LJM." (Emphasis in original).

22. Rasmussen was the primary Enron in-house attorney working on the CS2 deal. He actively negotiated various terms of the agreement and drafted several of the key deal documents. While doing this, he worked closely with Leboe to ensure that the wording in the various deal documents did not jeopardize ENA's efforts to circumvent GAAP. In addition, he provided deal documentation to LJM2 and worked as an intermediary between LJM2 and Avista to help facilitate the timely closing of the option transaction.

23. Various documents also detail Rasmussen's contemporaneous knowledge of the deal. For example, Leboe sent numerous emails to Rasmussen and others detailing the structure and purpose of the separate transactions. Also, Rasmussen spelled out his understanding of the

overall deal in a Legal Risk Memo to his superiors. Under the heading “structural risk,”

Rasmussen wrote:

Transaction structure is unusual due to accounting requirements for current revenue recognition. . . . Accounting dept. has been active in structuring transaction. Structure requires arrangement with LJM2 Co-Investors (‘LJM’, a ‘Friend of Enron’) involving Avista’s buying a 2-week put option for turbine from LJM. If option is not exercised, LJM is to return \$3.2 million of \$3.5 million option payment to ENA through future unspecified transactions. If option is exercised, ENA is to reimburse LJM \$3.8 million. **Agreement between LJM and ENA cannot be documented due to accounting concerns and is not reflected in the [approval sheet] for the turbine sale.** (Emphasis in original)

24. In an early draft of this memo, when Rasmussen assigned a legal risk rating of four to the CS2 deal on a scale of five, with five being the riskiest, he was directed by his supervisor to change it to a rating of two to ensure that the deal went forward. A legal risk level of four would have potentially stopped the deal. Rasmussen acquiesced, and changed the rating to two.

25. In addition, in response to Leboe’s request that the LJM-related documents not be included with the other CS2 documents, Rasmussen replied that he would “go through [ENA’s] copies and pull the LJM2/GE documents, and [would] confirm that PGE does not have those documents in their files.” Rasmussen subsequently contacted PGE and requested that specific documents “be pulled . . . and destroyed or returned to [his] office.”

CLAIMS FOR RELIEF

FIRST CLAIM

Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5]

26. Paragraphs 1 through 25 are realleged and incorporated by reference herein.

27. As set forth more fully above, Leboe and Rasmussen, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by the use of the mails and of the facilities of a national securities exchange, in connection with the purchase or sale of securities: has employed devices, schemes, or artifices to defraud, has made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or has engaged in acts, practices, or courses of business which operate or would operate as a fraud or deceit upon any person.

28. By reason of the foregoing, Leboe and Rasmussen violated and aided and abetted violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

SECOND CLAIM

Violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, & 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-13]

29. Paragraphs 1 through 28 are realleged and incorporated by reference herein.

30. By engaging in the conduct described above, Leboe and Rasmussen knowingly and substantially caused Enron to file with the Commission a materially false and misleading annual report on Form 10-K for the fiscal year ended December 31, 2000 and a materially false

and misleading quarterly report on Form 10-Q for the third quarter of fiscal year 2000.

31. By reason of the foregoing, Leboe and Rasmussen aided and abetted violations by Enron of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

THIRD CLAIM

Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(2)(B)] and Rule 13b2-1 thereunder [17C.F.R. § 240.13b2-1]

32. Paragraphs 1 through 31 are realleged and incorporated by reference herein.

33. By engaging in the conduct described above, Leboe and Rasmussen aided and abetted Enron's failures to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflected Enron's transactions and dispositions of its assets, in violation of Section 13(b)(2)(A) of the Exchange Act, and further aided and abetted failures to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that Enron's corporate transactions were executed in accordance with management's authorization and in a manner to permit the preparation of financial statements in conformity with generally accepted accounting principles in violation of Section 13(b)(2)(B) of the Exchange Act.

34. By engaging in the conduct described above, Leboe and Rasmussen, directly or indirectly, falsified and caused to be falsified Enron's books, records, and accounts subject to Section 13(b)(2)(A) of the Exchange Act in violation of Rule 13b2-1.

35. By reason of the foregoing, Leboe and Rasmussen aided and abetted violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and violated Rule 13b2-1 thereunder.

FOURTH CLAIM

Violations of Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]

36. Paragraphs 1 through 35 are realleged and incorporated by reference herein.

37. By engaging in the conduct described above, Leboe and Rasmussen knowingly circumvented or knowingly failed to implement a system of internal financial controls at Enron.

38. By reason of the foregoing, defendants Leboe and Rasmussen violated and aided and abetted violations of Section 13(b)(5) of the Exchange Act.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

- (A) Grant a Permanent Injunction restraining and enjoining Leboe and Rasmussen from violating the statutory provisions set forth herein and ordering each of them to pay disgorgement and civil penalties;
- (B) Pursuant to Section 308 of the Sarbanes-Oxley Act of 2002, enter an order providing that the amount of civil penalties ordered against Leboe and Rasmussen be added to and

become part of a disgorgement fund for the benefit of the victims of the violations alleged herein;

and

(C) Grant such other and additional relief as this Court may deem just and proper.

Dated: March 27, 2006

Respectfully submitted,

S/

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UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

		:
SECURITIES AND EXCHANGE COMMISSION,		:
		:
	Plaintiff,:	:
		:
	-against-	:
		:
SCIENTIFIC-ATLANTA, INC.,		:
		:
	Defendant.	:
		:

Plaintiff Securities and Exchange Commission (“Commission”), for its Complaint against defendant Scientific-Atlanta, Inc. (“Scientific-Atlanta” or the “Company”), alleges as follows:

SUMMARY

1. In the fall of 2000, Adelphia Communications Corporation (“Adelphia”), a cable television system owner and operator, asked Scientific-Atlanta, a vendor that provided digital cable set-top boxes used by Adelphia, to enter into a marketing support transaction. Following negotiations between Adelphia and Scientific-Atlanta, the parties agreed that Scientific-Atlanta would make marketing support payments for the stated purpose of helping Adelphia increase demand for digital set-top boxes provided by Scientific-Atlanta and, in return, Scientific-Atlanta would receive a corresponding increase in the price of digital set-top boxes it had supplied Adelphia

in the past and was contractually obligated to supply in the future pursuant to a long-term purchase contract that had been entered into in May 2000. Adelphia did not use the marketing support payments to help increase demand for digital set-top boxes. Adelphia recorded the price increases it paid Scientific-Atlanta as capital expenditures, and recognized the marketing support payments paid by Scientific-Atlanta as a contra marketing expense, thereby artificially reducing its marketing expense and increasing Earnings Before Interest, Taxes, Depreciation, and Amortization (“EBITDA”). In this manner, Adelphia was able to use the transaction to reduce improperly its operating costs and increase its earnings by approximately \$16.8 million in 2000 and \$26.2 million in 2001.

2. Scientific-Atlanta agreed to enter into the marketing support transaction as an accommodation to one of its largest clients, and a primary concern was to ensure that its profit margins under the long-term purchase contract would not be eroded by the transaction. Scientific-Atlanta was not concerned with the type or amount of marketing to be done by Adelphia with the marketing support payments at the time the marketing support transaction was entered into.

3. Against this backdrop, various officers and employees of Scientific-Atlanta were confronted with numerous facts that together demonstrated that the marketing support agreement was being misused by Adelphia. These facts included, among others: (i) a retroactive price increase on set-top boxes previously delivered to Adelphia; (ii) Adelphia’s request for a commercially unreasonable high dollar amount in marketing support payments; (iii) repeated requests for higher levels of marketing support in later periods even though the major marketing push was to have occurred in earlier periods; (iv) knowledge that Adelphia’s request for the marketing support agreement was driven by its desire to obtain an accounting benefit; and (v) the

inclusion of a false reason for the price increase in one of the contracts documenting the marketing support agreement.

VIOLATIONS

4. By engaging in the conduct described in this Complaint, Scientific-Atlanta directly or indirectly, singly or in concert, has engaged in acts, practices, and courses of business that aided and abetted Adelphia's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B), and Rules 12b-20, 13a-1, and 13a-13 promulgated thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13.

JURISDICTION AND VENUE

5. The Commission brings this action pursuant to the authority conferred upon it by Section 21(d)(1) of the Exchange Act, 15 U.S.C. § 78u(d)(1), seeking to restrain and enjoin permanently Scientific-Atlanta from engaging in the acts, practices and courses of business alleged herein. The Commission also seeks an order requiring Scientific-Atlanta to disgorge ill-gotten gains it received as a result of the conduct alleged herein.

5. This Court has jurisdiction over this action pursuant to Sections 21(d) and 27 of the Exchange Act, 15 U.S.C. §§ 78u(d) and 78aa.

6. Scientific-Atlanta, directly or indirectly, used the means and instrumentalities of interstate commerce, or of the mails, or the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged herein. At the time of the wrongful conduct described herein, the common stock of Scientific-Atlanta and Adelphia was traded on the New York Stock Exchange located in New York, New York.

DEFENDANT

7. **Scientific-Atlanta** is a Georgia corporation, with corporate headquarters in Lawrenceville, Georgia. Scientific-Atlanta sells end-to-end networks used by programmers and cable operators and provides customer service and support for the cable television industry. At all relevant times, Scientific-Atlanta's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was publicly traded on the New York Stock Exchange.

OTHER RELEVANT ENTITY

8. **Adelphia** is a Delaware corporation, headquartered in Greenwood Village, Colorado. During the relevant period, Adelphia was headquartered in Coudersport, Pennsylvania. Adelphia owns, operates, and manages cable television systems and other related telecommunications businesses. On March 27, 2002, Adelphia announced that it was liable for approximately \$2.3 billion in debt that it had previously failed to disclose. In May 2002, certain members of the Rigas family, who controlled and held officer and director positions with Adelphia, resigned and Adelphia disclosed that it expected to restate its financial statements for the fiscal years 2000 and 2001. On July 18, 2002, the Commission filed *SEC v. Adelphia Communications Corporation, et al.*, 02 Civ. 5776 (PKC) (S.D.N.Y.), alleging that widespread, multifaceted financial fraud occurred at Adelphia. On May 31, 2005, the U.S. District Court for the Southern District of New York entered a consent order enjoining Adelphia from violating Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, and 13a-13 under the Exchange Act.

STATEMENT OF FACTS

Background

9. In May 2000, Adelphia entered into a purchase contract for digital set-top boxes with Scientific-Atlanta. The long-term purchase contract, which was to extend through December 31, 2001, required Adelphia to purchase digital set-top boxes at a price of approximately \$350 per set-top box, as well as other equipment at prices fixed by the terms of the agreement. The Adelphia agreement contained no provision regarding marketing.

10. In June 2000, Adelphia realized that its second quarter reported EBITDA would fall below analysts' expectations. Two senior Adelphia executives devised a plan to increase EBITDA by reducing operating costs through a marketing support agreement with Scientific-Atlanta.

11. Adelphia's purported business rationale for the marketing support was to assist Adelphia in the roll-out of its digital cable service, which was in direct competition with satellite television. Adelphia proposed structuring the transaction so that Scientific-Atlanta's payment obligation would be funded entirely by a price increase applied to digital set-top boxes it had supplied Adelphia in the past and was contractually obligated to supply in the future pursuant to the long-term purchase contract. The transaction would thus have no economic impact on Scientific-Atlanta's net revenue or income from the sale of set-top boxes to Adelphia because, before Scientific-Atlanta would be required to make the marketing support payments, Adelphia would pay to Scientific-Atlanta an amount equal to the marketing support payments in the form of a price increase applied to each set-top box delivered to Adelphia.

The 2000 Transaction

12. In August 2000, Adelphia asked Scientific-Atlanta to consider entering into the marketing support agreement. Adelphia requested marketing support retroactive to the beginning of 2000, and continuing throughout the life of its long-term purchase contract with Scientific-Atlanta. In August 2000, Scientific-Atlanta's CFO (chief financial officer) and its CAO (chief accounting officer) approved the concept of entering into a marketing support agreement with Adelphia, although not on the terms as initially proposed by Adelphia.

13. In October 2000, Adelphia and Scientific-Atlanta began negotiating the terms of the marketing support agreement. Adelphia initially insisted that Scientific-Atlanta pay marketing support of \$50 per set-top box, which equaled approximately 15% of the price of a set-top box. Scientific-Atlanta rejected that percentage as commercially unreasonable, and the parties eventually agreed that Scientific-Atlanta would pay an average of approximately \$20 per set-top box over the life of the contract, with Adelphia paying the same amount to Scientific-Atlanta in the form of price increases applied to Adelphia's orders.

14. At Adelphia's request, Scientific-Atlanta agreed to invoice Adelphia a price increase of \$31 per set-top box for deliveries from April through December 2000 and to invoice a price increase of \$16 per set-top box ordered in 2001, resulting in an average price increase of approximately \$20 per set-top box. Adelphia's purported rationale for structuring the price increase in this way was that it would incur greater marketing costs in the early stages of the digital rollout.

15. The contract documents consisted of two separate agreements. The "Spot Telecast Agreement" set forth Scientific-Atlanta's payment obligations for advertising but did not specify the type or quantity of advertising to be provided by Adelphia. The "Price Increase Letter" set

forth the price increases owed by Adelphia for set-top boxes. Although the parties understood that the sole reason for the price increase was to offset Scientific-Atlanta's payment obligations under the Spot Telecast Agreement, the Price Increase Letter stated falsely that the price increase was due to "increased costs on certain electronic components."

16. Pursuant to the contracts, on May 10, 2001, Adelphia paid Scientific-Atlanta \$16.8 million in price increases and Scientific-Atlanta immediately returned to Adelphia \$16.8 million in marketing support payments.

The 2001 Transaction

17. The long-term purchase contract required that Adelphia purchase 350,000 set-top boxes per quarter in 2001. Scientific-Atlanta became aware in June 2001 that Adelphia was going to be ordering fewer set-top boxes than required under the contract due to decreased demand, and it appeared that Adelphia would not order sufficient set-top boxes to cover the \$22.4 million in marketing support payments Scientific-Atlanta was obligated to make for calendar year 2001.

18. Scientific-Atlanta agreed to expand coverage of the marketing support arrangement to cover all of Adelphia's purchases of transmission equipment (ancillary equipment used to transmit signal that is located outside of the home and is not visible to the end-user), in addition to set-top boxes, retroactive to 2000. By expanding the range of products covered by the marketing support agreement, Scientific-Atlanta was able to ensure that the overall price increase would maintain its margin on the sales due to the marketing support it was obligated to pay without exceeding what it viewed as a commercially reasonable ratio between marketing support and product price.

19. In June 2001, when Adelphia advised Scientific-Atlanta that it would be ordering fewer set-top boxes, Scientific-Atlanta requested that Adelphia order 240,000 set-top boxes pursuant to the long-term purchase contract by the end of the fiscal quarter. Scientific-Atlanta offered Adelphia a price reduction on the June order. Adelphia agreed to purchase the 240,000 set-top boxes.

20. In December 2001, Adelphia demanded an increase in the amount of marketing support to be paid by Scientific-Atlanta for 2001 from \$22.4 million to between \$28 to \$29 million. At or about the same time, Scientific-Atlanta also requested that Adelphia purchase 200,000 set-top boxes before the end of the quarter pursuant to the long-term purchase contract. Adelphia agreed to purchase the set-top boxes, and the parties ultimately agreed on \$26.2 million in marketing support, which covered set-top boxes purchased in 2001 and transmission equipment purchased between July 2000 and December 31, 2001.

Accounting Treatment For The Transaction

21. At the time the transactions were entered into, GAAP (Generally Accepted Accounting Principles) required that the accounting for a transaction must reflect its substance.

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23. Adelphia, however, recorded the marketing support payments as a "contra-expense" to marketing costs even though it did not use the marketing support payments to market any products. This accounting treatment lowered the amount of recorded marketing expenses and, in turn, artificially inflated Adelphia's EBITDA. Adelphia recorded the price increases paid to

Scientific-Atlanta as capital expenditures, which are depreciated over time and, as such, have no impact on EBITDA and a minimal impact on earnings. In total, over seven quarters from April 2000 through December 2001, Adelphia recorded improperly approximately \$43 million in marketing support payments as reductions in current operating expenses, with the intended effect of inflating improperly its reported EBITDA by \$43 million over the course of those quarters. Adelphia's accounting treatment violated GAAP because it improperly reflected the transactions as decreasing its reported expenses and increasing its reported income when it did not have that effect.

Events In 2002

24. On March 27, 2002, approximately one month after Scientific-Atlanta paid Adelphia a \$26.2 million marketing support payment, Adelphia announced that the company was liable for \$2.3 billion in off-balance sheet liabilities. -

25. On June 10, 2002, Adelphia filed a Form 8-K with the Commission, making downward revisions of its 2000 and 2001 reported EBITDA, citing marketing support agreements with two unnamed vendors (one of which was Scientific-Atlanta). Adelphia stated that properly accounting for the marketing support agreements would reduce EBITDA by approximately \$54 million in 2001 and \$37 million in 2000, of which \$26.2 million and \$16.8 million, respectively, is attributable to the transactions with Scientific-Atlanta.

SCIENTIFIC-ATLANTA ENTERED INTO THE MARKETING SUPPORT AGREEMENT TO SATISFY A LARGE CLIENT

26. Despite the fact that Scientific-Atlanta was paying Adelphia over \$4 million dollars in marketing support per quarter in 2000 and over \$6 million per quarter in 2001, no one in the Company ever confirmed how Adelphia was spending the money. Scientific-Atlanta's

marketing department had no role or input into the transaction. Although the marketing support transaction was supposed to be used to market Scientific-Atlanta set-top boxes, the Spot Telecast Agreement did not specify the type or quantity of marketing to be done. The final documentation also did not condition Scientific Atlanta's obligation to make multi-million dollar marketing support payments on receipt of documentation of marketing done by Adelphia.

27. An important motivation for Scientific-Atlanta in the transaction was to satisfy one of its largest clients, and one of its primary concerns was that the marketing support agreement not alter its profit margins. To ensure that it put no money at risk, Scientific-Atlanta made marketing support payments only after it had received equivalent payments for the set-top box price increases from Adelphia.

28. The Adelphia marketing support transaction was a unique transaction for Scientific-Atlanta, and many aspects of the transaction were outside of Scientific-Atlanta's ordinary course of business. During the events leading up to and continuing throughout the life of the marketing support transaction, various officers and employees of Scientific-Atlanta were aware of significant facts that Scientific-Atlanta either ignored, or to which it gave limited attention. These facts, taken together, indicated that Adelphia was misusing the transaction in a manner that violated the reporting, books and records, and internal controls provisions of the federal securities laws.

***Scientific-Atlanta Knew That The Transaction
Provided No Direct Economic Benefit To Scientific-Atlanta***

29. Scientific-Atlanta knew that the marketing support transaction would have no economic impact on its net revenue or income from the sales of set-top boxes to Adelphia and that it was done as an accommodation to Adelphia, one of its largest customers.

30. All Scientific-Atlanta personnel involved in the marketing support transaction knew that it was structured so that the marketing support payments made by Scientific-Atlanta would be equal to Adelphia's payment of the price increases on the set-top boxes and that the sole purpose of the price increases was to offset the marketing support payments. To avoid any risk of loss, Scientific-Atlanta did not make its two marketing support payments until it had first received payment from Adelphia for the price increases.

***Scientific-Atlanta Believed That Adelphia Would Use The
Marketing Support Payments To Improve EBITDA***

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32. In November 2000, a Scientific-Atlanta employee prepared a PowerPoint document for use by Scientific-Atlanta of "talking points" regarding the marketing support agreement. The document states that "\$10M benefit generates 1.5 points of Operating Margin." The following year, in correspondence to an Adelphia executive dated September 28, 2001, seeking prompt payment of past due receivables, Scientific-Atlanta reminded Adelphia that Scientific-Atlanta's "finance team led the structuring of the joint marketing agreement that clearly provides operating expense benefits to Adelphia."

***Adelphia Asked Scientific-Atlanta To Add Unique
Terms To A Previously-Documented Deal***

33. Adelphia did not approach Scientific-Atlanta with the idea of entering into the marketing support agreement until approximately three months after the parties had documented their May 23, 2000 long-term purchase contract. In the ordinary course of Scientific-Atlanta's

business, requests for marketing support were dealt with during the course of negotiating the overall contract.

34. It was also highly unusual for a customer to request, as Adelphia did, that marketing support be in the form of money payments as opposed to marketing credits that effectively reduced the price charged by Scientific-Atlanta for its products.

35. Shortly before Adelphia approached Scientific-Atlanta with the idea of entering into the marketing support transaction, another cable operator also asked Scientific-Atlanta to enter into a marketing support transaction similar to the Adelphia transaction. In September 2000, Scientific-Atlanta and the other cable operator consummated a marketing support transaction involving approximately \$6 million that covered the fourth quarter of 2000.

36. Prior to the transactions with the other cable operator and Adelphia, Scientific-Atlanta had never been asked to enter into a marketing support transaction involving a simultaneous price increase designed to fund its marketing support payment obligations. Prior to the transaction with the other cable operator, Scientific-Atlanta had never been asked to enter into a marketing support arrangement involving millions of dollars. The size of the transaction with the other cable operator was much smaller than the Adelphia transaction, which totaled approximately \$43 million in marketing support. The timing, the form, and the dollar amount of the Adelphia transaction were all outside of Scientific-Atlanta's ordinary course of business.

***Adelphia Demanded More Marketing
Support, Even When Its Orders Of Set-Top Boxes Were Declining***

37. When negotiations over the terms of the marketing support agreement began in October 2000, Adelphia demanded marketing support in the amount of \$50 per set-top box or approximately 15% of the set-top box price, an amount that Scientific-Atlanta deemed

commercially unreasonable. Scientific-Atlanta viewed 4%-7% of the set-top box price as a reasonable range of marketing support. The parties reached agreement on an average price increase and associated marketing support of approximately \$20 per set-top box. Because Adelphia was supposed to incur higher marketing costs at the beginning of the digital rollout, at Adelphia's request Scientific-Atlanta agreed to a price increase and associated marketing support of \$31 per set-top box for deliveries from April through December 2000, and of \$16 per set-top box for deliveries in 2001.

38. By June 2001, Adelphia's orders of set-top boxes had declined and it became clear to Scientific-Atlanta that Adelphia would order less than the 350,000 set-top boxes per quarter it was required to purchase pursuant to the long-term purchase contract. Even though Adelphia had ordered far fewer set-top boxes than its minimum purchase obligations under the long-term purchase contract and Adelphia had stated that it would incur higher marketing costs at the beginning of the digital rollout, Adelphia asked to increase the amount of marketing support from \$22.4 million to \$26 million.

39. Although Scientific-Atlanta apparently did not agree to increase the amount of marketing support at that time, Adelphia again requested more marketing support at the end of 2001. Scientific-Atlanta then agreed to increase marketing support for 2001 from \$22.4 million to \$26.2 million.

***Adelphia Requested That The Marketing Support
Apply Retroactively To Set-Top Boxes Delivered In The Past***

40. When Adelphia approached Scientific-Atlanta with the idea of entering into a marketing support agreement, it asked that the agreement apply retroactively to the beginning of 2000, despite the fact that the long-term purchase contract had not been finalized until May 23,

2000. Although the marketing support agreement was not finalized until at least the end of calendar year 2000, Scientific-Atlanta agreed to make the marketing support agreement retroactive to April 1, 2000, the first day of the quarter in which the May 23, 2000 agreement took effect. During negotiations in June 2001, when Scientific-Atlanta agreed to expand the coverage of marketing support to include transmission equipment, it again agreed to apply the marketing support retroactively to all transmission equipment purchased by Adelphia from July 2000 through December 2001.

Scientific-Atlanta Employees Knew That The Price Increase Letter Was False

41. The overall price increase was calculated to equal the total marketing support payments so that Scientific-Atlanta's profit margin on the transactions would remain unaffected. The Price Increase Letter, which was one of the two agreements documenting the marketing support transaction, states falsely that the price increase was due to "increased costs on certain electronic components," rather than the true reason which was to fund the marketing support payments.

FIRST CLAIM FOR RELIEF

**Aiding and Abetting Violations of Section 13(a)
of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13**

42. The Commission realleges and incorporates by reference herein each and every allegation contained in Paragraphs 1 through 41.

43. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers of registered securities to file with the Commission factually accurate annual and quarterly reports. Exchange Act Rule 12b-20 provides that in addition to the information expressly required to be included in a statement or report, there shall be added such further

material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

44. By reason of the foregoing, Scientific-Atlanta knowingly provided substantial assistance to another who violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

45. By reason of the foregoing, Scientific-Atlanta aided and abetted, and unless enjoined will continue to aid and abet, violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13.

SECOND CLAIM FOR RELIEF

Aiding and Abetting Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act

46. The Commission realleges and incorporates by reference herein each and every allegation contained in Paragraphs 1 through 45.

47. Section 13(b)(2)(A) of the Exchange Act requires that issuers make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the issuer. Section 13(b)(2)(B) of the Exchange Act requires, among other things, that issuers maintain a system of internal accounting controls that permit the preparation of financial statements in conformity with GAAP.

48. By reason of the foregoing, Scientific-Atlanta knowingly provided substantial assistance to another who violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

49. By reason of the foregoing, Scientific-Atlanta aided and abetted, and unless enjoined will continue to aid and abet, violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests a Final Judgment:

I.

Permanently enjoining Scientific-Atlanta and its agents, servants, employees and attorneys and all persons in active concert or participation with them who receive actual notice of the injunction by personal service or otherwise, and each of them, from violating and aiding and abetting any violations of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-1, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13.

II.

Permanently enjoining Scientific-Atlanta and its agents, servants, employees and attorneys and all persons in active concert or participation with them who receive actual notice of the injunction by personal service or otherwise, and each of them, from violating and aiding and abetting any violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

III.

Ordering Scientific-Atlanta to disgorge the ill-gotten gains it received as a result of its violations of the federal securities laws, and to pay interest on all such gains.

IV.

Granting such other and further relief as the Court may deem just and proper.

Dated: New York, New York
June 22, 2006

/s/ Mark K. Schonfeld
Mark K. Schonfeld (MS-2798)
Regional Director

Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
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Of Counsel:

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MARK K. SCHONFELD (MS-2798)
REGIONAL DIRECTOR

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UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

	:	
SECURITIES AND EXCHANGE COMMISSION,	:	
	:	
Plaintiff,:	:	06 Civ. 4823 (PKC)
	:	
-against-	:	COMPLAINT
	:	
SCIENTIFIC-ATLANTA, INC.,	:	
	:	
Defendant.	:	
	:	

Plaintiff Securities and Exchange Commission (“Commission”), for its Complaint against defendant Scientific-Atlanta, Inc. (“Scientific-Atlanta” or the “Company”), alleges as follows:

SUMMARY

1. In the fall of 2000, Adelphia Communications Corporation (“Adelphia”), a cable television system owner and operator, asked Scientific-Atlanta, a vendor that provided digital cable set-top boxes used by Adelphia, to enter into a marketing support transaction. Following negotiations between Adelphia and Scientific-Atlanta, the parties agreed that Scientific-Atlanta would make marketing support payments for the stated purpose of helping Adelphia increase demand for digital set-top boxes provided by Scientific-Atlanta and, in return, Scientific-Atlanta would receive a corresponding increase in the price of digital set-top boxes it had supplied Adelphia

in the past and was contractually obligated to supply in the future pursuant to a long-term purchase contract that had been entered into in May 2000. Adelphia did not use the marketing support payments to help increase demand for digital set-top boxes. Adelphia recorded the price increases it paid Scientific-Atlanta as capital expenditures, and recognized the marketing support payments paid by Scientific-Atlanta as a contra marketing expense, thereby artificially reducing its marketing expense and increasing Earnings Before Interest, Taxes, Depreciation, and Amortization (“EBITDA”). In this manner, Adelphia was able to use the transaction to reduce improperly its operating costs and increase its earnings by approximately \$16.8 million in 2000 and \$26.2 million in 2001.

2. Scientific-Atlanta agreed to enter into the marketing support transaction as an accommodation to one of its largest clients, and a primary concern was to ensure that its profit margins under the long-term purchase contract would not be eroded by the transaction. Scientific-Atlanta was not concerned with the type or amount of marketing to be done by Adelphia with the marketing support payments at the time the marketing support transaction was entered into.

3. Against this backdrop, various officers and employees of Scientific-Atlanta were confronted with numerous facts that together demonstrated that the marketing support agreement was being misused by Adelphia. These facts included, among others: (i) a retroactive price increase on set-top boxes previously delivered to Adelphia; (ii) Adelphia’s request for a commercially unreasonable high dollar amount in marketing support payments; (iii) repeated requests for higher levels of marketing support in later periods even though the major marketing push was to have occurred in earlier periods; (iv) knowledge that Adelphia’s request for the marketing support agreement was driven by its desire to obtain an accounting benefit; and (v) the

inclusion of a false reason for the price increase in one of the contracts documenting the marketing support agreement.

VIOLATIONS

4. By engaging in the conduct described in this Complaint, Scientific-Atlanta directly or indirectly, singly or in concert, has engaged in acts, practices, and courses of business that aided and abetted Adelphia's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B), and Rules 12b-20, 13a-1, and 13a-13 promulgated thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13.

JURISDICTION AND VENUE

5. The Commission brings this action pursuant to the authority conferred upon it by Section 21(d)(1) of the Exchange Act, 15 U.S.C. § 78u(d)(1), seeking to restrain and enjoin permanently Scientific-Atlanta from engaging in the acts, practices and courses of business alleged herein. The Commission also seeks an order requiring Scientific-Atlanta to disgorge ill-gotten gains it received as a result of the conduct alleged herein.

5. This Court has jurisdiction over this action pursuant to Sections 21(d) and 27 of the Exchange Act, 15 U.S.C. §§ 78u(d) and 78aa.

6. Scientific-Atlanta, directly or indirectly, used the means and instrumentalities of interstate commerce, or of the mails, or the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged herein. At the time of the wrongful conduct described herein, the common stock of Scientific-Atlanta and Adelphia was traded on the New York Stock Exchange located in New York, New York.

DEFENDANT

7. **Scientific-Atlanta** is a Georgia corporation, with corporate headquarters in Lawrenceville, Georgia. Scientific-Atlanta sells end-to-end networks used by programmers and cable operators and provides customer service and support for the cable television industry. At all relevant times, Scientific-Atlanta's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was publicly traded on the New York Stock Exchange.

OTHER RELEVANT ENTITY

8. **Adelphia** is a Delaware corporation, headquartered in Greenwood Village, Colorado. During the relevant period, Adelphia was headquartered in Coudersport, Pennsylvania. Adelphia owns, operates, and manages cable television systems and other related telecommunications businesses. On March 27, 2002, Adelphia announced that it was liable for approximately \$2.3 billion in debt that it had previously failed to disclose. In May 2002, certain members of the Rigas family, who controlled and held officer and director positions with Adelphia, resigned and Adelphia disclosed that it expected to restate its financial statements for the fiscal years 2000 and 2001. On July 18, 2002, the Commission filed *SEC v. Adelphia Communications Corporation, et al.*, 02 Civ. 5776 (PKC) (S.D.N.Y.), alleging that widespread, multifaceted financial fraud occurred at Adelphia. On May 31, 2005, the U.S. District Court for the Southern District of New York entered a consent order enjoining Adelphia from violating Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, and 13a-13 under the Exchange Act.

STATEMENT OF FACTS

Background

9. In May 2000, Adelphia entered into a purchase contract for digital set-top boxes with Scientific-Atlanta. The long-term purchase contract, which was to extend through December 31, 2001, required Adelphia to purchase digital set-top boxes at a price of approximately \$350 per set-top box, as well as other equipment at prices fixed by the terms of the agreement. The Adelphia agreement contained no provision regarding marketing.

10. In June 2000, Adelphia realized that its second quarter reported EBITDA would fall below analysts' expectations. Two senior Adelphia executives devised a plan to increase EBITDA by reducing operating costs through a marketing support agreement with Scientific-Atlanta.

11. Adelphia's purported business rationale for the marketing support was to assist Adelphia in the roll-out of its digital cable service, which was in direct competition with satellite television. Adelphia proposed structuring the transaction so that Scientific-Atlanta's payment obligation would be funded entirely by a price increase applied to digital set-top boxes it had supplied Adelphia in the past and was contractually obligated to supply in the future pursuant to the long-term purchase contract. The transaction would thus have no economic impact on Scientific-Atlanta's net revenue or income from the sale of set-top boxes to Adelphia because, before Scientific-Atlanta would be required to make the marketing support payments, Adelphia would pay to Scientific-Atlanta an amount equal to the marketing support payments in the form of a price increase applied to each set-top box delivered to Adelphia.

The 2000 Transaction

12. In August 2000, Adelphia asked Scientific-Atlanta to consider entering into the marketing support agreement. Adelphia requested marketing support retroactive to the beginning of 2000, and continuing throughout the life of its long-term purchase contract with Scientific-Atlanta. In August 2000, Scientific-Atlanta's CFO (chief financial officer) and its CAO (chief accounting officer) approved the concept of entering into a marketing support agreement with Adelphia, although not on the terms as initially proposed by Adelphia.

13. In October 2000, Adelphia and Scientific-Atlanta began negotiating the terms of the marketing support agreement. Adelphia initially insisted that Scientific-Atlanta pay marketing support of \$50 per set-top box, which equaled approximately 15% of the price of a set-top box. Scientific-Atlanta rejected that percentage as commercially unreasonable, and the parties eventually agreed that Scientific-Atlanta would pay an average of approximately \$20 per set-top box over the life of the contract, with Adelphia paying the same amount to Scientific-Atlanta in the form of price increases applied to Adelphia's orders.

14. At Adelphia's request, Scientific-Atlanta agreed to invoice Adelphia a price increase of \$31 per set-top box for deliveries from April through December 2000 and to invoice a price increase of \$16 per set-top box ordered in 2001, resulting in an average price increase of approximately \$20 per set-top box. Adelphia's purported rationale for structuring the price increase in this way was that it would incur greater marketing costs in the early stages of the digital rollout.

15. The contract documents consisted of two separate agreements. The "Spot Telecast Agreement" set forth Scientific-Atlanta's payment obligations for advertising but did not specify the type or quantity of advertising to be provided by Adelphia. The "Price Increase Letter" set

forth the price increases owed by Adelphia for set-top boxes. Although the parties understood that the sole reason for the price increase was to offset Scientific-Atlanta's payment obligations under the Spot Telecast Agreement, the Price Increase Letter stated falsely that the price increase was due to "increased costs on certain electronic components."

16. Pursuant to the contracts, on May 10, 2001, Adelphia paid Scientific-Atlanta \$16.8 million in price increases and Scientific-Atlanta immediately returned to Adelphia \$16.8 million in marketing support payments.

The 2001 Transaction

17. The long-term purchase contract required that Adelphia purchase 350,000 set-top boxes per quarter in 2001. Scientific-Atlanta became aware in June 2001 that Adelphia was going to be ordering fewer set-top boxes than required under the contract due to decreased demand, and it appeared that Adelphia would not order sufficient set-top boxes to cover the \$22.4 million in marketing support payments Scientific-Atlanta was obligated to make for calendar year 2001.

18. Scientific-Atlanta agreed to expand coverage of the marketing support arrangement to cover all of Adelphia's purchases of transmission equipment (ancillary equipment used to transmit signal that is located outside of the home and is not visible to the end-user), in addition to set-top boxes, retroactive to 2000. By expanding the range of products covered by the marketing support agreement, Scientific-Atlanta was able to ensure that the overall price increase would maintain its margin on the sales due to the marketing support it was obligated to pay without exceeding what it viewed as a commercially reasonable ratio between marketing support and product price.

19. In June 2001, when Adelphia advised Scientific-Atlanta that it would be ordering fewer set-top boxes, Scientific-Atlanta requested that Adelphia order 240,000 set-top boxes pursuant to the long-term purchase contract by the end of the fiscal quarter. Scientific-Atlanta offered Adelphia a price reduction on the June order. Adelphia agreed to purchase the 240,000 set-top boxes.

20. In December 2001, Adelphia demanded an increase in the amount of marketing support to be paid by Scientific-Atlanta for 2001 from \$22.4 million to between \$28 to \$29 million. At or about the same time, Scientific-Atlanta also requested that Adelphia purchase 200,000 set-top boxes before the end of the quarter pursuant to the long-term purchase contract. Adelphia agreed to purchase the set-top boxes, and the parties ultimately agreed on \$26.2 million in marketing support, which covered set-top boxes purchased in 2001 and transmission equipment purchased between July 2000 and December 31, 2001.

Accounting Treatment For The Transaction

21. At the time the transactions were entered into, GAAP (Generally Accepted Accounting Principles) required that the accounting for a transaction must reflect its substance.

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37. When negotiations over the terms of the marketing support agreement began in October 2000, Adelphia demanded marketing support in the amount of \$50 per set-top box or approximately 15% of the set-top box price, an amount that Scientific-Atlanta deemed

commercially unreasonable. Scientific-Atlanta viewed 4%-7% of the set-top box price as a reasonable range of marketing support. The parties reached agreement on an average price increase and associated marketing support of approximately \$20 per set-top box. Because Adelphia was supposed to incur higher marketing costs at the beginning of the digital rollout, at Adelphia's request Scientific-Atlanta agreed to a price increase and associated marketing support of \$31 per set-top box for deliveries from April through December 2000, and of \$16 per set-top box for deliveries in 2001.

38. By June 2001, Adelphia's orders of set-top boxes had declined and it became clear to Scientific-Atlanta that Adelphia would order less than the 350,000 set-top boxes per quarter it was required to purchase pursuant to the long-term purchase contract. Even though Adelphia had ordered far fewer set-top boxes than its minimum purchase obligations under the long-term purchase contract and Adelphia had stated that it would incur higher marketing costs at the beginning of the digital rollout, Adelphia asked to increase the amount of marketing support from \$22.4 million to \$26 million.

39. Although Scientific-Atlanta apparently did not agree to increase the amount of marketing support at that time, Adelphia again requested more marketing support at the end of 2001. Scientific-Atlanta then agreed to increase marketing support for 2001 from \$22.4 million to \$26.2 million.

***Adelphia Requested That The Marketing Support
Apply Retroactively To Set-Top Boxes Delivered In The Past***

40. When Adelphia approached Scientific-Atlanta with the idea of entering into a marketing support agreement, it asked that the agreement apply retroactively to the beginning of 2000, despite the fact that the long-term purchase contract had not been finalized until May 23,

2000. Although the marketing support agreement was not finalized until at least the end of calendar year 2000, Scientific-Atlanta agreed to make the marketing support agreement retroactive to April 1, 2000, the first day of the quarter in which the May 23, 2000 agreement took effect. During negotiations in June 2001, when Scientific-Atlanta agreed to expand the coverage of marketing support to include transmission equipment, it again agreed to apply the marketing support retroactively to all transmission equipment purchased by Adelphia from July 2000 through December 2001.

Scientific-Atlanta Employees Knew That The Price Increase Letter Was False

41. The overall price increase was calculated to equal the total marketing support payments so that Scientific-Atlanta's profit margin on the transactions would remain unaffected. The Price Increase Letter, which was one of the two agreements documenting the marketing support transaction, states falsely that the price increase was due to "increased costs on certain electronic components," rather than the true reason which was to fund the marketing support payments.

FIRST CLAIM FOR RELIEF

**Aiding and Abetting Violations of Section 13(a)
of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13**

42. The Commission realleges and incorporates by reference herein each and every allegation contained in Paragraphs 1 through 41.

43. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers of registered securities to file with the Commission factually accurate annual and quarterly reports. Exchange Act Rule 12b-20 provides that in addition to the information expressly required to be included in a statement or report, there shall be added such further

material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

44. By reason of the foregoing, Scientific-Atlanta knowingly provided substantial assistance to another who violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

45. By reason of the foregoing, Scientific-Atlanta aided and abetted, and unless enjoined will continue to aid and abet, violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13.

SECOND CLAIM FOR RELIEF

Aiding and Abetting Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act

46. The Commission realleges and incorporates by reference herein each and every allegation contained in Paragraphs 1 through 45.

47. Section 13(b)(2)(A) of the Exchange Act requires that issuers make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the issuer. Section 13(b)(2)(B) of the Exchange Act requires, among other things, that issuers maintain a system of internal accounting controls that permit the preparation of financial statements in conformity with GAAP.

48. By reason of the foregoing, Scientific-Atlanta knowingly provided substantial assistance to another who violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

49. By reason of the foregoing, Scientific-Atlanta aided and abetted, and unless enjoined will continue to aid and abet, violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests a Final Judgment:

I.

Permanently enjoining Scientific-Atlanta and its agents, servants, employees and attorneys and all persons in active concert or participation with them who receive actual notice of the injunction by personal service or otherwise, and each of them, from violating and aiding and abetting any violations of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-1, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13.

II.

Permanently enjoining Scientific-Atlanta and its agents, servants, employees and attorneys and all persons in active concert or participation with them who receive actual notice of the injunction by personal service or otherwise, and each of them, from violating and aiding and abetting any violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

III.

Ordering Scientific-Atlanta to disgorge the ill-gotten gains it received as a result of its violations of the federal securities laws, and to pay interest on all such gains.

IV.

Granting such other and further relief as the Court may deem just and proper.

Dated: New York, New York
June 22, 2006

/s/ Mark K. Schonfeld
Mark K. Schonfeld (MS-2798)
Regional Director

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**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK**

UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. LIME ENERGY CO., JAMES G. SMITH, JULIANNE M. CHANDLER, JOAQUIN ALBERTO DOS SANTOS ALMEIDA, AND KARAN RAINA, Defendants.	COMPLAINT [Securities Fraud] 1:16-CV-8088 ECF CASE

Plaintiff, the United States Securities and Exchange Commission (“SEC” or “Commission”), alleges as follows:

SUMMARY

1. In 2010 and 2011, Defendant Lime Energy Co. (“Lime”) improperly recognized millions of dollars of revenue earlier than appropriate under generally accepted accounting principles (“GAAP”) and millions of dollars of non-existent revenue, and in publicly filed quarterly and annual reports that misstated a total of more than \$33 million of such revenue. In May 2012, Lime’s false financial statements were used in the offer and sale of \$2.55 million of common stock to one of Lime’s directors.

2. Defendant Joaquin Alberto Dos Santos Almeida (“Almeida”), known at Lime as Jack Almeida, and Defendant Karan Raina (“Raina”), worked in Lime’s Utilities Division and, under substantial pressure from a senior manager to help meet company-wide revenue goals, began to knowingly and intentionally recognize millions of dollars of revenue earlier than appropriate starting no later than 2010.

3. Starting in January 2012, Almeida and Raina, together with Lime Energy Executive Vice President of Operations James G. Smith (“Smith”), knowingly and intentionally recognized

millions of dollars of improper revenue from the Utilities Division to help Lime meet its 2011 revenue targets. Separately, in late 2011 and early 2012, Smith knowingly and intentionally directed the booking of more than \$500,000 of improper revenue from the company's Public Sector Division earlier than appropriate in order to help Lime meet its 2011 revenue targets.

4. Lime's Corporate Controller Julianne M. Chandler ("Chandler"), who helped establish Lime's internal accounting controls to ensure revenue was properly recorded, failed to follow those controls during the relevant time period and recklessly participated in the improper recognition of revenue by both the Utilities Division and Public Sector.

5. Through the actions and misconduct of its employees, Lime violated Section 10(b) of the Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77q(a)], Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. § 78j(b)] and Exchange Act Rules 10b-5 [17 C.F.R. § 240.10b-5], Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)], and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13].

6. The misconduct of Smith, Chandler, and Almeida related to Lime's improper revenue recognition violated Section 17(a)(1) and (3) of the Securities Act, Sections 10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5(a) and (c) and 13b2-1. Raina's misconduct related to Lime's improper revenue recognition also violated Section 17(a)(3) of the Securities Act, Section 13(b)(5) of the Exchange Act, and Exchange Act Rule 13b2-1. The misconduct of Smith, Chandler, Almeida, and Raina also aided and abetted Lime's violations of Section 17(a) of the Securities Act, Sections 10(b), 13(a), and 13(b)(2)(A) of the Exchange Act, and Exchange Act Rules 10b-5, 13a-1, and 13a-13.

JURISDICTION AND VENUE

7. This Court has jurisdiction over this matter pursuant to Securities Act Sections 20 and 22(a) [15 U.S.C. §§ 77t and 77v(a)] and Exchange Act Sections 21 and 27 [15 U.S.C. §§ 78u and 78aa].

8. Defendants, directly or indirectly, made use of the means or instrumentalities of interstate commerce or the mails, or a facility of a national securities exchange, in connection with the conduct alleged herein.

9. Venue is proper because, among other reasons, Lime stock was publicly traded on the NASDAQ Capital Market, which is headquartered in this judicial district, and Lime's Utilities Division and Public Sector Division both transacted business within this judicial district.

DEFENDANTS

10. Lime is a Delaware corporation that was formed in December 1997 as Electric City LLC but ultimately became Lime Energy Co. in 2006 to reflect its new Energy Efficiency Services focus ("Lime" is an acronym for "Less is More Efficient"). Its headquarters are in Newark, New Jersey. During the relevant time period, Lime had its headquarters, first, in Elk Grove Village, Illinois, and then, beginning in August 2011, in Huntersville, North Carolina. During the relevant time period, Lime had a Public Sector Division that was located in North Carolina and a Utilities Division that maintained offices in New Jersey and New York. Both of these divisions serviced customers in those regions and this judicial district. During the relevant time period, Lime's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the NASDAQ Capital Market under the trading symbol "LIME." Its stock is now quoted on the OTC Link (previously "Pink Sheets") operated by OTC Markets Group, Inc.

11. James G. Smith, age 49, is a resident of North Carolina. Smith was Vice President and Group Vice President at Lime, principally responsible for Lime's Public Sector Division, before becoming Executive Vice President of Operations in January 2012, where he acquired additional responsibility for Lime's Utilities Division, the position he held until his termination in November 2012.

12. Julianne M. Chandler, age 40, is a resident of North Carolina. Chandler joined Lime Energy in May 2009, where she held positions as Senior Accounting Manager and Business Unit Controller before becoming Corporate Controller in 2011, the position she held until her termination in November 2012.

13. Joaquin Alberto Dos Santos Almeida, age 58, is a citizen of Portugal who resides in Asbury, New Jersey. He graduated high school in New Jersey, earned an Associates Degree from Devry Technical School in 1978, and earned a Bachelor of Science Degree in Electrical Engineering from Farleigh Dickinson University in 1981. Almeida worked as a Program Manager for the New York Power Authority for twenty-two years before joining AECOM, an energy efficiency company, in New York City in 2002, as Project Manager and then Director of Business Development for the Mid-Atlantic Region. Almeida was hired in 2008 by Lime where he worked as Vice President of Operations for Lime's newly formed Utilities Division in New Jersey until his termination in August 2012.

14. Karan Raina, age 32, is a Canadian citizen who was born in New Delhi, India and was raised in New Jersey. Raina earned a Degree in Marketing from the University of Hartford in 2004, and began working as a Marketing Coordinator for AECOM in New York City in 2005. Raina worked as a Marketing Coordinator for AECOM until he joined Lime in late 2008, after which he worked as a Program Manager for Lime's New Jersey Direct Install program before becoming

Director of Operations for Lime's Utilities Division in New Jersey, a position he held until his termination in August 2012.

FACTS

I. LIME'S CLEAN ENERGY SOLUTIONS BUSINESS

15. During the relevant time period, Lime was in the business of planning and delivering clean energy solutions to assist clients in achieving their energy efficiency and renewable energy goals. Lime operated in three specific markets – the utility market, the public sector and institutional market, and the commercial and industrial market – and its clients included utilities, energy service companies, government entities, educational institutions, commercial and industrial businesses, and property owners and managers. Lime's Public Sector Division was located in North Carolina, and its Utilities Division had offices in New Jersey and New York. Both divisions serviced customers in those regions.

16. Lime focused on deploying solutions to improve building energy efficiency, reduce energy-related expenditures and the impact of energy use on the environment, thereby helping its clients save money, improve their facilities, and meet their energy efficiency goals and mandates. Lime provided energy solutions across a range of facilities, from high-rise office buildings, distribution facilities, manufacturing plants, retail sites, multi-tenant residential buildings, mixed use complexes, hospitals, colleges and universities, and large government sites to small, single-tenant facilities. Lime's solutions include energy efficient lighting upgrades, energy efficient mechanical and electrical retrofit and upgrade services, water conservation, building weatherization, on-site generation, and renewable energy project development and implementation.

II. SMITH, CHANDLER, ALMEIDA, AND RAINA IMPROPERLY RECOGNIZED MILLIONS OF DOLLARS OF REVENUE

17. The Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 605-10-25-1 set forth, among other things, the requirements for the recognition of revenue by an entity in its internal accounting records and publicly filed financial statements. “Revenue and gains generally are not recognized until realized or realizable,” which occurs “when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash” and when “related assets received or held are readily convertible to known amounts of cash or claims to cash.” FASB ASC 605-10-25-1(a). “[R]evenue is not recognized until earned. . . . [A]n entity’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.” FASB ASC 605-10-25-1(b).

18. In 2010, the fastest growing division at Lime Energy was its Utilities Division, which performed a large number of relatively small jobs pursuant to energy efficiency programs run by large utilities. It recognized revenue from its jobs using the percentage of completion method, recognizing revenue on a job in the same percentage as the percentage of costs incurred for that job. For example, the incurrence of 50% of a job’s anticipated expense would allow recognition of 50% of a job’s anticipated revenue. Thus, generally speaking, as the expenses incurred on a job increased, so did the revenues.

19. Lime’s internal accounting controls did not require documentary support for the Utilities Division’s journal entries to be given to the company’s financial reporting personnel, and as a consequence the financial reporting personnel entered cost information from the Utilities Division into the accounting system relying only on assurances operations personnel

that documentary support for the entries existed. Lime's Utilities Division book-keeping personnel who prepared the journal entries that recorded expenses for the Division did not have any reporting responsibility to the company's accounting or financial reporting personnel, and instead reported solely to the Utilities Division's operations management.

20. Beginning in at least 2010, Almeida, the Vice President of Operations for the Utilities Division, worked with his direct report, Raina, the Division's Director of Operations, to have revenue recognized on some jobs for which Lime Energy did not yet have the requisite documentation of its corresponding costs. In some cases, the expenses had been incurred, but the company had not yet received the documentation; in other instances, the documentation had not been received because the relevant expenses had not in fact yet been incurred. Raina, in turn, directed the employees who recorded the Division's expenses to record expenses prematurely.

21. As the year end approached in December 2010, Almeida was added to an e-mail discussion of the short-fall in anticipated Utilities Division revenue, especially for one of the Division's principal utility demand-side management programs, its New Jersey Direct Install ("NJ Direct") program. Almeida forwarded the NJ Direct discussion to Raina, who responded that, prior to actually selling jobs to direct install customers, the Division was already creating purchase orders and sending the purchase orders to vendors that supplied Lime Energy with materials, so that the Division could quickly get invoices from the vendors to acknowledge that materials for the jobs had been ordered, in order to allow the Division to recognize revenue on jobs shortly after the jobs were sold, up to the full percentage of job expenses allocated to materials.

22. In fact, Lime Energy did not receive documentation before the 2010 fiscal year end showing that it had incurred costs on several Utilities Division jobs that customers purportedly had agreed to near the end of the fiscal year, the Utilities Division, at the direction of Almeida

and Raina, nevertheless recorded those costs and thus improperly recognized revenue. Utilities Division employees kept both Raina and Almeida informed regarding jobs for which revenue had been recognized but which had not been completed, had not been started, or had not been submitted to the contractor overseeing the NJ Direct program for approval.

23. On November 8, 2011, Lime filed a current Report on Form 8-K with the Commission along with a press release indicating the company's reported revenue for the first three quarters of 2011 was \$75.4 million and that projected revenue for the fourth quarter of 2011 would be \$47-53 million, for a 2011 year-end total revenue projection of \$122.4-128.4 million.

24. Shortly before the company's November 2011 public announcement of its year-to-date revenue and year-end revenue projection, Smith emailed Chandler, Almeida, Raina, and other employees in both the Public Sector and Utilities Divisions about the company's year-end revenue projection: "pulling the \$123mm off will be nothing short of exceptional. That should be the focus, the main thought, anything less is (YOU FILL IN THE BLANK)."

25. In early January 2012, Raina asked a Utilities Division bookkeeper to send an email to Chandler asking whether it was "possible to add more Revenue . . . in Nov so Dec doesn't look so heavy – apparently we are going to have to be a little bit more aggressive than originally thought." Chandler immediately responded, "Nope. We have already done our entries that are based off of revenue. We cannot drag our closing any longer. Next month this will not be an option at all."

26. Chandler forwarded Raina's request to add more revenue to November to Smith, and informed Smith that November 2011 revenue from the Utilities Division was only \$3.5 million. Chandler and Smith ultimately did agree to Raina's request to re-open the company's

books and records for November 2011, because, as Smith stated, there was “[n]o way we can go out with \$3.5mm in November.”

27. Chandler emailed Raina and the Utilities Division bookkeeper stating that she had spoken to Smith “and agreed to open Nov back up IF these entries are done today. They need to be done by the end of the day today. Anything not there will go in December.” Chandler added that “[t]his cannot happen in Dec. Your drop dead deadline i[s] Jan 20 for Dec entry. You will need to plan your time accordingly.” Smith said he would “most definitely” support upholding the deadlines set by Chandler.

28. Chandler separately emailed Lime’s Chief Financial Officer to inform him that the company’s November 2011 books would be re-opened, stating that “utilities missed some projects for Nov close and [Smith] would like to reopen it. I told them it needed to be completed today.”

29. After Chandler and Smith agreed to re-open Lime’s November 2011 books and records, Utilities Division employees emailed the necessary journal entries to Chandler and her staff for uploading into the company’s financial reporting system, and changed the revenue recognition percentages in the company’s financial systems so that revenue related to already existing projects would be recognized earlier than appropriate. This resulted in millions of dollars in revenue being improperly recorded and recognized in Lime’s November 2011 books and records.

30. Also in early January 2012, Smith met with Almeida and Raina to discuss a “year-end push” regarding 2011 revenue. Almeida and Raina presented Smith with a spreadsheet that showed the Utilities Division actual and projected revenue for 2011, and later emailed the spreadsheet to Smith at his request. While the spreadsheet identified a 2011 year-end goal for the Utilities Division of \$50 million, it indicated that no more than \$45 million would be

achieved and only by including in December 2011 revenue millions of dollars from new contracts that would not be signed by Lime customers until January 2012.

31. After discussions with Smith, Almeida and Raina instructed Utilities Division personnel to provide journal entries to Chandler and her staff, so that millions of dollars of revenue would be recognized by the company in December 2011 on contracts that were not signed by Lime customers until January 2012.

32. Almeida and Raina also instructed Utilities Division bookkeepers to increase the revenue recognition percentages in the company's financial systems so that revenue related to already existing projects would be recognized in December 2011, before it was actually earned by the company in 2012. Utilities Division bookkeepers followed these instructions, which resulted in Lime recognizing millions of dollars of revenue in 2011 that would not be earned until 2012.

33. Utilities Division bookkeepers followed these instructions and emailed the necessary journal entries to Chandler and her staff for uploading into the company's financial reporting system. Chandler and her staff immediately loaded the journal entries into the company's financial reporting system without asking any questions about the propriety of the revenue being booked. This resulted in Lime recognizing millions of dollars of revenue in 2011 that would not be earned until later in 2012.

34. Later in January 2012, Almeida, Raina, and another Utilities Division employee discussed recognizing revenue on so-called "pipeline" projects – that is, projects where contract proposals had been presented to customers but had not yet been agreed to or signed by those customers. Subsequent to these discussions, Raina provided revenue information for these "pipeline" projects to Utilities Division bookkeepers so that it could be recognized in December

2011. Almeida and Raina had never before booked revenue related to “pipeline” projects and knew that it was not properly recognizable as revenue.

35. In late January 2012 and early February 2012, Raina emailed lists reflecting millions of dollars of “pipeline” revenue to Utilities Division bookkeepers, who then followed Raina’s instructions to make and email the necessary journal entries to Chandler and her staff for uploading into the company’s financial reporting system. Chandler and her staff immediately loaded the journal entries into the company’s financial reporting system without asking any questions about the legitimacy of the projects or the propriety of the revenue being booked. This resulted in millions of dollars of non-existent revenue related to these “pipeline” projects – including, in some instances, entirely fabricated revenue amounts – being recognized by the company in its December 2011 revenue.

36. On Saturday, February 4, 2012, Smith and Chandler received an email from Lime’s Chief Financial Officer stating that that the company was roughly \$500,000 below a \$120 million revenue target that Lime’s Chief Executive Officer had recently informed Lime senior management was the “current and absolute drop dead goal.” The next morning, a Sunday, Smith emailed Chandler about additional revenue items from Lime’s Public Sector Division: “was waiting on the final number, have to get to \$120 so will have something coming your way.”

37. Smith shortly thereafter emailed Chandler with three new items of revenue relating to existing projects that totaled more than \$500,000 in Public Sector revenue, which Smith indicated he was providing because they needed to save the company’s \$120 million goal. Smith stated that the new revenue items related to one invoice that had been missed previously and two other invoices had not yet been received by the company but should have been, and suggested that Chandler make the accounting entries herself.

38. Within minutes, and without asking any questions about the untimeliness or propriety of these newly-discovered revenue items, Chandler emailed back that the journal entries had been made and “revenue is updated...[b]arring any adjustments...the revenue for 2011 is now at \$120,220,719.60.” Smith responded, “Ok, we will keep our fingers crossed there are no adjustment[s]. Get your tap dancing shoes on.....” Smith then emailed Public Sector employees about the new revenue that had been recognized and instructed them to make the necessary adjustments to Public Sector forecasts.

39. Contrary to what Smith emailed to Chandler, these new items of revenue could not be properly recognized by Lime in its 2011 revenue because they would not be earned by the company until the work related to these items was completed later in 2012.

40. On March 16, 2012, Lime filed its 2011 annual Report on Form 10-K with the Commission, reporting company-wide revenue for the year of \$120,083,000; an amount just over the company’s internal revenue target for that year.

III. SMITH AND CHANDLER FAILED TO FOLLOW INTERNAL ACCOUNTING CONTROLS AND ALLOWED IMPROPER REVENUE TO BE RECOGNIZED

41. Lime’s internal accounting controls, which Chandler provided to Lime’s outside auditors, established guideline dates by which journal entries and other activities related to revenue recognition were to be completed following the close of monthly, quarterly, and annual reporting periods.

42. As the Corporate Controller for Lime, Chandler had responsibility and control for opening and closing the company’s financial books and records every month. Chandler failed to enforce the company’s reporting guidelines and knowingly or recklessly permitted millions of dollars of revenue to be improperly recognized after those deadlines.

43. Lime's internal accounting controls also required that Chandler and Smith review and discuss every job completed by the company every month.

44. Chandler and Smith typically discussed Public Sector projects but not all Utilities projects, and they did not discuss the revenue items that resulted in the company improperly recognizing millions of dollars of revenue in 2011 from incomplete jobs.

IV. LIME'S FALSE FINANCIAL STATEMENTS WERE USED IN THE OFFER AND SALE OF \$2.55 MILLION OF COMMON STOCK TO ONE OF LIME'S DIRECTORS

45. On May 15, 2012, Lime entered into a subscription agreement to sell one million shares of its common stock to one of its board members at the most recent consolidated closing bid price of \$2.55 on the NASDAQ Capital Market.

46. Lime offered and sold these securities pursuant to a registration statement dated September 1, 2011, and a prospectus supplement dated May 15, 2012.

47. Lime's May 15, 2012 prospectus supplement incorporated by reference the company's 2011 annual report that had been filed with the Commission on March 16, 2012.

48. Lime received \$2,550,000 from its board member in exchange for the one million shares of common stock.

V. LIME IDENTIFIES MATERIAL AMOUNTS OF IMPROPER OR FRAUDULENT REVENUE AND RESTATES FINANCIAL REPORTS

49. On July 17, 2012, following a partial internal investigation by Lime's CFO, Lime announced that its consolidated annual financial statements in its annual Reports on Form 10-K for 2010 and 2011 could no longer be relied on because revenue had been recorded improperly, including some instances where non-existent revenue may have recorded and where revenue may have been recorded earlier than it should have been.

50. Subsequent to further investigation, Lime terminated the employment of Almeida, Raina, Smith, Chandler, and the Utilities Division bookkeeper involved in the improper revenue

recognition.

51. On December 27, 2012, as a result of its expanded internal investigation, Lime announced that its consolidated annual financial statements in its annual Reports on Form 10-K for the 2008 and 2009 also could no longer be relied on because “some portion of the Company’s revenue for 2009 and 2008 was recognized earlier than permitted under generally accepted accounting principles.”

52. In July 2013, Lime filed restated financial results for the annual reporting periods of 2008-2011, as well as for the first quarter of 2012.

53. Lime’s July 31, 2013 restatement disclosed that an investigation conducted by outside counsel and forensic accountants revealed “that certain individuals, including members of its accounting and operations staff, working together, circumvented its internal controls by obtaining or modifying documents in a fraudulent manner in order to recognize revenue earlier than appropriate and in some instances to support revenue that was not associated with valid customer contracts.”

54. Lime’s July 31, 2013 restatement further disclosed that “approximately \$14.2 million of revenue was recognized where no valid customer contract existed or the amount recognized exceeded the contract value and \$17.4 million of cumulative revenue . . . was recognized earlier than appropriate under generally accepted accounting principles.”

55. In making the restatement, Lime determined that the Utilities Division recognized over \$5 million of improper revenue throughout 2010, including more than \$4.5 million of revenue that was recognized earlier than appropriate. Lime also determined that the Utilities Division recognized over \$16 million of improper revenue throughout 2011, including more than \$10.5 million of unsupported or non-existent revenue of which \$7.5 million was recognized in the fourth quarter of 2011. Lime’s restatement of non-existent revenue from its 2011 financial

results included the millions of dollars of “pipeline” revenue that Almeida and Raina had instructed Utilities Division bookkeepers to record in Lime’s December 2011 revenue.

56. In making the restatement, Lime also determined that the Public Sector Division recognized over \$9.5 million of improper revenue in 2010, including more than \$9 million of revenue that was recognized earlier than appropriate. Lime further determined that the Public Sector Division recognized over \$10 million of improper revenue in 2011, including more than \$8 million of revenue that was recognized earlier than appropriate in the fourth quarter of 2011. Lime’s restatement efforts moved the more than \$500,000 of Public Sector revenue that Smith directed Chandler to include in Lime’s 2011 revenue to its 2012 revenue.

CLAIMS FOR RELIEF

First Claim (LIME)

Violations of Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)]

57. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

58. At all relevant times, Section 17(a) of the Securities Act provided that “[i]t shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly” to engage in certain fraudulent acts. 15 U.S.C. § 77q(a). Section 17(a)(1) makes it unlawful to, directly or indirectly, “employ any device, scheme, or artifice to defraud.” 15 U.S.C. § 77q(a)(1). Section 17(a)(2) makes it unlawful to, directly or indirectly, “obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” 15 U.S.C. § 77q(a)(2). Section 17(a)(3) prohibits, directly or indirectly, “engag[ing] in any transaction, practice, or course of business which

operates or would operate as a fraud or deceit upon the purchaser” in the offer or sale of securities. 15 U.S.C. § 77q(a)(3).

59. As described above, certain Lime employees used the means and instrumentalities of communication in interstate commerce to recognize improperly revenue so that the company could meet public revenue projections or report higher than accurate results to the public, and Lime filed financial statements with the Commission reflecting these false financial results. The improperly recognized revenue was quantitatively and qualitatively material. These false financial statements were used by Lime when it offered and sold \$2.55 million of common stock to one of its directors. Through the conduct of its employees, in the offer or sale of securities, Lime employed a device, scheme, or artifice to defraud, obtained money or property by means of untrue statements of material fact, and engaged in acts, practices, or courses of business that operated or would operate as a fraud or deceit upon any person, thereby violating Section 17(a)(1), (2), and (3) of the Securities Act.

Second Claim (LIME)

**Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]
and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5]**

60. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

61. At all relevant times, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5] made it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which

operates or would operate as a fraud or deceit upon any persons, in connection with the purchase or sale of any security.

62. As described above, certain Lime employees used the means and instrumentalities of interstate commerce to recognize false revenue so that the company could meet public revenue projections or report higher than accurate results to the public, and the improperly recognized revenue was quantitatively and qualitatively material. Lime filed financial statements with the Commission reflecting these false financial results. Through the conduct of its employees, Lime employed a device, scheme, or artifice to defraud, made untrue statements of material fact, and engaged in acts, practices or courses of business that operated or would operate as a fraud or deceit upon any person, thereby violating Section 10(b) of the Exchange Act and Exchange Act Rules 10b-5(a), (b), and (c).

Third Claim (SMITH, CHANDLER, ALMEIDA & RAINA)

**Violations of the Exchange Act Section 13(b)(5) [15 U.S.C. § 78m(b)(5)] and
Exchange Act Rule 13b2-1 [17 C.F.R. §§ 240.13b2-1]**

63. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

64. At all relevant times:

- a. Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)] required issuers, including Lime, to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and dispositions of the assets of the issuer;
- b. Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)] made it unlawful for any person to knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify books, records, or accounts that are described in Exchange Act Section 13(b)(2) of the Exchange Act [15 U.S.C. § 78m(b)(2)]; and

c. Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1] made it unlawful for any person to directly or indirectly falsify or cause to be falsified any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)].

65. As described above, Smith, Chandler, Almeida, and Raina falsified or caused to be falsified books, records, or accounts that are subject to Section 13(b)(2) of the Exchange Act, and therefore violated Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1].

66. As described above, Smith, Chandler, Almeida and Raina knowingly falsified books, records, or accounts that are described in Section 13(b)(2) of the Exchange Act, and therefore violated Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)].

67. As described above, Smith and Chandler knowingly circumvented Lime's system of internal accounting controls, and therefore violated Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]

Fourth Claim (LIME)

Violations of Exchange Act Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)] and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13]

68. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

69. At all relevant times:

a. Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13], required issuers, including Lime, to file with the Commission Forms 10-K (reporting annual results), and Forms 10-Q (reporting quarterly results), that truthfully and accurately report on the issuer's revenues, earnings, other financial results, information about accounting practices, and other related information.

b. Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)] required issuers, including Lime, to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and dispositions of the assets of the issuer.

c. Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)] required issuers, including Lime, to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: transactions are executed in accordance with management's general or specific authorization; transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets; access to assets is permitted only in accordance with management's general or specific authorization; and the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

70. As described above, Lime failed to file truthful and correct annual and quarterly reports (on Forms 10-K and 10-Q) with the Commission, and failed to include material information in its required statements and reports as was necessary to make the required statements, in the light of the circumstances under which they were made, not misleading.

71. By reason of the foregoing, Lime violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)], and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13].

Fifth Claim (SMITH, ALMEIDA & CHANDLER)

**Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]
and Rule 10b-5(a) and (c) [17 C.F.R. § 240.10b-5(a) and (c)]**

72. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

73. At all relevant times, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5] made it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons, in connection with the purchase or sale of any security.

74. As described above, Smith and Almeida knowingly or recklessly recognized millions of dollars of improper revenue so that the company could meet public revenue projections or report higher than accurate results to the public. During the relevant time period, Chandler failed to follow Lime's internal accounting controls to ensure revenue was properly recorded and recklessly participated in the improper recognition of revenue by both the Utilities and Public Sector divisions.

75. As described above, Smith, Almeida, and Chandler used and directed the means and instrumentalities of interstate commerce be used to recognize false or improper revenue that was both quantitatively and qualitatively material.

76. Through their conduct, Smith, Almeida, and Chandler knowingly or recklessly employed a device, scheme, or artifice to defraud and engaged in acts, practices, or courses of

business that operated or would operate as a fraud or deceit upon any person, thereby violating Section 10(b) of the Exchange Act and Exchange Act Rules 10b-5(a) and (c).

Sixth Claim (SMITH, ALMEIDA & CHANDLER)

**Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933
[15 U.S.C. §§ 77q(a)(1), and 77q(a)(3)]**

77. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

78. At all relevant times, Section 17(a) of the Securities Act provided that “it shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly “to engage in certain fraudulent acts. 15 U.S.C. § 77q(a). Section 17(a)(1) makes it unlawful to, directly or indirectly, “employ any device, scheme, or artifice to defraud.” 15 U.S.C. § 77q(a)(1). Section 17(a)(3) prohibits, directly or indirectly, “engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser” in the offer or sale of securities. 15 U.S.C. § 77q(a)(3).

79. As described above, Smith and Almeida knowingly or recklessly recognized millions of dollars of improper revenue so that Lime could meet public revenue projections or report higher than accurate results to the public. During the relevant time period, Chandler failed to follow Lime’s internal accounting controls to ensure revenue was properly recorded and recklessly participated in the improper recognition of revenue by both the Utilities and Public Sector divisions.

80. As described above, Smith, Almeida, and Chandler used and directed the means and instrumentalities of interstate commerce be used to recognize false or improper revenue, and the improperly recognized revenue was both quantitatively and qualitatively material.

81. Through their conduct, Smith, Almeida, and Chandler knowingly or recklessly employed a device, scheme, or artifice to defraud and engaged in acts, practices, or courses of

business that operated or would operate as a fraud or deceit upon a person, thereby violating Section 17(a)(1) and (a)(3) of the Securities Act.

Seventh Claim (RAINA)

**Section 17(a)(3) of the Securities Act of 1933
[15 U.S.C. § 77q(a)(3)]**

82. Paragraphs 1 through 56 are realleged and incorporated herein by reference.

83. At all relevant times, Section 17(a)(3) of the Securities Act provided that “it shall be unlawful for any person in the offer or sale of any securities . . . directly or indirectly . . . to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” 15 U.S.C. § 77q(a)(3).

84. As described above, Raina, often in coordination with Almeida and Smith, directed the improper recognition of millions of dollars of revenue that he knew, or should have known, had not been earned by Lime and, in some instances, directed that revenue be recorded even though he knew or should have known that it did not and would never exist, so that Lime could meet public revenue projections or report higher than accurate results to the public. Raina directed that the means and instrumentalities of interstate commerce be used to improperly recognize revenue. The improperly recognized revenue was quantitatively and qualitatively material. Through his conduct, Raina engaged in transactions, practices or courses of business that operated or would operate as a fraud or deceit upon a person, thereby violating Section 17(a)(3) of the Securities Act.

Eighth Claim (SMITH, ALMEIDA & CHANDLER)

Aiding and Abetting Lime’s Violation of Section 10(b) of the Exchange Act [15 U.S.C. § 78(j)] and Exchange Act Rule 10b-5(b) [17 C.F.R.240.10b-5(b)]

85. Paragraphs 1 through 56 are realleged and incorporated by reference.

86. At all relevant times, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and

Exchange Act Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)] made it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

87. As described above, Lime made untrue statements of material fact when it filed its reports on Forms 10-Q and Forms 10-K with the Commission that included financial statements that contained both early and non-existent revenue.

88. By reason of the foregoing, Lime violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)] thereunder.

89. By reason of the conduct described above, Smith, Chandler, and Almeida knowingly or recklessly provided substantial assistance to, and thereby aided and abetted, Lime's violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)].

90. Accordingly, Smith, Chandler and Almeida are liable under Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)] for aiding and abetting Lime's violations.

Ninth Claim (SMITH, ALMEIDA & CHANDLER)

**Aiding and Abetting Lime's Violations of Section 17(a)(2)
of the Securities Act [15 U.S.C. § 77q(a)(2)]**

91. Paragraphs 1 through 56 are realleged and incorporated by reference.

92. At all relevant time, Securities Act Section 17(a)(2) [15 U.S.C. 77q(a)(2)] made it unlawful for any person in the offer or sale of any securities, by any means or instruments of transportation or communication in interstate commerce, or by use of the mails, directly or indirectly, to obtain money or property by means of any untrue statement of material fact or any

omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

93. As described above, certain Lime employees used the means and instrumentalities of interstate commerce to recognize false or improper revenue so that the company could meet public revenue projections or report higher than accurate results to the public, and Lime filed financial statements with the Commission reflecting these false financial results. The improperly recognized revenue was quantitatively and qualitatively material. These false financial statements were used by Lime when it offered and sold \$2.55 million of common stock to one of its directors. Through the conduct of its employees, in the offer or sale of securities, Lime obtained money or property by means of untrue statements of material fact, thereby violating Section 17(a)(2) of the Securities Act [15 U.S.C. § 77q(a)(2)].

94. By reason of the conduct described above, Smith, Chandler, and Almeida knowingly or recklessly provided substantial assistance to, and thereby aided and abetted, Lime's violations of Section 17(a)(2) of the Exchange Act [15 U.S.C. § 77(q)(a)(2)].

95. Accordingly, Smith, Chandler, and Almeida are liable under Section 15(b) of the Securities Act [15 U.S.C. § 77(b)] for aiding and abetting Lime's violations.

Tenth Claim (SMITH, CHANDLER, ALMEIDA, & RAINA)

**Aiding and Abetting Lime's Violations of Sections 13(a) and 13(b)(2)(A)
of the Exchange Act [15 U.S.C. §§ 78m(a) and 78m(b)(2)] and Exchange Act
Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13]**

96. Paragraphs 1 through 56 are realleged and incorporated by reference.

97. At all relevant times,

d. Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13], required issuers, including Lime, to file with the Commission Forms 10-K (reporting annual

results) and Forms 10-Q (reporting quarterly results), that truthfully and accurately reported on Lime's revenues, earnings, other financial results, information about accounting practices, and other related information;

e. Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)] required issuers, including Lime, to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and dispositions of the assets of the issuer.

98. As described above, Lime failed to file truthful and correct annual and quarterly reports (on Forms 10-K and 10-Q) with the Commission, and failed to include material information in its required statements and reports as was necessary to make the required statements, in the light of the circumstances under which they were made, not misleading.

99. By reason of the foregoing, Lime violated Sections 13(a) and 13(b)(2)(A) of the Exchange Act [15 U.S.C. §§ 78m(a) and 78m(b)(2)(A)] and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13].

100. By reason of the conduct described above, Smith, Chandler, Almeida, and Raina, acting knowingly or recklessly, provided substantial assistance to and thereby aided and abetted Lime in its violations of Exchange Act Sections 13(a) and 13(b)(2)(A) [15 U.S.C. §§ 78m(a) and 78m(b)(2)(A)] and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. §§ 240.13a-1 and 240.13a-13].

101. Accordingly, Smith, Chandler, Almeida, and Raina are liable, pursuant to Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)], for aiding and abetting Lime's violations.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court enter a Final Judgment:

A. Permanently enjoining Lime from violating, directly or indirectly, Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)]; Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78j(b), 78m(a), 78m(b)(2)(A), 78m(b)(2)(B)]; and Exchange Act Rules 10b-5, 13a-1, and 13a-13 [17 C.F.R. §§ 240.10b-5, 240.13a-1, and 240.13a-13];

B. Permanently enjoining Smith, Chandler, and Almeida from violating, directly or indirectly, Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)]; Sections 10(b) and 13(b)(5) of the Exchange Act [15 U.S.C. §§ 78j(b) and 78m(b)(5)]; and Exchange Act Rules 10b-5 and 13b2-1 [17 C.F.R. § 240.10b-5 and § 240.13b2-1], and from aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act [15 U.S.C. §§ 78m(a) and 78m(b)(2)(A)], and Exchange Act Rules 13a-1, and 13a-13 [17 C.F.R. §§ 240.13a-1, and 240.13a-13];

C. Permanently enjoining Raina from violating, directly or indirectly, Section 17(a)(3) of the Securities Act [15 U.S.C. § 77q(a)]; Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]; and Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1]; and from aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(a) and § 78m(b)(2)(A)] and Exchange Act Rules 13a-1 and 13a-13 [17 C.F.R. § 240.13a-1 and § 240.13a-13];

D. Prohibiting Smith, Chandler, and Almeida, pursuant to Section 20(e) of the Securities Act [15 U.S.C. § 77t(e)] and Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)], from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)];

E. Imposing civil monetary penalties against each defendant pursuant to Securities Act Section 20(d) [15 U.S.C. § 77t(d)] and Exchange Act Section 21(d)(3) [15 U.S.C. § 78u(d)(3)]; and

F. Granting such other relief as this Court may deem just and appropriate.

Dated: October 18, 2016

Respectfully submitted,

/s/ Scott W. Friestad

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10242 / October 31, 2016

SECURITIES EXCHANGE ACT OF 1934
Release No. 79196 / October 31, 2016

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3821 / October 31, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17654

In the Matter of

DOMENICK F. CONSOLO, CPA
AND PKF O'CONNOR DAVIES,
LLP,

Respondents.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE
SECURITIES ACT OF 1933 AND
SECTIONS 4C AND 21C OF THE
SECURITIES EXCHANGE ACT OF
1934, AND RULE 102(e) OF THE
COMMISSION'S RULES OF
PRACTICE, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE AND DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Domenick F. Consolo ("Consolo") and PKF O'Connor Davies, LLP ("O'Connor Davies") (collectively "Respondents") pursuant to Sections 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C¹ and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.²

¹ Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order, as set forth below.

III.

On the basis of this Order and Respondents’ Offers, the Commission finds³ that:

A. SUMMARY

1. O’Connor Davies was the independent auditor for the Town of Ramapo, New York (the “Town”) and the Ramapo Local Development Corporation (the “RLDC,” and collectively with the Town, “Ramapo”) for fiscal years ended December 31, 2009 through December 31, 2014. Consolo was the audit partner responsible for the audits during that period. In that capacity, Respondents issued audit reports for these fiscal years stating that the Town’s and the RLDC’s financial statements were presented fairly, in all material respects, in conformity with generally accepted accounting principles (“GAAP”)⁴ and that the audits were performed in accordance with generally accepted auditing standards (“GAAS”). These statements were false in that the financial statements were not fairly presented in all material respects in accordance with GAAP and the audits were not performed in accordance with GAAS.

2. Respondents knew or should have known that the audit reports were or would be incorporated in municipal securities offering documents by the Town and the RLDC. Between

aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

² Rule 102(e)(1)(ii) provides, in pertinent part, that:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

³ The findings herein are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

⁴ As disclosed in Ramapo’s financial statements, the Governmental Accounting Standards Board (“GASB”) is the accepted standard setting board for establishing governmental accounting and financial reporting principles.

2010 and 2015, Ramapo raised approximately \$300 million from investors (including about \$85 million in “new money” issuances and the balance in refundings of existing debt) pursuant to 16 securities offerings, the official statements for which contained Respondents’ then most recent audit reports.

3. Between 2010 and 2011, four official statements contained the Town’s fiscal year (“FY”) 2009 financial statements. These financial statements included a \$3,080,000 receivable in the Town’s primary operating fund, called the General Fund, purportedly for a sale of land known as the “Hamlets” to the RLDC. While auditing the financial statements, Consolo learned that the alleged sale had not been completed. Nevertheless, as discussed below, following an inquiry from a Town finance department employee as to whether to book the receivable, Consolo allowed it to be recorded. The receivable represented approximately 75% of the Town’s FY 2009 General Fund balance.

4. While auditing the Town’s FY 2010 financial statements in or around April 2011, Consolo learned that the sale of the Hamlets, which he had previously been told would take place by December 2010, did not occur. Nevertheless, Respondents issued unmodified audit reports for the Town’s and the RLDC’s FY 2010 – FY 2014 financial statements, which continued to improperly reflect the receivable for the Hamlets sale as an asset in the Town’s General Fund and the Hamlets land as an asset of the RLDC. Without the receivable, the General Fund would have had a negative balance in each of these fiscal years.

5. Consolo violated applicable professional standards by failing to exercise due professional care and skepticism and to obtain sufficient appropriate audit evidence in connection with auditing the \$3,080,000 receivable as well as various other receivables, interfund transfers, and liabilities reported by the Town and the RLDC for FY 2009 – FY 2014.

6. Additionally, while auditing the Town’s FY 2011 – FY 2013 financial statements, Consolo failed to appropriately respond when employees in the Town’s finance department either expressed concerns concerning the propriety of the financial statements or declined to complete a fraud questionnaire.

7. Beginning in May 2013, senior management at O’Connor Davies learned that Ramapo’s financial statements were the subject of investigations by the Federal Bureau of Investigation, the United States Attorney for the Southern District of New York, and the Commission and that the \$3,080,000 receivable was a focus of their respective inquiries. However, O’Connor Davies failed to appropriately respond to the revelation that the Ramapo engagements presented a heightened risk of fraud. Subsequent to that revelation, the firm issued unmodified audit reports for the Town’s FY 2012 – FY 2014 financial statements, which reflected inflated General Fund balances as a result, among other things, of continued recognition of the \$3,080,000 receivable. The firm also issued unmodified audit reports for the RLDC’s FY 2012 – FY 2014 financial statements, which continued to improperly reflect the Hamlets property as an RLDC asset.

B. RESPONDENTS

8. Consolo, age 61, of Yorktown Heights, New York, is a Certified Public Accountant (“CPA”) licensed to practice in New York. Consolo has served as an accountant of O’Connor Davies and its predecessors since 1979. Consolo served as the O’Connor Davies engagement partner on, and had final audit responsibility over, the Town and RLDC engagements from FY 2009 through FY 2014. He has also acted as a quality control reviewer for O’Connor Davies on other municipal audits.

9. O’Connor Davies is a PCAOB-registered public accounting firm with its headquarters in Harrison, New York. The conduct at issue occurred in the course of audits of the Town and the RLDC, clients of the firm’s municipal practice.

C. OTHER RELEVANT ENTITIES

10. The Town is an incorporated municipal government in Rockland County, New York. The Town is governed by an elected five member board, including a supervisor whose function is akin to a mayor.

11. The RLDC is a not-for-profit corporation established in 2008 for the purpose of engaging in development projects within the Town. The RLDC is a component unit of the Town, but operates independently of the Town. During the relevant period, the president of the RLDC was the Town’s supervisor.

D. FACTS

The Securities Offerings and the Audit Reports

12. Between September 2010 and September 2015, the Town conducted 14 municipal securities offerings. During the same period, the RLDC conducted two securities offerings, which were guaranteed by the Town.

13. The official statements for the Town’s offerings contained unmodified audit reports accompanying the Town’s financial statements. The official statements for the RLDC’s offerings contained unmodified audit reports accompanying both the Town’s and the RLDC’s financial statements.

14. Although these official statements disclosed that O’Connor Davies was “not associated” with their preparation, Consolo knew or should have known that the official statements would include O’Connor Davies’ audit reports. Consolo agreed, when possible, to complete the audits on a timetable that would permit the use of the audited financial statements in connection with Ramapo’s offerings. Consolo, on behalf of the firm, also effectively consented to inclusion of the FY 2010 and FY 2012 audit reports in certain of Ramapo’s offering documents.

15. The audit reports stated in pertinent part, “We conducted our audit in accordance with auditing standards generally accepted in the United States of America In our opinion, the

financial statements . . . present fairly, in all material respects, the respective financial position [of the Town/ the RLDC] in conformity with accounting principles generally accepted in the United States of America.”

16. A summary of the relevant offerings and the audit reports contained therein is set out below:

Issuer	Official Statement Date	Issue Size (in millions)	Audit Report
Town	09/21/10	\$12.0	FY 09
Town	10/27/10	\$06.7	FY 09
Town	12/07/10	\$20.4	FY 09
RLDC	04/15/11	\$25.0	FY 09
Town	06/01/11	\$15.0	FY 10
Town	09/27/11	\$14.2	FY 10
Town	11/30/11	\$19.9	FY 10
Town	05/24/12	\$15.0	FY 10
Town	09/21/12	\$22.0	FY 11
Town	11/28/12	\$19.3	FY 11
RLDC	02/07/13	\$25.0	FY 11
Town	04/05/13	\$12.2	FY 11
Town	05/24/13	\$31.2	FY 11
Town	05/21/14	\$35.7	FY 12
Town	05/19/15	\$33.3	FY 14
Town	09/11/15	\$13.4	FY 14

17. The audit reports contained in the offering documents were signed by O’Connor Davies. As engagement partner, Consolo approved issuance of the audit reports.

18. The FY 2009 – FY 2014 audit reports were also publicly available pursuant to continuing disclosure agreements.

The General Fund

19. The General Fund is the Town’s primary operating fund. Tax revenues and other receipts that are not allocated by law or contractual agreement to another fund are accounted for in the General Fund.

20. Financial statements for governmental funds, including the General Fund, focus on near-term inflows and outflows of spendable resources. As explained in the Town’s financial statements, governmental fund financial statements were reported using a current financial resources measurement focus and a modified accrual basis of accounting, under which revenues were recognized as soon as they were both “measurable” and “available”; *i.e.*, collectible within the current period or soon enough thereafter to pay liabilities of the current period. According to

the Town's financial statements, a 90 day availability period was used for recognition of most governmental fund revenues.

21. Consolo believed that a decline in the reported General Fund balance may have resulted in a credit rating downgrade on Ramapo's bonds, leading investors to demand higher interest rates on the bonds.

22. As of fiscal year-end 2008, the Town reported a General Fund balance of \$4,501,666. However, revenues declined following the onset of the financial crisis, resulting in a decrease in the General Fund balance. Beginning in FY 2009, pressure on the Town's finances also resulted from increased debt service payments stemming from bonds issued to finance various projects, including the purchase of land for the construction of a minor league baseball stadium.

\$3,080,000 Receivable

23. In FY 2009, the Town recorded a \$3,080,000 receivable as an asset in the General Fund, which was purportedly for a sale by the Town of the Hamlets property, a 13.7-acre parcel of land, to the RLDC. The receivable represented approximately 75% of the Town reported General Fund balance for FY 2009.

24. While auditing the FY 2009 financial statements in April 2010, Consolo learned that the sale of the Hamlets was not expected to take place until sometime later in FY 2010. As he acknowledged to a colleague, "This is going to be a real problem. It's not even close to a sale by December 31, 2009."

25. Nevertheless, Consolo allowed the recording of the \$3,080,000 receivable in the Town's General Fund and the inclusion of the Hamlets property as an asset of the RLDC in the FY 2009 financial statements. The audit co-manager wrote in a contemporaneous email to a colleague, "No one wants to give the ok for this, but Dom [Consolo] said go ahead and book it."

26. At the time of the FY 2009 audit, O'Connor Davies' quality control policies and procedures required an independent preissuance review of the Town's financial statements. However, the audit workpapers do not contain evidence that such a review was conducted of the Town's FY 2009 audited financial statements.

27. While auditing the Town's FY 2010 financial statements, Consolo learned that the sale of the Hamlets still had not occurred because a habitat for timber rattlesnakes, a threatened species, was located on the land. That habitat called into question the potential to develop the Hamlets. Therefore, the Hamlets sale would not go forward.

28. Nevertheless, for FY 2010 – FY 2014, the audit workpapers reflected the continued recognition in the financial statements of a receivable in the General Fund for sale of the Hamlets

to the RLDC and inclusion of the Hamlets property as an asset of the RLDC.⁵ In each such fiscal year, inclusion of the receivable represented the difference between the Town reporting a positive or a negative General Fund balance.

29. During the FY 2010 audit, Consolo received false representations from Town officials that the Town would receive an identical \$3,080,000 from the RLDC during the 2011 calendar year pursuant to a reimbursement agreement executed in connection with the transfer of an unrelated parcel of land that was to be the site of a housing project (the “Housing Project Land”).

30. In relying on the Town’s false representations concerning the RLDC’s intention and ability to pay \$3,080,000 and the Town’s continued recognition of the \$3,080,000 receivable, Consolo ignored red flags. For example, Consolo knew that the Town’s FY 2009 financial statements had reported the Housing Project Land as a donation to the RLDC. Consolo also knew that, on its face, the reimbursement agreement relating to the Housing Project Land contained no reference to a \$3,080,000 payment.

31. Furthermore, Consolo was aware based on the terms of the reimbursement agreement that any amount possibly to be paid by the RLDC in connection with the Housing Project Land was undetermined and contingent on numerous events, including completion of the Housing Project, the repayment of construction loans, and the RLDC’s ability to pay. According to an audit workpaper prepared in connection with the RLDC’s FY 2010 financial statements, the RLDC had “no intention” of paying \$3,080,000 to the Town in the near future.

32. It was improper to include a receivable based on the Housing Project reimbursement agreement in the Town’s General Fund financial statement, the focus of which was to provide information on near-term inflows, outflows and balances of spendable resources.

33. While O’Connor Davies required that the receivable be classified as “nonspendable” on the Town’s FY 2012 through FY 2014 financial statements, Consolo’s failure to consider the need for a restatement resulted in a continued overstatement of the total balance of the Town’s General Fund.

\$314,000 Receivable

34. While auditing the Town’s FY 2010 financial statements, Consolo learned that a new, \$314,000 receivable in the General Fund was recorded for a contemplated – but unconsummated – sale of property to a third-party also controlled by the Town’s supervisor. Consolo did not obtain sufficient audit evidence to support inclusion of the receivable, which increased the General Fund balance by \$314,000 as if the sale had taken place.

⁵ In FY 2014, the receivable was reduced to \$2,500,000.

\$743,338 Receivable

35. While auditing the Town's FY 2012 financial statements, Consolo learned that the General Fund included a \$743,338 receivable for federal reimbursement aid relating to Hurricane Sandy.

36. Under GASB Statement No. 33, municipalities that receive expenditure-driven grants, such as federal reimbursement aid, "should recognize revenues in the period when all applicable eligibility requirements have been met *and* the resources are available." (Emphasis in original). According to the GASB Comprehensive Implementation Guide applicable to the Town's FY 2012 financial statements, the criterion that revenues from expenditure-driven grants "should be recognized when the expenditure is made" is an "additional requirement" that does not substitute for consideration of whether or not the resources are available.

37. Consolo verified that the expenditures associated with the \$743,338 receivable were made in FY 2012, such that the eligibility requirement had been satisfied. Consolo also required documentation that the \$743,338 claim had been approved by the federal government. However, Consolo failed to take sufficient steps to assess the availability of the \$743,338. In particular, while the Town's FY 2012 financial statements disclosed, consistent with GASB Statement No. 33, that "revenues from [expenditure-driven] Federal and State grants are accrued when the expenditure is made," the \$743,338 was not collected within the ninety day availability period that the Town disclosed was "used for revenue recognition for all . . . governmental fund revenues" other than property taxes. Further, the audit workpapers did not document consideration of an alternative availability period for expenditure-driven grants.

Transfers from the Ambulance Fund to the General Fund

38. Between FY 2009 and FY 2014, the Town used transfers from the Ambulance Fund to overstate the balance of the General Fund. These interfund transfers ranged between \$1,280,000 and \$2,410,960 each year, with a cumulative impact on the General Fund balance of more than \$12 million. During the audits, Consolo relied on a false representation from Town management that the Town's Ambulance Fund shared the same tax base with the General Fund.

39. Beginning during the FY 2011 audit, employees in the Town's finance department raised concerns to the audit engagement team relating to the propriety of such interfund transfers. Nevertheless, Consolo continued to rely on the Town official's representations without corroborating the composition of the tax bases for the Ambulance Fund and the General Fund, and O'Connor Davies' workpapers do not include documentation of the auditor's consideration of that matter.

40. In fact, the tax base from which the General Fund monies were raised excluded clergy residences owned by religious corporations, whereas the tax base from which the Ambulance Fund monies were raised included such properties. Therefore, the Ambulance Fund had a different tax base from the General Fund, and consistent with the state's general municipal law, consideration should have been given by the auditors whether to require the Town to record

these advances from the Ambulance Fund to the General Fund as loans (which require repayment with interest) rather than interfund transfers (which may be made without repayment).

41. Additionally, between FY 2010 and FY 2014, interfund receivables recorded in the General Fund as “due from” the Ambulance Fund increased the reported fund balance of the General Fund by amounts ranging between \$450,000 and \$1,424,609 each year. The interfund receivables were recorded because the transfers to the General Fund were in excess of the cash available in the Ambulance Fund. Consolo improperly did not obtain documentation to support these interfund receivables.

Unrecorded Liabilities

42. Consolo failed to identify certain significant liabilities omitted from Ramapo’s FY 2010 – FY 2014 financial statements by failing to perform appropriate audit procedures.

43. In particular, while auditing the RLDC’s FY 2010 financial statements, the audit engagement team sent out a third-party confirmation request to attempt to obtain evidence regarding the amount owed by the RLDC to its outside legal counsel. The audit team did not receive a response and, in the absence of obtaining the third party confirmation, failed to perform alternative procedures to obtain sufficient appropriate audit evidence for the amount of liabilities reported by the RLDC.

44. In fact, the RLDC’s FY 2010 financial statements, which were also incorporated into the Town’s financial statements in summary form, omitted a liability in excess of \$700,000 for fees owed to the outside legal counsel. Although such fees would likely have been capitalized as construction in progress such that reporting the liability would not have had an impact on the RLDC’s reported net assets, the omission resulted in a misrepresentation of the RLDC’s liquidity and overall financial condition.

45. In addition, from at least FY 2011 through FY 2014, the Town’s financial statements failed to reflect a payable of at least \$767,224, which was owed by the Town to an engineer involved in the construction of a minor league baseball stadium. Consolo failed to obtain sufficient audit evidence regarding the completeness of liabilities reported in the Town’s financial statements.

Fraud Concerns

46. On multiple occasions, Consolo failed to adequately investigate concerns regarding the propriety of the Town’s accounting expressed by employees in the Town’s finance department as well as other O’Connor Davies professionals. For example:

- a. In connection with the FY 2011 audit, an accountant in the Town’s finance department complained to the audit engagement team about fraud involving the Town’s financial statements, specifically citing the reporting of a sale of land from the Town to the RLDC. The employee also expressed concern regarding

fraud risk stemming from “inappropriate transactions involving [the Town’s governmental] funds.” Consolo did not adequately investigate the employee’s concerns.

- b. In connection with the FY 2012 audit, an audit manager informed Consolo that another accountant employed in the Town’s finance department refused to sign a fraud questionnaire. Consolo failed to discuss the concerns with the accountant or adequately investigate her concerns.
- c. In connection with the FY 2013 audit, the same accountant disclosed in a fraud questionnaire that she had concerns regarding interfund transfers and an outstanding receivable. Consolo failed to discuss the concerns with the accountant or adequately investigate her concerns.

O’Connor Davies Executive Committee

47. In May 2013, O’Connor Davies senior management, consisting of a five-member executive committee, learned that the FBI executed a search warrant at Ramapo Town Hall and seized documents from the finance department, including correspondence with O’Connor Davies, relating to the Town’s and the RLDC’s financial statements.

48. Senior management was further informed that, in May 2013, the Commission requested that O’Connor Davies provide information relating to audits of the Town’s financial statements, including documentation relating to the \$3,080,000 receivable and to the calculation and reporting of deferred revenue.

49. O’Connor Davies also notified the Commission staff that it received a grand jury subpoena, dated May 14, 2013, requesting documents relating to its audits of the Town’s and RLDC’s financial statements since FY 2009.

50. In response to the revelation of a heightened fraud risk in connection with Ramapo’s financial statements and the \$3,080,000 receivable in particular, O’Connor Davies failed to take sufficient and appropriate steps to mitigate the risk of material misstatements in its audit reports. In particular, the Executive Committee determined, following a meeting with the Ramapo audit team, that O’Connor Davies would require the Town to classify the \$3,080,000 receivable as “nonspendable.” However, permitting continued recognition of the receivable resulted in an overstatement of the total balance of the General Fund. O’Connor Davies also did not implement enhanced quality control procedures for the Ramapo engagements and permitted Consolo to continue as engagement partner without additional supervisory procedures or oversight.

51. After O’Connor Davies senior management became aware of the law enforcement investigations relating to Ramapo’s financial statements, the firm issued unmodified audit reports for the Town’s and the RLDC’s FY 2012 – FY 2014 financial statements, which reported inflated General Fund balances and continued to improperly reflect the Hamlets as an asset of the RLDC.

E. VIOLATIONS

52. As a result of the conduct described above, Consolo violated Section 17(a)(1) of the Securities Act, which prohibits any person from employing any device, scheme, or artifice to defraud in the offer or sale of securities.

53. As a result of the conduct described above, Consolo and O'Connor Davies violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit any person in the offer or sale of securities from obtaining money or property by means of any misstatement or omission of material fact and engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser of such securities.

54. As a result of the conduct described above, Consolo violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of any security involving: a) the use of any device, scheme, or artifice to defraud; b) the making of material misrepresentations or omissions; and c) any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

55. Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice provide, in pertinent part, that the Commission may censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to any person who is found by the Commission to have engaged in improper professional conduct. Section 4C(b)(1) of the Exchange Act and Rule 102(e)(1)(iv)(A) define improper professional conduct" to include "intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards." Section 4C(b)(2) and Rule 102(e)(1)(iv)(B) define improper professional conduct to include the following two types of negligent conduct (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or (2) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. Respondents' conduct failed to comply with the applicable professional auditing standards:

- a. GAAS requires an auditor to "obtain sufficient appropriate audit evidence . . . on which to base the auditor's opinion" (AU-C § 500.04/ AU § 326.01)⁶ and to "design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence." (AU-C § 500.06). Respondents failed to obtain sufficient appropriate audit evidence for certain assets reported in the General Fund's FY 2009 – FY 2014 financial statements, including a \$3,080,000 receivable (FY 2009 – FY 2013), a

⁶ AU-C § 500 became effective for audits of fiscal years ending on or after December 15, 2012, superseding, but not changing in any significant respect, AU § 326.

\$314,000 receivable (FY 2010), a \$743,338 receivable (FY 2012), and interfund balances between \$450,000 and \$1,424,609 reported as “due from” the Ambulance Fund (FY 2010 – FY 2014). Respondents similarly failed to obtain sufficient appropriate audit evidence for certain assets and liabilities reported in the RLDC’s FY 2009 – FY 2014 financial statements.

- b. Under GAAS, auditors must also exercise appropriate professional judgment and professional skepticism. (AU-C § 200.08/ AU § 230.08).⁷ Professional skepticism is defined as an attitude that includes a questioning mind and a critical assessment of audit evidence. (AU-C § 200.14/ AU § 230.07). In addition, AU-C § 200.17 requires auditors to “plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.” As discussed above, Respondents did not exercise the appropriate professional judgment when conducting the audit and issuing an opinion on the Town’s and RLDC’s financial statements for FY 2009 – FY 2014. The expressions of concern by Town accounting personnel, coupled with Respondents’ knowledge of the criminal and civil investigations relating to the Town’s financial statements, should have caused Respondents to place greater emphasis on obtaining sufficient appropriate audit evidence regarding General Fund assets. Respondents failed to perform additional audit procedures sufficient to address those risks.
- c. GAAS requires that an auditor should modify its opinion when it concludes that the financial statements as a whole are materially misstated or is unable to obtain sufficient appropriate audit evidence to conclude that they are free from material misstatement. (AU-C § 705.07).⁸ Consolo approved the issuance of audit reports for FY 2009 – FY 2014 containing unmodified opinions. However, the Town’s financial misstatements materially overstated the balance of its General Fund, and Respondents failed to obtain sufficient appropriate audit evidence for such balances. As such, Respondents should not have issued an audit report containing an unmodified opinion.
- d. GAAS requires that, in auditing financial statements, a firm must “establish and maintain effective quality control procedures to provide it with reasonable assurances that the firm and its personnel comply with professional standards and applicable legal and regulatory requirements and that reports issued by the

⁷ AU-C § 200 became effective for audits of fiscal years ending on or after December 15, 2012, superseding, but not substantially changing in pertinent part, AU § 230.

⁸ AU-C § 705 became effective for audits of fiscal years ending on or after December 15, 2012, superseding, but not changing in any significant respect, AU § 508.

firm are appropriate in the circumstances. (AU-C §§ 220.03; 220.24).⁹ Although O'Connor Davies established a system of quality controls, as discussed above, the system failed to detect that the firm's personnel did not comply with certain professional standards in conducting the FY 2012–FY 2014 audits of the Town and the RLDC.

56. As a result of the conduct described above, Consolo engaged in improper professional conduct under Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) as defined in Rule 102(e)(1)(iv)(A) and Rule 102(e)(1)(iv)(B) of the Commission's Rules of Practice.

57. As a result of the conduct described above, O'Connor Davies engaged in improper professional conduct under Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) as defined in Rule 102(e)(1)(iv)(B) of the Commission's Rules of Practice.

F. UNDERTAKINGS

Consolo

58. Municipal Audit Partner Ban. Consolo undertakes that he shall not serve as the engagement partner or engagement quality control reviewer in connection with any municipal audit engagement for a period of five years from the entry of this Order.

59. Consolo undertakes that he shall certify annually on October 15, in writing, compliance with the undertaking set forth in paragraph 58 above. The certifications shall identify the undertaking and provide written evidence of compliance in the form of a narrative. The Commission staff may make reasonable requests for further evidence of compliance, and Consolo agrees to provide such evidence. The certifications and supporting material shall be submitted to Sanjay Wadhwa, Senior Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, New York, NY 10281, with a copy to the Office of Chief Counsel of the Enforcement Division, by December 31 of each year through 2021.

60. Cooperation. Consolo undertakes that he shall cooperate fully with the Commission in any and all investigations, litigations, administrative or other proceedings relating to or arising from the matters described in this Order. In connection with such investigations, litigation, administrative or other proceedings, Consolo agrees to the following: (i) to produce, without service of a notice or subpoena, any and all documents and other materials or information as requested; (ii) to appear and testify without service of a notice or subpoena in such investigations, interviews, depositions, hearings and trials, at such times and places as reasonably requested; and (iii) to respond promptly to all inquiries.

⁹ AU-C § 220 became effective for audits of fiscal years ending on or after December 15, 2012.

O'Connor Davies

61. O'Connor Davies Review. Within 90 days after the entry of this Order, O'Connor Davies shall perform and complete a review and evaluation ("O'Connor Davies Review") of the sufficiency and adequacy of O'Connor Davies' quality controls regarding the following (hereinafter referred to as "O'Connor Davies' Policies"):

- a. the exercise of due professional care and professional skepticism;
- b. assessing the risk of fraud, including appropriately responding to identified fraud risks;
- c. evaluation of evidence obtained concerning matters that are the subject of written representations from management in order to consider the reliability of the representations made and whether reliance on management's representations is appropriate and justified;
- d. obtaining sufficient appropriate audit evidence;
- e. effective supervision by engagement partners and managers, including review of work performed by the engagement team;
- f. audit documentation, including risk assessment procedures and responses, significant findings and resulting actions, work paper sign-off, archiving, and dating;
- g. obtaining reasonable assurance that i) the engagement partner and other individuals assisting the engagement partner in supervising the engagement possess the competencies that are necessary and appropriate in the individual circumstances, and ii) work is assigned to personnel having the degree of technical training and proficiency required in the circumstances; and
- h. the effect of laws and regulations in an audit of financial statements.

The O'Connor Davies Review shall assess the foregoing areas to determine whether O'Connor Davies' Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant professional standards.

62. O'Connor Davies Report. Within 60 days of completing the O'Connor Davies Review, O'Connor Davies shall deliver to the Commission staff a detailed written report ("O'Connor Davies Report") summarizing its review and changes to O'Connor Davies' Policies, if any, to provide reasonable assurance of compliance with all relevant professional standards. The O'Connor Davies Report shall identify the undertaking, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The

Commission staff may make reasonable requests for further evidence of compliance, and O'Connor Davies agrees to provide such evidence.

63. Independent Consultant's Review. O'Connor Davies has undertaken to retain, within 150 days after entry of this Order, an independent consultant ("Independent Consultant"), not unacceptable to the Commission staff. O'Connor Davies shall provide to the Commission staff a copy of the engagement letter detailing the scope of the Independent Consultant's responsibilities. The Independent Consultant's compensation and expenses shall be borne exclusively by O'Connor Davies. O'Connor Davies shall deliver to the Independent Consultant the O'Connor Davies Report at the same time as O'Connor Davies provides such report to the Commission staff as specified in paragraph 62 above. O'Connor Davies shall require that the Independent Consultant perform a review (the "IC Review") of O'Connor Davies' Policies to determine whether O'Connor Davies' Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant professional standards. O'Connor Davies shall cooperate fully with the Independent Consultant and shall provide reasonable access to firm personnel, information, and records as the Independent Consultant may reasonably request for the IC Review, subject to O'Connor Davies' right to withhold from disclosure any information or records protected by any applicable protection or privilege such as the attorney-client privilege or the attorney work product doctrine.

64. Independent Consultant's Report. After the IC Review is completed, but no later than ninety days after receiving the O'Connor Davies Report, the Independent Consultant shall issue a detailed written report (the "IC Report") to O'Connor Davies: (a) summarizing the IC Review; and (b) making recommendations, where appropriate, reasonably designed to ensure that O'Connor Davies' Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant professional standards. O'Connor Davies shall require the Independent Consultant to provide a copy of the IC Report to the Commission staff when the IC Report is issued.

65. O'Connor Davies shall adopt, as soon as practicable, all recommendations of the Independent Consultant in the IC Report.

66. Certification by O'Connor Davies' Managing Partner. Within sixty days of issuance of the IC Report, but no sooner than thirty days after a copy of the IC Report is provided to the Commission staff, O'Connor Davies' managing partner must certify to the Commission staff in writing that (i) O'Connor Davies has adopted and has implemented or will implement all recommendations of the Independent Consultant, if any; and (ii) the Independent Consultant agrees with O'Connor Davies' adoption and implementation of the recommendations. To the extent that O'Connor Davies has not implemented all recommendations of the Independent Consultant within sixty days of issuance of the IC Report, O'Connor Davies' managing partner must certify to the Commission staff in writing, no later than thirty days after their implementation, that (i) O'Connor Davies has adopted and has implemented all recommendations of the Independent Consultant; and (ii) the Independent Consultant agrees that the recommendations have been adequately adopted and implemented by O'Connor Davies. The certifications by O'Connor Davies' managing partner shall identify the undertakings, provide written evidence of compliance in the form of a narrative,

and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and O'Connor Davies agrees to provide such evidence.

67. To ensure the independence of the Independent Consultant, O'Connor Davies: (1) shall not have the authority to terminate the Independent Consultant or substitute another independent compliance consultant for the initial Independent Consultant, without the prior written approval of the Commission staff; and (2) shall compensate the Independent Consultant and persons engaged to assist the Independent Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

68. O'Connor Davies shall require the Independent Consultant to enter into an agreement that provides that, for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with O'Connor Davies, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement shall also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional relationship with O'Connor Davies, or any of its present or former affiliates, directors, officers, employees or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

69. O'Connor Davies shall not be in, and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to Commission staff.

70. Training. By September 30, 2017, O'Connor Davies shall require each audit professional then employed and that has been employed by O'Connor Davies for at least one year as of March 31, 2017 to complete successfully a minimum of 32 hours of audit-related training. At least 16 such hours shall be devoted, collectively, to the topics of (a) the importance of exercising due care and professional skepticism in evaluating audit evidence and (b) fraud prevention and detection training. In addition, at least 4 such hours shall be devoted to ethics and independence training.

71. Notice of Order. Within five (5) days of the entry of this Order, O'Connor Davies shall post prominently on the "Government Entity Audits and Compliance" and "Government and Public Sector Government Contracting" sections of its website a summary of this Order in a form and location acceptable to the Commission's staff, with hyperlinks to the entire Order. O'Connor Davies shall maintain these postings and hyperlinks on its website until the earlier of twelve (12) months from entry of this Order or the date of certification by O'Connor Davies' managing partner, pursuant to paragraph 66, that O'Connor Davies has adopted and has implemented all recommendations of the Independent Consultant.

72. By October 31, 2017, O'Connor Davies' managing partner shall certify, in writing, compliance with the undertakings set forth in paragraphs 67 – 71. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and O'Connor Davies agrees to provide such evidence.

73. For a period of five years from the date of this Order, O'Connor Davies shall not assign Consolo to serve as the engagement partner or engagement quality control reviewer on any municipal audit and shall ensure that any work performed by Consolo regarding a municipal audit is overseen by an engagement partner or engagement quality control reviewer.

74. All reports and certifications mentioned in these undertakings shall be submitted to Sanjay Wadhwa, Senior Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, New York, NY 10281, with a copy to the Office of Chief Counsel of the Enforcement Division.

75. For good cause shown, the Commission staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

76. Cooperation. O'Connor Davies undertakes that it shall cooperate fully with the Commission in any and all investigations, litigations, administrative or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, O'Connor Davies shall: (i) produce, without service of a notice or subpoena, any and all documents and other materials information as requested; (ii) use its best efforts to cause its present and former employees to appear and testify without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested; (iii) use its best efforts to cause its present and former employees to be interviewed at such times and places as reasonably requested; and (iv) respond promptly to all inquiries.

77. In determining whether to accept the Offers, the Commission has considered Respondents' undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

Consolo

A. Consolo shall cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder; and Section 17(a) of the Securities Act.

B. Consolo is denied the privilege of appearing or practicing before the Commission as an accountant.

C. Consolo shall comply with the undertaking enumerated in paragraph 58 above.

D. Consolo shall, within 14 days of the entry of this Order, pay a civil money penalty of \$75,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofin.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Domenick Consolo as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Sanjay Wadhwa, Senior Associate Regional Director, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York 10281.

O'Connor Davies

E. O'Connor Davies shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

F. O'Connor Davies is censured.

G. O'Connor Davies shall comply with the undertakings enumerated in paragraphs 61 – 75 above.

H. O'Connor Davies shall pay disgorgement of \$355,600, plus prejudgment interest thereon of \$24,265.

I. O'Connor Davies shall pay a civil money penalty of \$100,000.

J. O'Connor Davies shall make the payments required by Sections IV.H and IV.I to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717 and SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying O'Connor Davies as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Sanjay Wadhwa, Senior Associate Regional Director, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York 10281.

By the Commission.

Brent J. Fields
Secretary

**IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION**

SECURITIES AND EXCHANGE COMMISSION,	§	
	§	
Plaintiff,	§	
	§	
vs.	§	
	§	
DGSE COMPANIES INC. and	§	
I. JOHN BENSON	§	
	§	CIVIL ACTION
	§	No. 14-1909
	§	
Defendants,	§	
	§	

COMPLAINT

Plaintiff Securities and Exchange Commission (the “Commission”) alleges:

SUMMARY OF THE ACTION

1. This case concerns financial reporting, books and records, and internal controls violations by DGSE Companies Inc. (“DGSE” or the “Company”) and its former Chief Financial Officer (“CFO”), I. John Benson (“Benson”). DGSE buys and sells jewelry, diamonds, fine watches, rare coins and currency, precious metal bullion products, scrap gold, silver, platinum and palladium, as well as collectibles and other valuables.

2. Since at least 2009, DGSE failed to maintain appropriate accounting systems, policies, procedures, and controls. As a result, DGSE created and filed with the Commission materially inaccurate financial statements.

3. The most significant irregularities related to DGSE’s inventory, which was overvalued by millions of dollars, as detailed in DGSE’s Form 10K-A, filed with the Commission on December 19, 2012.

4. The inventory irregularities were caused by fraudulent accounting entries made or directed by Benson. Other irregularities, detailed in the December 19, 2012 Form 10K-A, were

caused either by the same improper entries made or directed by Benson or by DGSE's lack of accounting controls.

5. The Commission seeks an order enjoining DGSE and Benson from future violations of the securities laws.

JURISDICTION AND VENUE

6. The Commission brings this action pursuant to Section 20(b) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77q(b)] and Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d)].

7. This Court has jurisdiction over this action pursuant to Sections 21(d), 21(e) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d), 78u(e) and 78aa].

8. Venue is proper in this District pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because defendant DGSE is headquartered in, and a substantial portion of the conduct alleged in this complaint occurred within, the Northern District of Texas.

DEFENDANTS

9. DGSE is a Nevada corporation headquartered in Dallas, Texas. Its common stock is registered with the Commission under Section 12(b) of the Exchange Act [15 U.S.C. § 78f] and is traded on the NYSE MKT under the symbol "DGSE."

10. Benson is a natural person residing in Dallas, Texas.

FACTUAL ALLEGATIONS

11. DGSE is a company which buys and sells jewelry, diamonds, fine watches, rare coins and currency, precious metal bullion products, scrap gold, silver, platinum and palladium, as well as collectibles and other valuables. DGSE markets its products and services throughout the country to individual consumers, dealers, and institutions throughout the United States.

12. As disclosed in its April 16, 2012 Form 8-K, in early 2012 DGSE's Board of Directors determined the existence of certain accounting irregularities, which could affect the reliability of DGSE's reported financial information. As a result of these accounting irregularities, DGSE stated that its previously-filed financial statements, starting in the second quarter of 2007, should not be relied upon.

13. DGSE's initial investigation indicated that the accounting irregularities were the result of improper accounting for inventory and other accounts by Benson, DGSE's former CFO.

14. As a result of the discovery of the accounting irregularities, DGSE retained a forensic accounting firm to assist in determining the cause of the accounting irregularities. During the course of its investigation, the forensic accounting firm examined DGSE's books and records and accounting controls and conducted interviews with a number of key personnel.

15. The investigation revealed a number of deficiencies in DGSE's accounting systems and controls, including: (1) many unsupported and/or improperly-described accounting entries; (2) no standard, formalized process for reconciling intercompany accounts; (3) booking unsupported entries directly into the general ledger rather than the appropriate subsystems; (4) lack of regular inventory counts and matching to the general ledger; (5) lack of an audit trail with which to identify the reason for accounting adjustments; (6) use of antiquated accounting systems that did not maintain the proper audit trail and thus allowed for the manipulation of the general ledger; (7) improper data security; and (8) no backup of the accounting data.

16. These deficiencies in DGSE's accounting systems and controls led to significant problems which significantly compromised the integrity of DGSE's financial data. Included in these deficiencies was the failure to properly record intercompany transactions, including inventory transfers between stores. As a result of these failures, DGSE's intercompany accounts became out of balance by millions of dollars.

17. In order to bring the intercompany accounts—and DGSE's general ledger as a whole—back into balance, Benson made a number of fraudulent accounting entries. These entries resulted in a number of errors in DGSE's financial statements—including overstating DGSE's inventory by millions of dollars.

18. Benson concealed these improper entries by manipulating inventory detail listings to reflect consigned inventory, which DGSE did not own, as being owned by DGSE. Benson sent these listings to DGSE's external auditor.

19. Benson misled DGSE's external auditor regarding DGSE's coding for consigned inventory—leading the auditor to believe that the consigned goods were owned by DGSE.

20. Benson also knowingly signed a false "management representation letter" to the auditor, which stated that Company management was not aware of any fraud, that DGSE held good title to all assets, and that all consignment goods had been excluded from inventory.

21. To get DGSE's accounting systems to match his manipulated inventory listings, Benson ordered accounting personnel to make "adjusting" entries to the general ledger. When questioned by DGSE's Controller regarding these adjusting entries and inventory balances, Benson stated that that DGSE's external auditor had examined and confirmed the inventory balances and adjusting entries, and that the adjusting entries were being made at the auditor's request. DGSE's Controller and other managers relied upon Benson to be in charge of preparing financial reports and providing information to the auditor.

22. As a result of the improper adjusting entries and the manipulated inventory listings which Benson caused to be provided to DGSE's external auditor, DGSE's publicly-reported financial information contained a number of misstatements—including the large overstatements of DGSE's inventory.

23. Benson knowingly signed the misleading public filings—including DGSE's Forms 10-K for the Fiscal Years Ended December 31, 2009 and December 31, 2010, as well as quarterly filings for the same period. Benson also signed false management certifications, which were attached to these filings.

24. As a result of the internal investigation initiated by DGSE that is discussed above and additional work performed by outside accountants retained by DGSE, the Company voluntarily restated its historical financial statements in its Form 10K-A, filed December 19, 2012.

25. The irregularities identified above can be traced in part to deficiencies in DGSE's accounting systems and internal controls.

26. DGSE's own internal investigation revealed that the Company lacked sufficient controls to adequately maintain and reconcile its accounts—including its intercompany accounts. DGSE's antiquated accounting systems required it to make unnecessary intercompany entries in order to track transfers between its various stores. In addition, DGSE's accounting department was not sufficiently staffed, resulting in many transfers not being booked and leaving the intercompany accounts significantly out of balance. Benson took advantage of DGSE's deficient controls by employing improper accounting entries to fill the "hole" in the intercompany accounts.

27. DGSE lacked sufficient written policies and procedures to ensure that its accounting entries were accurate and properly documented. In addition, DGSE failed to follow accounting best practices. For example, DGSE regularly booked entries directly into the general ledger rather than into its subsystems, many of which were not properly documented. As a result, DGSE did not have

an audit trail that would enable it to confirm the accuracy of its reported financial information.

DGSE also lacked proper system security and data backups.

28. These deficiencies enabled Benson to make the improper accounting entries undetected, and prevented DGSE from being able to go back and properly audit its accounting data.

29. DGSE responded to the discovery of Benson's conduct by implementing extensive remedial measures designed to improve internal controls. These measures included DGSE: (1) removing and replacing all members of the prior management team; (2) hiring new independent auditors to report to the Audit Committee; (3) engaging a national consulting firm to identify errors in electronic accounting system functioning, reconcile prior inventory discrepancies, and balance the general ledger to the physical inventory counts; (4) augmenting electronic inventory tracking capabilities and procedures; (5) instituting a regular blind inventory check that is independently reconciled by a newly-formed Inventory Accounting and Control Department; and (6) reinforcing the Code of Business Conduct & Ethics and Related Person Transaction Policy.

FIRST CLAIM FOR RELIEF

(against Benson only)

Violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder

30. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

31. Benson violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit any person from employing, in connection with the purchase or sale of any security registered on a national security exchange, any manipulative or deceptive device or contrivance.

32. Benson violated and, unless restrained and enjoined, will continue to violate Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. §240.10b-5].

SECOND CLAIM FOR RELIEF

Violations of Section 17(a) of the Securities Act

33. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

34. Benson violated Sections 17(a)(1)-(3) of the Securities Act, which prohibit any person from, in the offer or sale of securities: (1) employing devices, schemes or artifices to defraud; (2) obtaining money or property by means of untrue statements or omissions; and (3) engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit.

35. DGSE violated Section 17(a)(2) of the Securities Act.

36. Benson violated and, unless restrained and enjoined, will continue to violate Sections 17(a)(1)-(3) of the Securities Act [15 U.S.C. § 77q(a)(1)-(3)].

37. DGSE violated and, unless restrained and enjoined, will continue to violate Section 17(a)(2) of the Securities Act [15 U.S.C. § 77q(a)(2)].

THIRD CLAIM FOR RELIEF

Violations of Section 13(b)(5) of the Exchange Act

(against Benson only)

38. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

39. Benson violated Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m], which prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account of an issuer of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l].

40. Benson violated and, unless restrained and enjoined, will continue to violate Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m].

FOURTH CLAIM FOR RELIEF

Violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, and 13a-14 thereunder

41. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

42. DGSE has violated, and unless restrained and enjoined, will continue to violate Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, and 13a-13 [17

C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13] thereunder, which obligate issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to file with the Commission accurate periodic reports, including annual and quarterly reports.

43. Benson aided and abetted DGSE's violations, and unless restrained and enjoined, will continue to aid and abet violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13] thereunder, which obligate issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to file with the Commission accurate periodic reports, including annual and quarterly reports.

44. Benson violated, and unless restrained and enjoined, will continue violate of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rule 13a-14 [17 C.F.R. §§ 240.13a-14] thereunder, which obligates the principal financial officer of issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to sign personal certifications indicating that they reviewed certain periodic reports filed with the Commission and that, based on their knowledge, these reports did not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report.

FIFTH CLAIM FOR RELIEF

Violations of Section 13(b)(2)(A) of the Exchange Act

45. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

46. DGSE failed to make and keep books, records, or accounts which, in reasonable detail, accurately and fairly reflected its transactions and dispositions of its assets, in violation of Section 13(b)(2)(A) of the Exchange Act.

47. DGSE violated and, unless restrained and enjoined, will continue to violate Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)].

48. Benson aided and abetted DGSE's violations and, unless restrained and enjoined, will continue to aid and abet violations of Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)].

SIXTH CLAIM FOR RELIEF

Violations of Section 13(b)(2)(B) of the Exchange Act

49. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

50. DGSE violated and, unless restrained and enjoined, will continue to violate Section 13(b)(2)(B) of the Exchange Act, which obligates issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)] to devise and maintain a sufficient system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

51. Benson aided and abetted DGSE's violations and, unless restrained and enjoined, will continue to aid and abet violations of Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)].

SEVENTH CLAIM FOR RELIEF

Violations of Rule 13b2-2(a) under the Exchange Act

(against Benson only)

52. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

53. Benson violated Rule 13b2-2(a) under Exchange Act, which prohibits a director or officer of an issuer of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] from, in connection with a financial statement audit: (1) making or causing to be made a materially false and misleading statement to an accountant; or (2) omitting to state any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading.

54. Benson violated and, unless restrained and enjoined, will continue to violate Rule 13b2-2(a) under the Exchange Act [17 C.F.R. §240.13b2-2(a)].

EIGHTH CLAIM FOR RELIEF

Violations of Rule 13b2-1 under the Exchange Act

55. The Commission realleges and incorporates by reference Paragraphs 1 through 29.

56. Benson violated Rule 13b2-1 under Exchange Act, which prohibits any person from directly or indirectly, falsifying or causing to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue an order permanently enjoining DGSE from violating Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)] and Rules 12b-20, 13a-1, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13] thereunder, and Section 17(a)(2) of the Securities Act [15 U.S.C. § 77q(a)(2)].

II.

Issue an order permanently enjoining Benson from violating Sections 17(a)(1)-(3) of the Securities Act [15 U.S.C. § 77q(a)(1)-(3)] and Sections 10(b), 13(a), and 13(b)(5) of the Exchange Act [15 U.S.C. §§ 78j(b), 78m(a), and 78m(b)(5)] and Rules 10b-5, 13a-14, 13b2-1, and 13b2-2(a) thereunder [17 C.F.R. §§ 240.10b-5, 240.13a-14, 240.13b2-1, and 240.13b2-2(a)], and aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)] and Rules 12b-20, 13a-1, and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13].

III.

Order civil penalties against Benson pursuant to Sections 20(d) of the Securities Act [15 U.S.C. § 77d] and 21(d)(3) of the Exchange Act [15 USC § 78u].

IV.

Retain jurisdiction of this action in accordance with the principles of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered, or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court.

Dated May 27, 2014.

Respectfully submitted,

/s/Chris Davis

Christopher A. Davis
Texas Bar No. 24050483
United States Securities and
Exchange Commission
Fort Worth Regional Office
801 Cherry Street, Suite 1900

Fort Worth, Texas 76102
(817) 900-2638
(817) 978-4927 (facsimile)
DavisCa@SEC.gov

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74401 / March 2, 2015

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3641 / March 2, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16413

In the Matter of

ROBERT W. ELLIOT

Respondent.

**ORDER INSTITUTING CEASE-AND-DESIST
PROCEEDINGS PURSUANT TO SECTION
21C OF THE SECURITIES EXCHANGE ACT
OF 1934, MAKING FINDINGS, AND
IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Robert W. Elliot (“Respondent” or “Elliot”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Respondent

1. Respondent, 51 years old, is a resident of Delmar, MD. From August 2012 through January 2014, Respondent was the vice president of finance at Michael's Finer Meats, LLC ("MFM"), a wholly owned subsidiary of The Chefs' Warehouse, Inc. ("Chefs"). Respondent is not, and has never been, a certified public accountant. Respondent is currently employed as a credit manager at a private company in Seaford, Delaware.

Relevant Entities

2. The Chefs' Warehouse, Inc., a Delaware corporation with principal offices in Ridgefield, Connecticut, is a distributor of specialty food products. The company has securities registered under Section 12(b) of the Exchange Act, which trade on the Nasdaq Global Select Market.

3. Michael's Finer Meats, LLC was a private company headquartered in Columbus, Ohio, specializing in the sale of frozen meat and seafood. On or around August 13, 2012, Chefs acquired MFM. MFM is now a wholly-owned subsidiary of Chefs.

Background

4. From May 2008 to August 2012, Elliot was the chief financial officer ("CFO") of MFM. As the CFO, Elliot had primary responsibility for all accounting functions at MFM, including accounting for the company's inventory and cost of goods sold.

5. In August 2012, Chefs acquired MFM, and MFM became a wholly-owned subsidiary of Chefs. Elliot remained with MFM after the acquisition in the role of vice president of finance, and continued to have primary responsibility for MFM's accounting functions, including accounting for the company's inventory and cost of goods sold. As a wholly-owned subsidiary of Chefs, MFM's books, records, and accounts were incorporated and reported in Chefs' consolidated financial statements.

6. Both before and after the acquisition, MFM conducted manual counts of its inventory at the end of every quarter. MFM employees recorded the inventory of products on "count sheets," which were then provided to Elliot. Elliot input the information from those count sheets into a spreadsheet that he maintained and controlled. Both before and after the acquisition, Elliot used the information in this spreadsheet to calculate certain financial results for MFM, including inventory values, cost of goods sold, and profit margins.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

7. At the end of each quarter, after inputting the inventory information from the count sheets into the spreadsheet, Elliot would compare current profit margins to historical margins. If a particular product's profit margin deviated significantly from historical margins, Elliot normally worked with warehouse employees who conducted the inventory counts to determine whether an error had been made. At times, errors were discovered, and Elliot adjusted the inventory information in the spreadsheet. Elliot failed to prepare any documentation supporting these adjustments.

8. At other times, Elliot did not investigate or otherwise was unable to identify inventory count errors that explained why profit margins were lower than historical margins. In these instances, Elliot improperly increased the inventory amounts recorded in the spreadsheet to lower cost of goods sold, and increase profit margins, to a range consistent with historical margins. Elliot knew that these unsupported accounting adjustments were improper.

9. These improper accounting entries resulted in Chefs reporting inaccurate financial statements in its quarterly report filed on Form 10-Q for the third quarter of 2012, its annual report filed on Form 10-K for 2012, its quarterly report filed on Form 10-Q for the first quarter of 2013, its quarterly report filed on Form 10-Q for the second quarter of 2013, and its quarterly report filed on Form 10-Q for the third quarter of 2013.

10. Chefs terminated Elliot in January 2014.

11. On January 27, 2014, Chefs filed a Form 8-K disclosing that unsupported accounting adjustments made by an employee of its MFM subsidiary had resulted in an aggregate overstatement of inventory, and understatement of cost of goods sold, of approximately \$905,000. The company further reported that it did not believe the impact of the improper adjustments was material to the company's consolidated financial statements for any one reporting period, and that it corrected the misstatements by recording a non-cash charge in the fourth quarter of 2013.

Violations

12. As a result of the conduct described above, Elliot violated Section 13(b)(5) of the Exchange Act, which provides that no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account, and Rule 13b2-1, which provides that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account, and caused a violation of Section 13(b)(2)(A) of the Exchange Act, which requires that every issuer of securities registered pursuant to Section 12 of the Exchange Act make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Elliot's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Elliot cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder.

B. Respondent shall, within seven days of the entry of this Order, pay a civil money penalty in the amount of \$25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Robert W. Elliot as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Scott W. Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74401 / March 2, 2015

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II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Respondent

1. Respondent, 51 years old, is a resident of Delmar, MD. From August 2012 through January 2014, Respondent was the vice president of finance at Michael's Finer Meats, LLC ("MFM"), a wholly owned subsidiary of The Chefs' Warehouse, Inc. ("Chefs"). Respondent is not, and has never been, a certified public accountant. Respondent is currently employed as a credit manager at a private company in Seaford, Delaware.

Relevant Entities

2. The Chefs' Warehouse, Inc., a Delaware corporation with principal offices in Ridgefield, Connecticut, is a distributor of specialty food products. The company has securities registered under Section 12(b) of the Exchange Act, which trade on the Nasdaq Global Select Market.

3. Michael's Finer Meats, LLC was a private company headquartered in Columbus, Ohio, specializing in the sale of frozen meat and seafood. On or around August 13, 2012, Chefs acquired MFM. MFM is now a wholly-owned subsidiary of Chefs.

Background

4. From May 2008 to August 2012, Elliot was the chief financial officer ("CFO") of MFM. As the CFO, Elliot had primary responsibility for all accounting functions at MFM, including accounting for the company's inventory and cost of goods sold.

5. In August 2012, Chefs acquired MFM, and MFM became a wholly-owned subsidiary of Chefs. Elliot remained with MFM after the acquisition in the role of vice president of finance, and continued to have primary responsibility for MFM's accounting functions, including accounting for the company's inventory and cost of goods sold. As a wholly-owned subsidiary of Chefs, MFM's books, records, and accounts were incorporated and reported in Chefs' consolidated financial statements.

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¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

7. At the end of each quarter, after inputting the inventory information from the count sheets into the spreadsheet, Elliot would compare current profit margins to historical margins. If a particular product's profit margin deviated significantly from historical margins, Elliot normally worked with warehouse employees who conducted the inventory counts to determine whether an error had been made. At times, errors were discovered, and Elliot adjusted the inventory information in the spreadsheet. Elliot failed to prepare any documentation supporting these adjustments.

8. At other times, Elliot did not investigate or otherwise was unable to identify inventory count errors that explained why profit margins were lower than historical margins. In these instances, Elliot improperly increased the inventory amounts recorded in the spreadsheet to lower cost of goods sold, and increase profit margins, to a range consistent with historical margins. Elliot knew that these unsupported accounting adjustments were improper.

9. These improper accounting entries resulted in Chefs reporting inaccurate financial statements in its quarterly report filed on Form 10-Q for the third quarter of 2012, its annual report filed on Form 10-K for 2012, its quarterly report filed on Form 10-Q for the first quarter of 2013, its quarterly report filed on Form 10-Q for the second quarter of 2013, and its quarterly report filed on Form 10-Q for the third quarter of 2013.

10. Chefs terminated Elliot in January 2014.

11. On January 27, 2014, Chefs filed a Form 8-K disclosing that unsupported accounting adjustments made by an employee of its MFM subsidiary had resulted in an aggregate overstatement of inventory, and understatement of cost of goods sold, of approximately \$905,000. The company further reported that it did not believe the impact of the improper adjustments was material to the company's consolidated financial statements for any one reporting period, and that it corrected the misstatements by recording a non-cash charge in the fourth quarter of 2013.

Violations

12. As a result of the conduct described above, Elliot violated Section 13(b)(5) of the Exchange Act, which provides that no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account, and Rule 13b2-1, which provides that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account, and caused a violation of Section 13(b)(2)(A) of the Exchange Act, which requires that every issuer of securities registered pursuant to Section 12 of the Exchange Act make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Elliot's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Elliot cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder.

B. Respondent shall, within seven days of the entry of this Order, pay a civil money penalty in the amount of \$25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Robert W. Elliot as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Scott W. Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 74626 / April 1, 2015

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 3649 / April 1, 2015

ADMINISTRATIVE PROCEEDING

File No. 3-16471

In the Matter of

**TIMOTHY EDWIN
SCRONCE**

Respondent.

**ORDER INSTITUTING CEASE-AND-DESIST
PROCEEDINGS PURSUANT TO SECTION
21C OF THE SECURITIES EXCHANGE ACT
OF 1934, MAKING FINDINGS, AND
IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Timothy Edwin Scronce (“Scronce” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-And-Desist Proceedings, Pursuant to Section 21C Of The Securities Exchange Act of 1934, Making Findings, And Imposing A Cease-And-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that

Summary

1. This case involves a fraudulent scheme directed by Respondent, the owner of four private telecommunications companies (collectively, "TelWorx") to inflate the value of assets that the companies sold to PCTEL, Inc. ("PCTEL"), a public company, and its wholly owned subsidiary PCTelWorx, Inc. ("PCTelWorx"). The scheme had two main components: first, to inflate the value of inventory and to prematurely recognize revenue prior to the sale in order to fraudulently inflate the sale price; and second, to conceal these facts from PCTEL by prematurely recognizing revenue after the asset purchase. As a result of this scheme, TelWorx provided PCTEL materially false financial statements which were incorporated in a Commission filing.

Respondent

2. **Timothy Edwin Scronce**, age 49, is a resident of Winston-Salem, North Carolina. He was the majority owner and CEO of TelWorx Communications, LLC and controlled the day-to-day operations of TowerWorx, which were two of the TelWorx entities. After the sale of assets to PCTEL, Scronce became a Vice President of PCTEL and the general manager of PCTelWorx until he resigned on December 19, 2012. Previously, Respondent was the President and Chief Operating Officer of a publicly traded company.

Other Relevant Entities

3. **PCTEL, Inc.** is a Delaware corporation with its principal place of business in Bloomingdale, Illinois. The company provides products and services for wireless communication networks. Its stock is traded on the NASDAQ (ticker symbol PCTI).

4. **PCTelWorx, Inc.** was a wholly owned subsidiary of PCTEL. PCTEL merged PCTelWorx into PCTEL on June 30, 2014.

Background

5. In the first and second quarters of 2012, PCTEL and PCTelWorx negotiated with Respondent to acquire the assets of TelWorx. PCTEL and PCTelWorx relied, in part, on TelWorx's earnings before interest, taxes, depreciation, and amortization ("EBITDA") to determine the price it would pay to acquire the assets.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

6. Consequently, Respondent understood that artificially increasing TelWorx's earnings would benefit him by increasing TelWorx's purchase price.

7. In July of 2012, PCTEL and PCTelWorx acquired TelWorx's assets for a total of \$18 million, consisting of cash and an earn-out payment, based on PCTEL's 2013 financial performance and payable in PCTEL's common stock.

8. After the acquisition, Respondent operated and managed PCTelWorx similarly to the way he had operated and managed TelWorx.

9. In the third and fourth quarter of 2012, PCTEL's publicly-filed, consolidated financial statements included PCTelWorx's financial results, and Respondent was aware of this fact.

Revenue Forecasts

10. Prior to the acquisition, Respondent provided PCTEL and PCTelWorx with TelWorx's revenue forecasts for the second quarter of 2012.

11. After the acquisition, PCTEL received PCTelWorx's revenue forecasts from Respondent on a quarterly basis. Respondent knew that it was important to PCTEL's business that PCTelWorx meet or exceed the quarterly revenue forecasts he provided to PCTEL.

Before The Acquisition, False Entries In TelWorx's General Ledger Inflated Revenue and EBITDA

12. In April of 2012, Respondent directed TelWorx's controller (the "Controller") to make a false entry in TelWorx's general ledger which improperly inflated the value of certain obsolete telecommunications equipment ("the Modules") in TelWorx's inventory and improperly inflated TelWorx's EBITDA.

13. Subsequently, Respondent instructed the Controller to send TelWorx's accounting firm (the "Accountants") an email that falsely stated that the Modules were undervalued on TelWorx's general ledger and that the Controller had corrected this error.

14. In May of 2012, Respondent also directed the Controller to invoice certain customer orders before those orders had shipped, but to backdate the orders to the first quarter of 2012. The Controller generated invoices for these orders, which caused TelWorx to recognize revenue prematurely in its books and records in the first quarter of 2012.

15. Respondent then directed the Controller to provide TelWorx's income statements to the Accountants, which he did.

16. Respondent later directed the Controller to reverse these orders, thus reversing the revenue generated from these orders from TelWorx's books and records.

17. Near the end of the second quarter, PCTEL requested estimated second quarter revenue from TelWorx. Respondent instructed the Controller to send PCTEL an email providing

TelWorx's actual revenue for the first two months of the second quarter and estimated revenue for the final month of the second quarter.

18. Respondent then directed the Controller to re-invoice several of the orders Respondent had previously instructed the Controller to invoice and reverse, causing TelWorx to recognize revenue for these orders prematurely a second time.

19. These false accounting entries caused material overstatements of TelWorx's EBITDA and its first and second quarter 2012 revenue.

20. Respondent caused TelWorx to provide PCTEL with financial information that included these overstatements. These false accounting entries increased the purchase price which PCTEL paid for TelWorx.

21. Despite these false entries, TelWorx still did not meet the second quarter revenue forecast that Respondent had provided to PCTEL.

22. Shortly before the acquisition, PCTEL learned that TelWorx did not meet the second quarter 2012 revenue forecast. This revenue shortfall was due, in part, to a large order that a customer ("Customer A") had postponed until the third quarter of 2012.

**PCTelWorx Recorded Revenue From Two False Transactions To Conceal
The Pre-Acquisition Inventory Write-Up and Third Quarter Revenue Shortfall**

23. After the acquisition, in the middle of the third quarter of 2012, PCTEL began performing inventory valuation testing at PCTelWorx, which would have included testing the Modules whose value Respondent directed the Controller to inflate prior to the acquisition.

24. In order to conceal this fact from PCTEL, Respondent told the Controller that he planned to purchase the Modules himself.

25. Even though Respondent was the purchaser, he subsequently instructed the Controller to make an entry in PCTelWorx's books and records showing an order for the Modules naming a PCTelWorx's vendor, a telecommunications company located in Taiwan ("Vendor A"), as the purchaser.

26. Respondent also instructed the Controller to create an invoice for this false order. The Controller carried out Respondent's instructions, which caused PCTelWorx to record a false order in its books and records and to recognize revenue on the false order prematurely.

27. Respondent paid PCTelWorx's invoice to Vendor A but concealed from PCTEL the fact that he had purchased the Modules himself. PCTelWorx never shipped the Modules to Vendor A.

28. Towards the end of the third quarter of 2012, Respondent realized that even with the revenue from Vendor A's false order, PCTelWorx still would not meet the quarterly revenue forecast he had provided to PCTEL.

29. Respondent also knew that PCTelWorx still had not received the large order from Customer A that he had forecast for the third quarter. So Respondent decided to improperly use an intermediate purchaser for Customer A's anticipated order to conceal the revenue forecast shortfall.

30. Respondent proposed that the intermediate purchaser eventually would resell the products to Customer A at a profit. Respondent planned to offer the intermediate purchaser extended payment terms so that it could collect the full purchase price from Customer A before having to pay PCTelWorx's invoice.

31. Respondent identified a vendor that provided services to – but that had not previously purchased a large order from – PCTelWorx ("Vendor B") as a potential intermediate purchaser.

32. Respondent instructed PCTelWorx's Vice President of Sales and Tech Services (the "Vice President") to ask Vendor B if it would act as the intermediate purchaser for this order.

33. The Vice President followed Respondent's direction and obtained a purchase order from Vendor B with the same terms as the order that PCTelWorx expected eventually to receive from Customer A.

34. Using the purchase order obtained by the Vice President, Respondent instructed a PCTelWorx employee ("Employee A") to record Vendor B's order in PCTelWorx's books and records and to indicate that the order had been shipped to Vendor B and that Vendor B had been invoiced. These actions resulted in improper, premature revenue recognition in PCTelWorx's books and records during the third quarter.

35. PCTelWorx never shipped the products listed on the false order to Vendor B, nor did it send Vendor B the invoice for the false order.

PCTelWorx Created False Documents In The Fourth Quarter To Conceal The Fake Orders From PCTEL

36. In the middle of the fourth quarter of 2012, PCTEL asked PCTelWorx to provide it with all of the records concerning Vendor A's order. Because it was a false order, most of the requested records, such as the purchase order and shipping records, did not exist.

37. In order to conceal the fact that Vendor A's order was false, Respondent instructed the Controller to request certain records for Vendor A's order by email from a PCTelWorx employee ("Employee B"). The Controller sent the email as Respondent instructed. However, Respondent knew that the records described in that email did not exist.

38. Respondent then created several false records concerning Vendor A's order that PCTEL had requested. He provided these records to Employee B, and instructed Employee B to email the records and other false information concerning Vendor A's order to the Controller, who then provided the false information and documents to PCTEL.

39. Midway through the fourth quarter, Customer A still had not placed the order with PCTelWorx as expected by Respondent. In addition, PCTelWorx's books and records indicated that Vendor B's payment for the order was due and unpaid. Respondent became concerned that PCTEL would attempt to collect on the overdue invoice to Vendor B, detect the false order in its books and records and determine that PCTelWorx had recognized revenue prematurely in the third quarter.

40. Respondent decided to conceal from PCTEL the false third quarter order from Vendor B by reversing it from PCTelWorx's books and records and recording a new false transaction that matched an actual purchase order from another PCTelWorx customer ("Customer B"). According to Respondent's plan, Customer B's order would be cancelled on PCTelWorx's books, but Customer B would pay for the order placed by Vendor B.

41. Respondent instructed the Vice President to obtain a revised, false purchase order from Vendor B that was identical to the order that PCTelWorx had received from Customer B.

42. Respondent and the Vice President, at Respondent's direction, then instructed Employee A to cancel Customer B's order and to reverse Vendor B's false order from the third quarter in PCTelWorx's books and records. Respondent and the Vice President, at Respondent's direction, also instructed Employee A to enter Vendor B's revised, false purchase order into PCTelWorx's books and records.

43. Ultimately, the items supposedly ordered by Vendor B pursuant to the revised, false purchase order were shipped to – and paid for – by Customer B.

**After The Acquisition, PCTEL Filed A Form 8-K/A That
Included TelWorx's Materially Overstated Second Quarter Revenue**

44. PCTEL informed Respondent that it was required to file with the Commission pro forma financial statements that included financial information for both PCTEL and TelWorx as if PCTEL had owned TelWorx for the first two quarters of 2012 and that it had retained the Accountants to prepare compilations of TelWorx's financial statements. Respondent agreed to release TelWorx's compiled financial statements to PCTEL for filing with the Commission.

45. On September 24, 2012, PCTEL filed a Form 8-K/A which reported TelWorx's audited financial statements for 2010 and 2011, an unaudited compilation of TelWorx's financial statements as of June 30, 2012, and PCTEL's unaudited pro forma consolidated financial statements that included financial information for both PCTEL and TelWorx as if PCTEL had acquired TelWorx as of January 1, 2011.

46. The Form 8-K/A materially overstated revenue on TelWorx's financial statements due to the false accounting entries made, at Respondent's direction.

47. On March 13, 2013, PCTEL issued a Form 8-K/A disclosing these irregularities.

PCTEL Confronts Scronce With The False Entries in TelWorx's And PCTelWorx's Books and Records

48. Notwithstanding Respondent's efforts to conceal from PCTEL the false entries in TelWorx's books and records and the false entries in PCTelWorx's books and records, PCTEL discovered the false entries.

49. PCTEL confronted Respondent about one of the false purchase orders and, shortly thereafter, Respondent resigned his position with PCTelWorx.

50. PCTEL and Respondent subsequently entered into a settlement agreement pursuant to which Respondent paid PCTEL a total of \$4.75 million, \$3.2 million of which represented the return of a portion of the purchase price PCTEL paid for TelWorx's assets, and gave up the right to receive any stock earn-out payments.

Violations

51. As a result of the conduct described above, Respondent violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder which prohibit fraudulent conduct in connection with the purchase or sale of securities.

52. As a result of the conduct described above, Respondent acted through or by means of another person to violate Section 20(b) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Section 20(b) of the Exchange Act makes it unlawful for any person, directly or indirectly, to do an act or thing which it would be unlawful for such person to do under the Exchange Act or any rule or regulation thereunder through or by means of any other person.

53. As a result of the conduct described above, Respondent violated Section 13(b)(5) of the Securities Act which prohibits the knowing falsification of any book, record, or account or circumvention of internal controls.

54. As a result of the conduct described above, Respondent caused PCTEL's violations of Section 13(a) of the Exchange Act and Rules 13a-11 and 12b-20 promulgated thereunder, which collectively require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission accurate current reports on Form 8-K that contain material information necessary to make the required statements made in the reports not misleading.

55. As a result of the conduct described above, Respondent caused PCTEL's violation of Section 13(b)(2)(A) of the Exchange Act, which requires Section 12 registrants to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of their assets.

56. As a result of the conduct described above, Respondent violated Rule 13b2-1 of the Exchange Act, which prohibits the direct or indirect falsification of any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Scronce cease and desist from committing or causing any violations and any future violations of Section 10(b), 20(b), 13(a), 13(b)(2)(A), 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-11, and 13b2-1 promulgated thereunder.

B. Respondent Scronce be, and hereby is, prohibited, for ten years following the date of the entry of this Order, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

C. Respondent shall, within 10 days of the entry of this Order, pay disgorgement of \$376,007, prejudgment interest of \$29,212.47, and a civil money penalty in the amount of \$140,000 to the Securities and Exchange Commission for transfer to the general fund of United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Timothy Edwin Scronce as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Paul Montoya, Assistant Regional Director, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, Illinois 60604.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary



U.S. Securities and Exchange Commission

UNITED STATES OF AMERICA Before the SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Release No. 50428 / September 23, 2004

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2108 / September 23, 2004

Admin. Proc. File No. 3-11678

	:	
In the Matter of	:	ORDER INSTITUTING CEASE-
	:	AND-DESIST PROCEEDINGS,
JOHN E. ISSELMANN, JR.,	:	MAKING FINDINGS, AND
	:	IMPOSING A CEASE-AND-
Respondent.	:	DESIST ORDER PURSUANT TO
	:	SECTION 21C OF THE
	:	SECURITIES EXCHANGE ACT OF
	:	1934
	:	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against John E. Isselmann, Jr. ("Respondent" or "Isselmann").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. Summary

Isselmann, the former General Counsel of Electro Scientific Industries, Inc. ("ESI" or "Company"), failed to provide important information to ESI's Audit Committee, Board of Directors, and auditors regarding a significant accounting transaction that enabled ESI to report a profit rather than a loss. Isselmann's failure to fulfill his gatekeeper role was a cause of the Company reporting materially false financial results for ESI's first quarter ended August 31, 2002.

ESI's former Chief Financial Officer and Controller had fraudulently decided to eliminate vested retirement and severance benefits for ESI's Asian employees in order to increase ESI's bottom line by \$1 million. Isselmann later received written legal advice that the law prohibited the unilateral elimination of the benefits. Despite having opportunities to provide the advice to ESI's Audit Committee, Board of Directors, and auditors, Isselmann failed to do so. Isselmann's failure allowed the CFO and Controller to hide an ongoing fraud. Moreover, while in possession of the written legal advice stating that the law prohibited the unilateral elimination of the benefits, Isselmann was involved in the review process for ESI's

quarterly report filed with the Commission describing the elimination of the benefits and the resulting impact on ESI's income.

B. Respondent

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. ESI is a high technology manufacturer based in Portland, Oregon.²

C. Isselmann Is a Cause of ESI's Filing of a Materially Inaccurate Form 10-Q for the Quarter Ended August 31, 2002

1. ESI's Senior Management Artificially Inflates Quarterly Income

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. Through this fraudulent accounting transaction, ESI artificially inflated its profits by 28% for the quarter.

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

2. Isselmann Becomes Aware of the Elimination of the Retirement and Severance Benefits

Isselmann participated in a September 17, 2002 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.

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 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.

3. Isselmann Receives Contradictory Written Legal Advice

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

4. Isselmann's Involvement in the Filing of ESI's Form 10-Q

ESI's Disclosure Committee met on October 7, 2002 in order 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.

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.

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.

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. The restatement revealed that, as a result of the improper reversal of the accrued liability, ESI's originally reported net income was overstated by 28%.

D. Legal Discussion

Section 13(a) of the Exchange Act requires issuers such as ESI to file quarterly reports with the Commission containing such information as the Commission prescribes by rule. Exchange Act Rule 13a-13 requires issuers to file quarterly reports. Under Exchange Act Rule 12b-20, the reports must contain, in addition to disclosures expressly required by statute and rules, such other information as is necessary to ensure that the statements made are not, under the circumstances, materially misleading. The obligation to file reports includes the requirement that the reports be true and correct. The reporting provisions are violated if false and misleading reports are filed. Scienter is not an element of the violations alleged herein.

As described in Parts III(A) through (C) above, Isselmann's failure to convey written legal advice concerning the elimination of the Japanese retirement and severance benefits was a cause of ESI filing a materially false and misleading Form 10-Q for the period ended August 31, 2002.

ESI violated Section 13(a) and Rules 13a-13 and 12b-20 by filing with the Commission a Form 10-Q containing inaccurate financial statements for the quarter ended August 31, 2002. As a result of the conduct described above, Isselmann was a cause of ESI's violation of Section 13(a) and Rules 12b-20 and 13a-13.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED that:

A. Respondent cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder.

By the Commission.

Jonathan G. Katz
Secretary

Endnotes

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² At all relevant times, ESI was an Oregon corporation with its principal place of business in Portland. ESI's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the Nasdaq National Market.

<http://www.sec.gov/litigation/admin/34-50428.htm>

[Home](#) | [Previous Page](#)

Modified: 09/23/2004

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 79127 / October 20, 2016

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3816 / October 20, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17639

In the Matter of

**FMC TECHNOLOGIES,
INC., JEFFREY FAVRET,
CPA, and STEVEN K.
CROFT, CPA,**

Respondents.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTIONS 4C AND 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS, CEASE-AND-
DESIST ORDERS AND PENALTIES**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against FMC Technologies, Inc. ("FMCTI"), Jeffrey Favret, CPA ("Favret"), and Steven K. Croft, CPA ("Croft") (collectively, "Respondents"), and that public administrative proceedings be, and hereby are, instituted against Favret and Croft pursuant to Section 4C¹ of the Exchange Act and Rule 102(e)(1)(iii)² of the Commission's Rules of Practice.

¹ Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

² Rule 102(e)(1)(iii) provides, in pertinent part, that:

The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission’s Rules of Practice, Making Findings and Imposing Remedial Sanctions, Cease-and-Desist Orders and Penalties (“Order”), as set forth below.

III.

On the basis of this Order and Respondents’ Offers, the Commission finds³ that:

SUMMARY

This matter involves various books and records and internal accounting controls violations by FMC Technologies, Inc. and two of its former executives: segment controller Jeffrey Favret and his subordinate, business unit controller Steven Croft.

During the first quarter of 2013, Favret and Croft improperly reversed required accruals to improve their segment’s results. Their improper adjustments, which overstated their segment’s pre-tax operating profits by \$800,000 in that period, enabled the segment to meet its internal target. Favret and Croft continued to understate this accrual inappropriately in part of the second quarter of 2013.

Favret and Croft also failed to comply with FMCTI’s internal accounting controls by not reporting internally, as required, that they had corrected a \$730,000 error recorded in 2012 that increased their segment’s operating results in the first quarter of 2013. Within about two weeks of discussing this correction, Favret and Croft signed management representation letters attesting there had been no out-of-period adjustments larger than \$250,000 recorded during the period ending March 31, 2013.

Separately, Croft failed to comply with FMCTI’s internal accounting controls by directing that his business unit switch to a new accounting system before obtaining assurance that the new system would operate properly. This failure resulted in errors that significantly overstated the segment’s results in two quarterly periods in 2014.

³ The findings herein are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

FMCTI committed other books and records and internal accounting controls violations as well. Another business that FMCTI acquired in 2012 failed to account properly for the same accrual account that Favret and Croft used improperly. And FMCTI improperly accounted for interest income associated with certain large intercompany loans, which resulted in an \$8 million out-of-period adjustment in 2014.

RESPONDENTS

1. FMC Technologies, Inc., a Delaware corporation headquartered in Houston, Texas, describes itself as a global provider of technology solutions for the energy industry. FMCTI is a Fortune 500 company whose common stock is registered with the Commission pursuant to Section 12(b) of the Securities Act of 1933 and trades on the New York Stock Exchange. FMCTI has three reporting segments: Subsea Technologies, Surface Technologies, and Energy Infrastructure. Energy Infrastructure is FMCTI's smallest segment. During most of the relevant period, Jeffrey Favret was Energy Infrastructure's controller. During 2012, Energy Infrastructure acquired Automation & Control ("A&C") as a new business unit. Steven Croft was A&C's controller.

2. Jeffrey Favret, CPA, 55, is a resident of Spring, Texas and holds a Louisiana CPA license, which expired in 2012. From May 2012 until May 2013, Favret was the controller of FMCTI's Energy Infrastructure segment.

3. Steven K. Croft, CPA, 42, is a resident of Manhattan, Kansas and holds an inactive Louisiana CPA license. Croft is currently the controller of a private company. Croft served as FMCTI's consolidations and reporting manager from April 2010 until mid-2012, when he became the controller of Automation & Control ("A&C"), a newly acquired FMCTI business unit in the company's Energy Infrastructure segment. As controller of A&C, Croft reported to Segment Controller Jeffrey Favret until Favret's departure from FMCTI in May 2013.

FACTS

Favret's and Croft's Manipulation of a Paid Time Off Account to Improve Segment Results

FMCTI's Paid Time Off Policy

4. FMCTI has an atypical paid time off ("PTO") policy in that employees earn their full-year PTO allowances on January 1 of each year, instead of ratably in each pay period. For example, whereas in most companies, an employee who receives 12 days of PTO per year earns 1 day of leave each month, an FMCTI employee with the same amount of PTO would earn the entire 12 days on January 1. If that employee were to resign from FMCTI on January 2, she would be paid for all 12 days. Because this liability accrues on January 1, Generally Accepted Accounting Principles ("GAAP") require FMCTI to establish a reserve for its full-year PTO liabilities as of January 1.⁴ Throughout the relevant period, FMCTI had internal accounting policies, described as "Financial Standards," which specified that PTO accruals must be maintained in this manner.

⁴ ASC 710-10-25-1 Compensated Absences, states that "An employer shall accrue a liability for employees' compensation for future absences if . . . [t]he obligation relates to rights that vest or accumulate."

5. Like many employers, FMCTI allowed its employees to roll over a certain amount of unused PTO from one year to the next. GAAP required FMCTI's PTO accounts to hold the full year PTO liabilities for the current year as well as the amount of unused PTO employees were allowed to carry from the prior year (the "roll-over") on January 1 of each year.

Croft Records the Required PTO Accruals.

6. In May 2012, FMCTI acquired a private company that it renamed Automation and Control ("A&C"). A&C had a traditional PTO policy wherein employees earned their leave over the course of each year. A&C accrued this liability ratably. A&C continued using this PTO policy throughout 2012.

7. FMCTI required A&C to adopt FMCTI's PTO policy as of January 1, 2013. Consequently, on January 1, 2013, A&C was required to record an accrual for its full-year 2013 PTO liability, while also maintaining an accrual for the 2012 PTO roll-over.

8. As A&C's controller, Croft was responsible for ensuring that the business unit was appropriately accounting for its PTO liability. Because he was new to the role, Croft consulted in January 2013 with a long-time FMCTI employee to determine what accrual he needed to establish for A&C's 2013 PTO liability. At that point, FMCTI's PTO accrual included only the 2012 roll-over (\$223,000). They concluded that A&C was required to also accrue the entire amount of its full-year 2013 PTO liability (\$928,000). In late January 2013, Croft directed his staff to accrue this additional liability.

Favret and Croft Revise A&C's Approach to the PTO Accrual.

9. The 2013 PTO accrual had a significant, negative impact on not only A&C's January results, but on the Energy Infrastructure segment's results as well. Favret and other executives in the segment were under pressure from the head of Energy Infrastructure to "push" their teams "to discomfort" to make up for lower revenues and earnings, and Favret began to question whether it was necessary for A&C to record the entire 2013 PTO accrual in January.

10. In early February 2013, Favret and Croft decided – without consulting FMCTI's corporate accounting office – to accrue for A&C's 2013 PTO liability ratably over the course of 2013, instead of accruing the liability all at once. Croft then directed a subordinate to reduce A&C's 2013 PTO accrual by almost \$800,000, leaving only the 2012 roll-over accrual (\$223,000) plus two-twelfths (representing two months' worth of accruals) of the full-year 2013 accrual (\$154,667). This method of accruing for A&C's PTO liability did not comply with FMCTI's accounting policy and resulted in an understatement of the required liability, which was not in compliance with GAAP.

11. Neither Favret nor Croft ever sought or received guidance, much less approval, from FMCTI's corporate accounting office before adopting this new approach.

12. In mid-March 2013, an FMCTI internal audit manager conducting a review of A&C advised Croft that his business unit needed to record the full 2013 PTO accrual.

Favret and Croft Revise the Approach Again, Completely Eliminating the 2013 PTO Accrual.

13. During the quarterly closing process in April 2013, Favret and Croft again sought to improve results for the first quarter. The head of Energy Infrastructure directed Favret to "push everyone for a couple of hundred k each above their stretch" and to "[s]ee if you can scratch out 100k somewhere" and told Favret to "keep following up with [Croft] please - has to be more there."

14. During this effort, Croft informed Favret that A&C's results may be even lower than they had anticipated. Croft warned Favret that A&C's bonus accrual was not sufficient to cover a larger-than-expected bonus payout for 2012.

15. To improve the segment's results, Favret and Croft decided during early April 2013 to eliminate A&C's 2013 PTO accrual entirely. Doing so left only the 2012 roll-over accrual (\$223,000) on A&C's general ledger for the quarter ended March 31, 2013.

16. The failure to accrue anything for A&C's 2013 PTO liability meant FMCTI's accrued liability for PTO was understated and was not in compliance with GAAP.

17. By not accruing anything for the 2013 PTO liability, Favret and Croft overstated the Energy Infrastructure segment's operating profits by about 10 percent for the quarter ended March 31, 2013 and allowed the company to claim that the segment's operating profit as a percentage of revenue had increased from 6.8 percent to 7.4 percent as compared to the prior year's first quarter. But for Favret and Croft's misconduct, Energy Infrastructure's operating profit as a percentage of revenue would have decreased to 6.7 percent.

18. Croft eliminated the 2013 PTO accrual at Favret's direction. After Favret and Croft "scrubbed" A&C's quarterly numbers together, Favret reported to the head of the Energy Infrastructure segment that he had changed Croft's computation for PTO, which subsequently reflected no accrual for 2013. Croft did not seek advice from anyone in FMCTI's internal audit or corporate accounting group even though an FMCTI internal audit manager had recently told him that A&C needed to have the full 2013 PTO accrual on its books and even though Croft was in contact with FMCTI's corporate accounting group at that time on other issues.

19. One of FMCTI's internal accounting controls required segment and business unit controllers to certify whether all significant liabilities, including accounts payable and payroll, had been properly recorded. Both Favret and Croft signed quarterly management representation letters to FMCTI's corporate controller on April 15, 2013 and April 11, 2013, respectively, in which they represented that all such liabilities had been properly recorded.

Favret and Croft Revise the Approach Yet Again, Using the 2012 Rollover Accrual to Improve April 2013 Results.

20. During April 2013, Favret and Croft reduced A&C's PTO accrual yet again. With nothing left on the books for A&C's 2013 PTO liability, this time they decided to release most of the 2012 PTO rollover. The new approach was to accrue the 2012 PTO rollover ratably such that A&C would not be fully accrued for this liability, which clearly existed as of the end of 2012, until the end of 2013.

21. After discussing with Favret, Croft directed a subordinate to reverse all but one-third (\$74,357) of the 2012 PTO rollover (\$223,000) that had remained on A&C's books at the end of the first quarter. This action improved A&C's income by nearly \$150,000 for the month.

22. The change in methodology to a ratable accrual of the 2012 rollover and the failure to accrue anything for A&C's 2013 PTO liability, meant FMCTI was not in compliance with GAAP.

FMCTI Re-Establishes A&C's 2013 PTO Accrual and the 2012 Roll-Over.

23. FMCTI's corporate accounting group learned about the issues with A&C's PTO accrual in late May or early June 2013. Before the end of the second quarter, the corporate accounting group directed A&C to re-establish its full-year 2013 PTO accrual and the 2012 rollover accrual by adding \$1.18 million to A&C's vacation accrual account.

Schilling Robotics' Improper Accounting for its 2013 PTO Liability

24. Schilling Robotics was another entity FMCTI acquired in 2012 that, like A&C, adopted FMCTI's PTO policy on January 1, 2013. Schilling, which was part of FMCTI's Subsea segment, also failed to properly accrue for its PTO liabilities in accordance with GAAP and FMCTI's accounting policies. Upon adoption of FMCTI's benefits program, Schilling took ratable accruals for its PTO liability throughout 2013 rather than recording the entire 2013 PTO liability (\$1.4 million) as of January 1, 2013.

Favret and Croft Fail to Report Internally an Out-of-Period Adjustment as Required by FMCTI's Internal Controls.

25. On March 30, 2013, during the same quarter in which Favret and Croft eliminated A&C's 2013 PTO accrual, Croft sought approval from Favret to capitalize \$730,000 in research and development costs that A&C had previously expensed in 2012. This spending should have been capitalized as incurred during 2012. Favret approved the capitalization, which corrected the earlier accounting treatment. Favret directed Croft to reverse the \$730,000 into income and capitalize the research and development costs. Though FMCTI's corporate accounting office had, only three weeks earlier, notified Favret that FMCTI's threshold for reporting internally out of period adjustments was \$250,000 (pre-tax), he instructed Croft that the \$730,000 was "not material enough to call an out of period charge."

26. One of FMCTI's internal accounting controls was to require segment and business unit controllers to certify whether they had made accounting entries during any given quarter over the \$250,000 threshold that related to a prior period. Both Favret and Croft signed quarterly management representation letters to FMCTI's corporate controller on April 15, 2013 and April 11, 2013, respectively, in which they represented that they had made no such entries. These statements were false. Both Favret and Croft knew that A&C had recorded the \$730,000 adjustment related to 2012 less than two weeks prior.

Croft's Additional Failure to Comply with FMCTI's Internal Controls

27. In January 2014, A&C implemented a new accounting system to replace a legacy accounting system that required the business unit to calculate revenue manually. FMCTI's internal accounting controls required that A&C either adequately test the new system before relying on it or maintain the old and new systems in parallel until the new system proved reliable. Despite this, Croft discontinued the legacy system as soon as the new accounting system became operable, before it was tested and found to be working reliably.

28. During A&C's transition to the new system, contractors made errors in using the new system that resulted in the Energy Infrastructure segment improperly recognizing \$6.7 million in revenue. These errors went undetected for two quarters, causing overstatements in the Energy Infrastructure segment's operating results in FMCTI's Forms 10-Q for the quarters ended March 31, 2014 and June 30, 2014.

Internal Controls Failures in Recording Inter-Company Loans Result in Additional Out-of-Period Adjustments.

29. As part of an April 2012 tax restructuring of FMC subsidiaries in Europe, FMC's Luxembourg subsidiary, which functions in U.S. dollars, made an 11.5 billion Norwegian Kroner (NOK) inter-company loan to FMC's Norwegian subsidiary, which functions in NOK. The loan between the two subsidiaries was considered to be part of FMC's net investment in the Norwegian subsidiary under GAAP within FMCTI's consolidated financial statements, which meant that only the interest income and accrued interest receivable (and not the principal balance) needed to be re-measured quarterly for currency fluctuations.⁵

30. FMCTI's Luxembourg entity did not, however, perform the required re-measurements. Due to a lack of internal accounting controls for non-routine tax transactions, the Luxembourg entity recorded its interest income receivable along with the loan principal in a general ledger account that did not automatically re-measure for currency fluctuations. As a result, the entity failed to re-measure the interest payments from NOK into U.S. dollars from the time of the loan's inception in April 2012 until the accounting error was discovered in the third quarter of 2014. The Norwegian entity also failed to make the necessary interest payments to the Luxembourg entity, triggering penalties that also needed to be re-measured. The required re-measurement of the penalties and interest required FMCTI to record an unrealized foreign currency

⁵ See ASC 830-20-35-2 through 35-4.

loss of \$20.9 million in the quarter ended September 30, 2014, \$8.1 million of which was an out-of-period adjustment to correct the prior failures to re-measure.

VIOLATIONS

31. Exchange Act Section 13(b)(2)(A) requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and the dispositions of their assets.

32. Exchange Act Section 13(b)(2)(B) requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

33. Exchange Act Section 13(b)(5) provides that no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account.

34. Exchange Act Rule 13b2-1 provides that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Exchange Act Section 13(b)(2)(A).

35. As a result of the conduct described above, FMCTI violated Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because it failed to make and keep appropriate books and records and devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that its newly acquired business units recorded the necessary accruals for their PTO liabilities, reported out-of-period adjustments, appropriately tested new revenue calculation systems before discontinuing old systems, and properly recorded inter-company loans.

36. As a result of the conduct described above, Favret violated Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2-1 and caused FMCTI's violations of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because he willfully manipulated FMCTI's PTO accrual and failed to report an out-of-period adjustment.

37. As a result of the conduct described above, Croft violated Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2-1 and caused FMCTI's violations of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because he willfully manipulated FMCTI's PTO accrual, failed to report an out-of-period adjustment, and discontinued A&C's old revenue calculation system before the new system was found to be working properly.

FINDINGS

38. Based on the foregoing, the Commission finds that FMCTI violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

39. Based on the foregoing, the Commission finds that Favret (a) willfully violated Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1; and (b) willfully aided and abetted and caused FMCTI's violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

40. Based on the foregoing, the Commission finds that Croft (a) willfully violated Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1; and (b) willfully aided and abetted and caused FMCTI's violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

UNDERTAKINGS

Respondent FMCTI undertakes to:

41. Cooperate fully with the Commission in any and all investigations, litigations, or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent FMCTI shall:

a. Produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission staff subject to any restrictions under the law of any foreign jurisdiction;

b. Use its best efforts to cause its officers, employees, and directors to be interviewed by Commission staff at such times and places as the staff reasonably may direct;

c. Use its best efforts to cause its officers, employees, and directors to appear and testify without service of a notice or subpoena in such investigations, depositions, hearings, or trials as may be requested by the Commission staff; and

d. In connection with any testimony of Respondent FMCTI's officers, employees, and directors to be conducted at deposition, hearing, or trial pursuant to a notice or subpoena, Respondent FMCTI:

i. Agrees that any such notice or subpoena for Respondent FMCTI's officers', employees', and directors' appearance and testimony may be served by regular or electronic mail on: John C. Wander, Esq., Vinson & Elkins LLP, 2001 Ross Avenue, Suite 3700, Dallas, Texas 75201-2975; jwander@VELaw.com; and

ii. Agrees that any such notice or subpoena for Respondent FMCTI's officers', employees', and directors' appearance and testimony in any action pending in a United States District Court may be served, and may require

testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

Respondent Favret undertakes to:

42. Cooperate fully with the Commission in any and all investigations, litigations, or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent Favret shall:

- a. Produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission staff subject to any restrictions under the law of any foreign jurisdiction;
- b. Appear and be interviewed by Commission staff at such times and places as the staff reasonably may direct;
- c. Appear and testify without service of a notice or subpoena in such investigations, depositions, hearings, or trials as may be requested by the Commission staff; and
- d. In connection with any testimony of Respondent to be conducted at deposition, hearing, or trial pursuant to a notice or subpoena, Respondent Favret:
 - i. Agrees that any such notice or subpoena for Respondent Favret's appearance and testimony may be served by regular or electronic mail on: Kenneth P. Held, Esq., Schiffer Odom Hicks & Johnson PLLC, 700 Louisiana St., Suite 1200, Houston, TX 77002; kheld@sohjlaw.com; and
 - ii. Agrees that any such notice or subpoena for Respondent Favret's appearance and testimony in any action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

Respondent Croft undertakes to:

43. Cooperate fully with the Commission in any and all investigations, litigations, or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent Croft shall:

- e. Produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission staff subject to any restrictions under the law of any foreign jurisdiction;
- f. Appear and be interviewed by Commission staff at such times and places as the staff reasonably may direct;

- g. Appear and testify without service of a notice or subpoena in such investigations, depositions, hearings, or trials as may be requested by the Commission staff; and
- h. In connection with any testimony of Respondent to be conducted at deposition, hearing, or trial pursuant to a notice or subpoena, Respondent Croft:
 - iii. Agrees that any such notice or subpoena for Respondent Croft's appearance and testimony may be served by regular or electronic mail on: Josh Roseman, Esq., Jones Day, 2727 N. Harwood Street, Dallas, Texas 75201; jsroseman@JonesDay.com; and
 - iv. Agrees that any such notice or subpoena for Respondent Croft's appearance and testimony in any action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

In determining whether to accept the Respondents' Offers, the Commission has considered these undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent FMCTI's, Respondent Favret's and Respondent Croft's Offers.

Accordingly, it is hereby ORDERED, effective immediately, that:

- A. FMCTI Technologies, Inc. shall cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.
- B. Jeffrey Favret shall cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1.
- C. Favret is denied the privilege of appearing or practicing before the Commission as an accountant. After two years from the date of this order, Favret may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:
 - 1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Favret's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Favret, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Favret, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in Favret's or the firm's quality control system that would indicate that Favret will not receive appropriate supervision;

(c) Favret has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Favret acknowledges his responsibility, as long as Favret appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

D. The Commission will consider an application by Favret to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Favret's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

E. Steven K. Croft shall cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1.

F. Croft is denied the privilege of appearing or practicing before the Commission as an accountant. After two years from the date of this order, Croft may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Croft's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Croft, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board (“Board”) in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Croft, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in Croft’s or the firm’s quality control system that would indicate that Croft will not receive appropriate supervision;

(c) Croft has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Croft acknowledges his responsibility, as long as Croft appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

G. The Commission will consider an application by Croft to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission’s review may include consideration of, in addition to the matters referenced above, any other matters relating to Croft’s character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

H. FMCTI shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$2,500,000.00 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

Payment must be made in one of the following ways:

- (1) Respondent FMCTI may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent FMCTI may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

- (3) Respondent FMCTI may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying FMC Technologies, Inc. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Rami Sibay, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

I. Respondent Favret shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$30,000.00 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

Payment must be made in one of the following ways:

- (1) Respondent Favret may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent Favret may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent Favret may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Jeffrey Favret as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Rami Sibay, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

J. Respondent Steven K. Croft shall pay civil penalties of \$10,000.00, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment shall be made in installments according to the following schedule: (1) \$2,500.00 within 14 days of the entry of this Order; (2) \$1,500.00 by December 31, 2016; (3) \$1,500.00 by March 31, 2017; (4) \$1,500.00 by June 30, 2017; (5) \$1,500.00 by September 30, 2017; and (6) \$1,500.00 by December 31, 2017. Payments shall be deemed made on the date they are received by the Commission and shall be applied first to post judgment interest, which accrues pursuant to 31 U.S.C. § 3717 on any unpaid amounts due after 14 days of the entry of this Order. Prior to making the final payment set forth herein, Respondent shall contact the staff of the Commission for the amount due for final payment. If any payment is not made by the date the payment is required according the schedule set forth above, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application.

Payment must be made in one of the following ways:

- (1) Respondent Croft may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent Croft may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent Croft may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Steven Croft as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Rami Sibay, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

K. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalties, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of civil penalties in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a

Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents Jeffrey Favret and Steven K. Croft, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents Favret and Croft under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents Favret and Croft of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

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8
9 UNITED STATES DISTRICT COURT
10 NORTHERN DISTRICT OF CALIFORNIA
11

12 SECURITIES AND EXCHANGE COMMISSION,
13 Plaintiff,
14 v.
15 DIAMOND FOODS, INC.,
16 Defendant.

Case No.
COMPLAINT

17 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

18 **SUMMARY OF THE ACTION**

19 1. This case involves financial reporting fraud and earnings management at
20 Diamond Foods, Inc. ("Diamond"), a San Francisco-based snack food company. One of
21 Diamond's businesses involved buying walnuts from its growers and selling those walnuts to
22 retailers. As a result of a scheme by Diamond's Chief Financial Officer Steven Neil to
23 fraudulently manipulate and delay appropriate recording of the costs paid to walnut growers,
24 Diamond reported inflated earnings during fiscal years 2010 and 2011.

25 2. During 2010, CFO Neil faced pressure to meet or exceed the earnings estimates of
26 Wall Street stock analysts. At that time, Neil and Diamond encountered sharp increases in
27 walnut prices. Diamond's largest commodity cost was walnuts. Diamond would need to pay
28 growers higher prices for their walnuts in order to maintain the company's longstanding

1 relationships with its growers. Yet Diamond could not increase the amounts paid to growers for
2 walnuts without decreasing Diamond's net income as reported to the investing public.

3 3. Faced with these two competing demands, Neil orchestrated a scheme to have it
4 both ways. In August of 2010, Diamond made a final installment payment to growers for the
5 2009 walnut crop. The final installment brought the total payments to growers close to market
6 prices. But instead of recording the final installment accurately as a cost of acquiring walnuts for
7 fiscal year 2010, Neil instructed his finance and accounting team to treat a portion of this amount
8 – referred to as the “continuity” payment – as an advance payment for a future, as yet
9 undelivered, walnut crop. According to Neil, the portion labeled the “continuity” payment
10 would “close the gap” between the recorded walnut cost and the market prices, but was not
11 recorded as a cost of walnuts acquired during fiscal year 2010. By delaying the recognition of a
12 portion of the cost of walnuts acquired into later fiscal periods, Neil materially underreported the
13 cost of acquiring walnuts and overstated earnings by \$10.5 million in fiscal year 2010.

14 4. Neil devised a similar, but even larger, payment (which Diamond personnel said
15 would “make up” for a low final price) when Diamond growers were paid for walnuts delivered
16 the following fiscal year. Neil treated this payment, labeled a “momentum” payment, as an
17 advance for future crops and did not recognize the payment as a cost of the walnuts Diamond
18 acquired in that fiscal year. By again delaying the recognition of a portion of the cost of walnuts
19 acquired into later fiscal periods, Neil materially underreported the cost of acquiring walnuts and
20 overstated earnings by \$23.6 million in fiscal year 2011.

21 5. Diamond materially misstated its financial results in multiple SEC Forms 10-Q,
22 10-K, and 8-K from at least February 2010 and ending in September 2011. In this timeframe,
23 Diamond reported artificially inflated earnings per share (“EPS”) that beat Wall Street earnings
24 estimates on a quarterly and yearly basis, and its stock price reached a high of over \$90 per share
25 after filing the last of its materially false financial statements in September 2011. Diamond also
26 successfully raised approximately \$181 million through a stock offering, and reached an
27 agreement to acquire a major potato chip brand with Diamond's stock as consideration.

28 6. Following media reports questioning the “momentum” payment, Diamond

1 conducted an internal investigation and concluded that its financial statements for fiscal years
 2 2010 and 2011 incorrectly excluded the “continuity” payment and “momentum” payment as
 3 costs of acquiring walnuts in those periods, respectively. Diamond’s stock price dropped from
 4 approximately \$90 per share in September 2011 to \$17 per share in November 2012 after the
 5 filing of its restatement. The stock drop represented a market capitalization loss of
 6 approximately \$1.7 billion.

7 **JURISDICTION AND VENUE**

8 7. The Commission brings this action pursuant to Sections 20(b) and 20(d) of the
 9 Securities Act of 1933 (“Securities Act”) [15 U.S.C. §§ 77t(b), 77t(d)] and Sections 21(d) and
 10 21(e) of the Securities Exchange Act of 1934 (“Exchange Act”) [15 U.S.C. §§ 78u(d), 78u(e)].

11 8. This Court has jurisdiction over this action pursuant to Section 22 of the
 12 Securities Act [15 U.S.C. § 77v] and Section 27 of the Exchange Act [15 U.S.C. § 78aa].

13 9. Defendant, directly or indirectly, made use of the means or instrumentalities of
 14 interstate commerce, or of the mails, or of the facilities of a national securities exchange in
 15 connection with the transactions, acts, practices and courses of business alleged herein.

16 10. Venue in the Northern District of California is proper pursuant to Section 22 of
 17 the Securities Act [15 U.S.C. § 77v] and Section 27 of the Exchange Act [15 U.S.C. § 78aa]
 18 because acts and transactions constituting the violations alleged in this Complaint occurred
 19 within the district, because the relevant offer or sale of securities took place in the district, and
 20 because the Defendant resides or transacts business in the district.

21 **INTRADISTRICT ASSIGNMENT**

22 11. Under Civil Local Rule 3-2, this civil action should be assigned to the San
 23 Francisco or Oakland Divisions, because a substantial part of the events or omissions which give
 24 rise to the claim occurred in the City and County of San Francisco.

25 **DEFENDANT**

26 12. **Diamond Foods, Inc.** (“Diamond”) is a Delaware corporation with its principal
 27 place of business in San Francisco, California. The company was founded as a walnut
 28 cooperative in 1912 and issued publicly-traded stock in 2005. During the time period of the

1 conduct alleged in this complaint, Diamond's stock was registered with the Commission
2 pursuant to Section 12(b) of the Exchange Act and was listed on NASDAQ.

3 **FACTUAL ALLEGATIONS**

4 **A. Background**

5 13. Diamond was originally formed in 1912 as a walnut grower cooperative. As a
6 cooperative, Diamond's principal business involved buying walnuts from California-based
7 growers, processing the walnuts, and reselling the walnuts through various channels to retailers.

8 14. Diamond converted from a walnut grower cooperative into a public corporation in
9 2005, issuing stock priced at \$17 per share through an initial public offering. Following this
10 initial stock offering, Diamond expanded into other snack food businesses through a series of
11 acquisitions, including the acquisition of businesses involved in the sale of microwave popcorn
12 and potato chips. By 2010, Diamond was becoming a large snack food conglomerate.

13 15. In 2010 and 2011, Diamond's walnut business, while no longer the sole focus,
14 still represented a significant part of its revenue, and the cost of acquiring walnuts was its largest
15 commodity cost. Any recorded increase in the walnut price Diamond paid to growers (also
16 referred to as the "walnut cost" or "final crop price") would decrease the company's reported
17 earnings, and would decrease the company's reported earnings per share ("EPS"). At the same
18 time, Diamond needed to pay a competitive walnut price in order to maintain longstanding
19 relationships with its growers and to avoid losing walnut supply to competitors.

20 16. During the time of the conduct alleged in this complaint, Diamond reported EPS
21 that consistently beat the forecasted expectations of Wall Street stock analysts. In this
22 timeframe, Diamond's stock price increased from approximately \$39 per share at the time of the
23 filing of SEC Form 10-Q for the second quarter of 2010 (filed on February 25, 2010) to
24 approximately \$90 per share after the filing of SEC Form 10-K for the 2011 fiscal year (filed on
25 September 15, 2011). Diamond registered two stock offerings during the relevant time period,
26 including (1) a successful \$181 million offering of Diamond stock priced at \$37 per share in
27 March 2010; and (2) a June 20, 2011 registration statement for an issuance of stock pursuant to
28 an agreement to acquire a potato chip business unit from a major snack food company.

B. Determining and Accounting for the Walnut Cost

17. Diamond was required to prepare financial statements in conformity with Generally Accepted Accounting Principles (“GAAP”), and disclosed in its SEC Forms 10-K annual reports filed with the Commission that its financial statements were prepared in conformity with GAAP. In its SEC Forms 10-K for fiscal years ended July 31, 2010 and July 31, 2011, Diamond disclosed the following accounting policy regarding the accounting for walnut crop payments:

We have entered into long-term Walnut Purchase Agreements with growers, under which they deliver their entire walnut crop to us during the Fall harvest season and we determine the minimum price for this inventory by March 31, or later, of the following calendar year. This purchase price will be a price determined by us in good faith, taking into account market conditions, crop size, quality, and nut varieties, among other relevant factors. Since the ultimate price to be paid will be determined subsequent to receiving the walnut crop, we must make an estimate of price for interim financial statements. Those estimates may subsequently change and the effect of the change could be significant.

18. GAAP required Diamond to record walnut inventory and any payables to growers at acquisition cost in the period in which the walnuts were purchased, and to recognize the cost of selling the walnut inventory in the period in which the walnuts were sold. Pursuant to GAAP, Diamond was required to record all payments used to acquire the 2009 crop in FY2010 (when the crop was purchased and mostly sold), and all payments used to acquire the 2010 crop in FY2011 (same). The “walnut cost” – i.e., the term that Diamond used to refer to the final price it paid growers for a given crop – had financial effects on several line items on Diamond’s financial statements, including value of inventory, payables to growers, and cost of goods sold.

19. During the relevant period, Diamond’s practice was to accept delivery of a walnut crop in the fall after the harvest, and then to determine the final walnut price it would pay to growers by fiscal year-end (i.e., July 31 of the next calendar year following the harvest). Because walnuts were being acquired and sold throughout the year and before the determination of the final crop price, Diamond recorded the costs of walnuts in its quarterly financial statements using a walnut cost estimate. According to the disclosed accounting policy, the walnut cost estimate was supposed to reflect the best estimate of the final walnut cost Diamond intended to pay its growers.

20. Diamond's contracts with its growers discussed the determination of the final crop price: "The Final Price will be determined in good faith, taking into account market conditions, quality, variety, and other relevant factors." Similar guidance appeared in Diamond's internal accounting controls, other accounting policies in effect during the relevant time period, and publicly-disclosed accounting policies contained in Diamond's SEC Forms 10-K and 10-Q. Pursuant to the contracts, Diamond issued a series of installment payments to growers, with the final payment accrued at fiscal year-end. These installment payments totaled the final crop price paid for the walnut crop acquired during that fiscal year.

21. At all relevant times, CFO Neil supervised both Diamond's finance and accounting team ("Finance Team"), and Diamond's team dealing with growers ("Grower Relations Team"). Diamond's Finance Team provided information to Diamond's independent outside auditors justifying the quarterly walnut cost accrual estimate and final walnut cost.

C. Understated Walnut Cost in Diamond's 2010 Financial Statements

22. As noted above, Diamond's critical accounting policy and contracts specified that the walnut cost would be determined in "good faith, taking into account market conditions, crop size, quality, and nut varieties, among other relevant factors." However, during the relevant time period Diamond did not maintain adequate internal accounting controls to reasonably ensure Diamond complied with this standard. In the absence of adequate controls governing the walnut cost, Diamond understated the recorded walnut cost in its financial statements in fiscal year 2010 by (1) improperly adjusting the walnut cost accrual estimates in certain quarters to hit EPS targets, and (2) improperly excluding a portion of the final walnut cost for the 2009 crop from fiscal year-end financial statements. As a result of the understated walnut cost, Diamond materially misstated its financial results from the second quarter of fiscal year 2010 through the fourth quarter of fiscal year 2010, and failed to keep and maintain accurate books and records.

1. Manipulation of the 2009 Walnut Cost to Meet EPS Targets

23. Diamond began understating its walnut cost, and thereby overstated earnings and EPS, in financial statements prepared for the second quarter of 2010 (ending January 31, 2010).

24. As of the quarter ending October 31, 2009, Diamond had received the 2009

1 walnut crop from growers and had recorded an average walnut cost of 82 cents per pound in
2 Diamond's financial statements based on the estimated walnut price of 82 cents.

3 25. In February 2010, Diamond CFO Neil instructed members of the Finance Team to
4 adjust the walnut cost to hit an EPS target for the second quarter. Members of the Finance Team
5 provided Neil with a walnut cost estimate that would result in reported EPS that would be higher
6 than the consensus analyst estimates of \$0.47 per share for the quarter. Based on these
7 calculations, Neil reduced the existing walnut cost estimate of 82 cents per pound by 10 cents per
8 pound, to 72 cents per pound. Diamond's quarterly financial statements for the second quarter of
9 2010, as well as its books and records, accounted for the walnut cost at the adjusted estimate of
10 72 cents per pound.

11 26. On or about February 25, 2010, Diamond filed an SEC Form 10-Q with the
12 Commission that included the second quarter 2010 financial statements. The same day,
13 Diamond filed an SEC Form 8-K reporting EPS of \$0.48, beating consensus analyst estimates.
14 A week later, on March 1, 2010, Diamond filed an SEC Form 424B5 prospectus related to a
15 proposed stock sale to pay a portion of the acquisition costs associated with Diamond's recent
16 acquisition of a snack food company, and the prospectus incorporated the Form 10-Q for second
17 quarter of 2010. This offering closed on March 8, 2010, and Diamond raised approximately
18 \$181 million.

19 27. On March 10, 2010, Diamond filed an SEC Form 8-K, which attached an investor
20 presentation touting Diamond's EPS record of "Twelve Consecutive Quarters of
21 Outperformance" from Q3 2007 through Q2 2010.

22 2. Extraordinary "Continuity" Payment Excluded from the 2009 Walnut Cost

23 28. In March 2010, Neil and others at Diamond began determining the final crop
24 price and final payment for the 2009 crop (which related to fiscal year 2010, ended July 31,
25 2010). At the time, Diamond's practice was to issue an individualized statement to each grower
26 projecting a "final minimum price," a number meant to communicate the guaranteed lowest price
27 that the grower would receive for the 2009 crop. The estimated "final minimum price" was on
28 average 71 cents per pound (further reduced from the Q2 2010 estimate of 72 cents per pound).

1 29. Neil was aware that growers were dissatisfied with Diamond's estimated "final
2 minimum price" of 71 cents per pound, and that other walnut handlers who purchased walnuts
3 from growers for resale were paying approximately 87 cents per pound. Neil was informed by
4 his Grower Relations Team that walnut growers expected Diamond to pay walnut prices that
5 were within five to seven cents per pound of what other handlers were paying for the 2009 crop.
6 Neil instructed the Grower Relations Team to tell growers that Diamond would "close the gap"
7 with other handlers' prices through its final payment.

8 30. From March 2010 through July 2010, Neil and others at Diamond discussed an
9 extraordinary payment to walnut growers that they termed a "continuity" payment. During these
10 discussions, Neil proposed excluding the "continuity" payment from costs recorded in
11 Diamond's financial statements for fiscal year 2010. However, Neil knew, or was reckless in not
12 knowing, that the payment should be treated as a cost of acquiring the 2009 crop and thus
13 recognized in fiscal year 2010. Ultimately, Neil caused Diamond to record the final walnut cost
14 for the 2009 crop using an average cost of 71 cents per pound, and excluded the "continuity"
15 payment (equal to \$20 million, or approximately 10 cents per pound) from the recorded walnut
16 cost at the end of fiscal year 2010 (July 31, 2010) in its financial statements for fiscal year 2010,
17 and its books and records.

18 31. In justifying the unusual accounting treatment for the "continuity" payment, Neil
19 instructed his Finance Team that the payment was an "advance" for the crop to be delivered in
20 the fall of 2010. Neil knew, however, that some growers believed that the payment was part of
21 the payment for the already-delivered 2009 crop. During visits to certain growers in July 2010,
22 Neil and others at Diamond assured the growers that they would receive a competitive price for
23 the 2009 crop and discussed specific final prices that were higher than Diamond's communicated
24 "final minimum price" of 71 cents per pound. Neil also knew that the "continuity" payment,
25 when added to the crop price for the 2009 crop, brought growers within competitive range of
26 market prices.

27 32. In August 2010, Neil authorized the Grower Relations Team to issue the
28 "continuity" payment together with the final grower payment in one check and accompanied by

1 one statement. The statement sent to growers accompanying the single check was titled, "Final
2 Payment 2009 Crop." The additional payment amount was approximately 10 cents per pound
3 above the final minimum price of 71 cents per pound already communicated to growers, but
4 appeared as a lump sum payment for the 2009 crop. Neil also approved and reviewed a letter to
5 growers that accompanied the final payment and "continuity" payment. This letter did not
6 explain the purpose of the "continuity" payment, did not separate the amount of the payment that
7 constituted a "continuity" payment, and did not identify the payment as an advance payment for
8 the 2010 crop.

9 33. Though Neil instructed his Finance Team to account for the "continuity" payment
10 as an advance on the 2010 crop, and told Diamond's independent auditors that the payment was
11 an advance to growers for the next year's deliveries, Neil did not instruct the Grower Relations
12 Team to issue the payment to only those growers that were under contract or otherwise expected
13 to deliver the 2010 crop. As a result, Diamond issued over \$400,000 in "continuity" payment
14 amounts to growers who delivered a 2009 crop but were not under contract to deliver the 2010
15 crop, and another \$450,000 in "continuity" payments to growers who delivered a 2009 crop but
16 did not ultimately deliver the 2010 crop.

17 34. Growers generally understood the "continuity" payment to be a 2009 payment.
18 The payment, if considered in conjunction with the previous installments and final payments,
19 would have totaled 82 cents per pound as the final walnut cost for the 2009 crop. The 82 cents
20 per pound would have brought Diamond closer to the walnut prices paid by other handlers for
21 the 2009 crop (approximately 87 cents per pound) and in some cases, what Diamond had
22 promised growers for the 2009 crop.

23 35. Diamond filed its SEC Form 10-K for the year ended July 31, 2010, on October 5,
24 2010. As a result of the walnut cost understatement, the Form 10-K reported EPS of \$1.91,
25 above consensus analyst expectations between \$1.84 and \$1.88. That same day, Diamond filed
26 an SEC Form 8-K attaching an earnings release, which touted its 52% growth in earnings during
27 fiscal year 2010 and raised its EPS guidance for fiscal year 2011.

28

C. Understated Walnut Cost in Diamond's 2011 Financial Statements

36. In fiscal year 2011, Diamond still lacked adequate internal controls governing the walnut cost, grower payments, and financial reporting. Diamond continued to understate the recorded walnut cost, and thereby overstated earnings and EPS, in its financial statements in fiscal year 2011, by (1) manipulating the walnut cost accruals in certain quarters to hit EPS targets, and (2) improperly excluding a portion of the final walnut cost for the 2010 crop from fiscal year-end financial statements. As a result of the understated walnut cost, Diamond materially misstated its financial results from the first quarter of fiscal year 2011 through the fourth quarter of fiscal year 2011, and similarly falsified its books and records.

1. Manipulation of Walnut Cost for the 2010 Crop to Meet EPS Targets

37. During fiscal year 2011, Neil continued to manipulate costs of acquiring the 2010 walnut crop to meet EPS targets. As a result of Neil's walnut cost adjustments, Diamond reported EPS that met or exceeded consensus analyst expectations for every quarter in 2011. In addition, Diamond continued to file SEC Forms 8-K with earnings releases touting its earnings and EPS record throughout 2011.

38. Diamond's stock price was central to its proposed acquisition of a major potato chip business unit in the spring of 2011. According to registration documents filed with the Commission, Diamond agreed, pursuant to the agreement between Diamond and the potato chip unit's parent, to issue 29 million shares of its stock to the parent company. The agreement also included a payment of \$850 million to the parent of the potato chip business unit, with a provision that Diamond would pay additional amounts if its stock dropped below a certain price.

2. Extraordinary "Momentum" Payment Excluded from Walnut Cost for the 2010 Crop

39. In the spring of 2011, Neil and others at Diamond began considering the final crop price for the 2010 crop. Neil was aware that other walnut handlers had paid other growers approximately \$1.00 to \$1.20 per pound for the 2010 crop. He also knew that Diamond's growers were concerned about Diamond's small first installment payments for the 2010 crop, which were an average of only 57 cents per pound. Neil assured the Grower Relations Team that

1 Diamond was on track to pay a competitive price close to \$1.00 per pound for the 2010 crop.

2 40. In the summer of 2011, Neil and others at Diamond began determining the final
3 payment and final price for the 2010 crop. Neil decided to issue a final payment of
4 approximately eight cents per pound, and an extraordinary and unusual payment, termed the
5 “momentum” payment, of 30 cents per pound. At fiscal year-end for 2011 (July 31, 2011),
6 Diamond recorded the final walnut cost for the 2010 crop as 74 cents per pound. Diamond did
7 not record the “momentum” payment as part of the costs of acquiring the 2010 crop in FY2011
8 in its financial statements for fiscal year 2011 or books and records. Rather, the Finance Team
9 treated the “momentum” payment as advance for the crop to be delivered in the fall of 2011.

10 41. Neil knew that the final price for the 2010 crop, not including the “momentum”
11 payment, was approximately 40 cents per pound below prices being paid by other handlers for
12 the walnut crop that year. This gap would have been unusual and unprecedented. At least some
13 growers were told by Diamond personnel that the purpose of the “momentum” payment was to
14 “make up” for the low final payment made only a few days earlier.

15 42. The “momentum” payment was issued to all growers who delivered walnuts to
16 Diamond for the 2010 crop approximately two days after the final payment for the 2010 crop.
17 The grower letter accompanying the final crop payment and the “momentum” payments did not
18 identify the “momentum” payment as an advance for the 2011 crop. The amount of the
19 “momentum” payment for each grower was calculated using the pounds of walnuts that they had
20 delivered for the 2010 crop.

21 43. By failing to limit the “momentum” payment to growers that were under contract
22 or otherwise expected to deliver a 2011 crop, Diamond issued more than \$3 million in
23 “momentum” payments to growers who delivered a 2010 crop but were not under contract to
24 deliver a 2011 crop, and another \$5.8. million in “momentum” payments to growers who
25 delivered a 2010 crop but did not ultimately deliver the 2011 crop.

26 44. Diamond filed its SEC Form 10-K for the year ended July 31, 2011 on September
27 15, 2011. As a result of the walnut cost understatement, the Form 10-K reported EPS of \$2.61,
28 above consensus analyst expectations of \$2.49. That same day, Diamond filed an SEC Form 8-K

1 attaching an earnings release, which touted its 37% increase in EPS during fiscal year 2011.

2 **D. Diamond Restates its Financial Statements to Correct Walnut Costs**

3 45. On November 1, 2011, Diamond filed with the Commission an SEC Form 8-K,
4 disclosing that the Audit Committee of the Board of Directors would be initiating an internal
5 investigation with respect to walnut crop payments.

6 46. On February 8, 2012, Diamond filed with the Commission an SEC Form 8-K,
7 disclosing that the Audit Committee of the Board of Directors determined that the company's
8 financial statements for fiscal years 2010 and 2011 did not correctly account for certain
9 extraordinary walnut payments and would need to be restated. The Form 8-K announced that the
10 company's CEO and its CFO Neil had been placed on administrative leave.

11 47. On November 14, 2012, Diamond filed with the Commission an SEC Form
12 10-K/A, which included restated financial results for fiscal years 2010 and 2011. The restated
13 financial results reported the extraordinary walnut payments as a prior period walnut cost,
14 thereby increasing cost of goods sold, value of inventory, and payables to growers in fiscal years
15 2010 and 2011. By improperly excluding the true cost paid related to walnut acquisitions,
16 Diamond's original financial statements materially misstated its financial results in multiple SEC
17 Forms 10-Q, 10-K, 8-K, and S-4 starting in at least February 2010 and ending in September
18 2011, as listed below:

- 19 a. SEC Form 10-Q for Q2 FY2010 (filed 2/25/10);
- 20 b. SEC Form 8-K and attachments thereto (2/25/10);
- 21 c. SEC Form 424B5 prospectus (filed 3/1/10);
- 22 d. SEC Form 10-Q for Q3 FY2010 (filed 5/27/10);
- 23 e. SEC Form 8-K and attachments thereto (filed 5/27/10);
- 24 f. SEC Form 10-K for FY2010 (filed 10/5/10);
- 25 g. SEC Form 8-K and attachments thereto (filed 10/5/10);
- 26 h. SEC Form 10-Q for Q1 FY2011 (filed 12/8/10);
- 27 i. SEC Form 8-K and attachments thereto (filed 12/8/10);
- 28 j. SEC Form 10-Q for Q2 FY2011 (filed 3/8/11);

- k. SEC Form 8-K and attachments thereto (filed 3/8/11);
- l. SEC Form 10-Q for Q3 FY2011 (filed 6/2/11);
- m. SEC Form 8-K and attachments thereto (filed 6/2/11);
- n. SEC Form S-4 (filed 6/20/11), with amendments filed on 8/4/11 and 9/16/11;
- o. SEC Form 10-K for FY2011 (filed 9/15/11); and
- p. SEC Form 8-K and attachments thereto (filed 9/15/11).

Diamond's stock price dropped to \$17 per share after the filing of the restatement in November 2012 from its high of approximately \$90 per share after the filing of its SEC Form 10-K for fiscal year 2011 in September 2011.

48. From at least February 25, 2010 through September 15, 2011, Diamond understated the reported walnut cost in its financial statements for the purpose of improving EPS. As a result of the understatement of the walnut cost, Diamond met or exceeded analyst expectations on EPS every quarter during the relevant timeframe. Diamond acted with scienter in issuing materially false and misleading financial statements, earnings releases, and other documents filed with the Commission because Neil, in his capacity as Diamond's CFO, knew or was reckless in not knowing that the statements contained in these documents were false.

49. Diamond's financial statements prepared for each quarter and each year-end during the relevant time frame understated the walnut costs, and overstated earnings, by a material amount, and the accurate reporting of the costs and earnings, including EPS, would have been material to a reasonable investor. Diamond's reported EPS for the fiscal year 2010 was overstated by more than 65 percent, and Diamond's reported EPS for the fiscal year 2011 was overstated by more than 89 percent.

50. Diamond failed to devise and maintain an adequate system of internal controls to ensure the accuracy of its books and records. Among other things, Diamond did not implement any policies to ensure the accuracy of the reported walnut cost, the accounting for walnut payments, and the manner in which the walnut cost was incorporated into the financial statements. The controls and policies in place were insufficient to prevent the manipulation of

1 walnut costs to meet EPS targets or the delayed recognition of walnut costs in incorrect fiscal
2 periods. The absence of adequate internal controls enabled Neil to falsify Diamond's books and
3 records regarding its walnut cost, earnings, EPS, and other financial information.

4 **FIRST CLAIM FOR RELIEF**

5 **Violations of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5**

6 51. Paragraphs 1 through 50 are re-alleged and incorporated herein by reference.

7 52. By engaging in the conduct described above, Diamond, directly or indirectly, in
8 connection with the purchase or sale of securities, by the use of means or instrumentalities of
9 interstate commerce, or the mails, with scienter:

10 (a) Employed devices, schemes, or artifices to defraud;

11 (b) Made untrue statements of material facts or omitted to state material facts
12 necessary in order to make the statements made, in the light of the circumstances
13 under which they were made, not misleading; and

14 (c) Engaged in acts, practices, or courses of business which operated or would
15 operate as a fraud or deceit upon other persons, including purchasers and sellers
16 of securities.

17 53. By reason of the foregoing, Diamond has violated and, unless restrained and
18 enjoined, will continue to violate Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and
19 Rule 10b-5 [17 C.F.R. § 240.10b-5].

20 **SECOND CLAIM FOR RELIEF**

21 **Violations of Sections 17(a)(1), (2), and (3) of the Securities Act**

22 54. Paragraphs 1 through 50 are re-alleged and incorporated herein by reference.

23 55. By engaging in the conduct described above, Diamond directly or indirectly, in
24 the offer or sale of securities, by use of the means or instruments of transportation or
25 communication in interstate commerce or by use of the mails,

26 (1) with scienter, employed devices, schemes, or artifices to defraud;

27 (2) obtained money or property by means of untrue statements of material fact or by
28 omitting to state a material fact necessary in order to make the statements made,

1 in light of the circumstances under which they were made, not misleading; and
2 (3) engaged in transactions, practices, or courses of business which operated or would
3 operate as a fraud or deceit upon purchasers.

4 56. By reason of the foregoing, Diamond violated and, unless restrained and enjoined,
5 will continue to violate Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)].

6 **THIRD CLAIM FOR RELIEF**

7 **Violations of Section 13(a) of the Exchange Act**

8 **and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13**

9 57. Paragraphs 1 through 50 are re-alleged and incorporated herein by reference.

10 58. Based on the conduct alleged above, Diamond violated Section 13(a) of the
11 Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder [17
12 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, 240.13a-13], which obligate issuers of securities
13 registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to file with the
14 Commission periodic reports, including annual reports, with information that is accurate and not
15 misleading, and unless restrained and enjoined, will continue to violate such provisions.

16 **FOURTH CLAIM FOR RELIEF**

17 **Violations of Section 13(b)(2)(A) of the Exchange Act**

18 59. Paragraphs 1 through 50 are re-alleged and incorporated herein by reference.

19 60. Based on the conduct alleged above, Diamond violated Section 13(b)(2)(A) of the
20 Exchange Act [15 U.S.C. § 78m(b)(2)(A)], which obligates issuers of securities registered
21 pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to make and keep books, records,
22 and accounts which, in reasonable detail, accurately and fairly reflect the transactions and
23 dispositions of the assets of the issuer, and unless restrained and enjoined, will continue to
24 violate these provisions.

25 **FIFTH CLAIM FOR RELIEF**

26 **Violations of Section 13(b)(2)(B) of the Exchange Act**

27 61. Paragraphs 1 through 50 are re-alleged and incorporated herein by reference.

28 62. Based on the conduct alleged above, Diamond violated Section 13(b)(2)(B) of the

1 Exchange Act [15 U.S.C. § 78m(b)(2)(B)], which obligates issuers of securities registered
2 pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to devise and maintain a sufficient
3 system of internal accounting controls, and unless restrained and enjoined, will continue to
4 violate such provisions.

5 **PRAYER FOR RELIEF**

6 WHEREFORE, the Commission respectfully requests that this Court:

7 **I.**

8 Permanently enjoin Defendant from directly or indirectly violating the applicable
9 provisions and rules of the Federal securities laws as alleged and asserted above.

10 **II.**

11 Order Defendant to pay civil penalties pursuant to Section 20(d) of the Securities Act [15
12 U.S.C. § 77t(d)] and Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)].

13 **V.**

14 Retain jurisdiction of this action in accordance with the principles of equity and the
15 Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and
16 decrees that may be entered, or to entertain any suitable application or motion for additional
17 relief within the jurisdiction of this Court.

18 **VI.**

19 Grant such other and further relief as this Court may determine to be just and necessary.

20 Dated: January 9, 2014

Respectfully submitted,

21
22 /s/ Jennifer J. Lee
23 JENNIFER J. LEE
24 Attorneys for Plaintiff
25 SECURITIES AND EXCHANGE COMMISSION
26
27
28

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933

Release No. 9646 / September 11, 2014

SECURITIES EXCHANGE ACT OF 1934

Release No. 73076 / September 11, 2014

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 3582 / September 11, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16098

In the Matter of

Wilmington Trust Corporation,

Respondent.

**ORDER INSTITUTING CEASE-AND-DESIST
PROCEEDINGS PURSUANT TO SECTION
8A OF THE SECURITIES ACT OF 1933 AND
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING REMEDIAL
SANCTIONS AND A CEASE-AND-DESIST
ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Wilmington Trust Corporation ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of

the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds¹ that

SUMMARY

These proceedings arise out of false and misleading disclosures by Wilmington Trust Corporation (“Wilmington Trust” or the “Bank”) concerning its accruing loans past due 90 days or more over multiple quarters during 2009 and 2010, its nonaccruing loans in the third quarter of 2009, and its reserves for loan losses in the third and fourth quarters of 2009. Wilmington Trust was the public holding company for Wilmington Trust Company, a retail and commercial bank headquartered in Wilmington, Delaware. By mid-2009, many of the construction projects underlying the Bank’s loans stalled or failed to sell or lease when completed. At the same time, an increasing number of the Bank’s loans to these projects “matured,” *i.e.*, the loan’s term expired without being extended, modified or paid off, such that the principal balance of the loan was contractually due.

The Bank had deficient underwriting and loan monitoring controls and failed, for these and other reasons, to take appropriate action on many of its matured loans for protracted periods of time. As a result, the Bank had a large volume of loans that were past due, for reasons of maturity, 90 days or more. Generally Accepted Accounting Principles (“GAAP”) requires that banks disclose loans that are past due 90 days or more and still accruing,² and Regulation S-K (through SEC Industry Guide 3) further indicates that banks should disclose their “accruing loans which are contractually past due 90 days or more as to principal or interest payments.”³ However, rather than disclose as past due loans that were matured (but purportedly “current for interest”), the Bank negligently and routinely omitted such loans from its disclosures of past due loans, based on unwritten, informal criteria that were loosely applied and liberally adjusted.

¹ The findings herein are made pursuant to Respondent’s Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² See Accounting Standards Codification (“ASC”) 310-10-50-7(b). References to GAAP in this Order are to standards in effect at the time of the misconduct. In July 2009, the Financial Accounting Standards Board promulgated its “Accounting Standards Codification,” effective for fiscal quarters ending after September 15, 2009, which changed the applicable citation standards but not the substantive GAAP requirements.

³ 17 C.F.R. § 229.303; SEC Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, 57 F.R. 36442.

As a result, the Bank omitted almost \$339 million in matured loans past due 90 days or more from its disclosures in its filings with the Commission for the third quarter of 2009. The Bank further omitted over \$330 million in matured loans past due 90 days or more from its disclosures in its filings for the year ended 2009, including its Form 10-K. The Bank then incorporated its false and misleading Form 10-K for 2009 by reference into the offering materials for a February 2010 public offering in which the Bank sold \$287 million of its common stock.

At the end of 2009, amidst increasing regulatory scrutiny, the Bank decided to address its misreporting of past due loans beginning in 2010; however, the Bank negligently implemented various practices that had the effect of avoiding full disclosure of the problems with matured loans in its portfolio. These practices included an “extension push” to extend the maturity dates of matured and maturing loans. This resulted in multiple short-term extensions for a high volume of loans even when the Bank did not have updated financial and collateral information for the loans, had not performed appropriate analysis for re-underwriting, or was engaged in difficult negotiations with borrowers concerning their matured loans. Wilmington Trust also failed to disclose in its Form 10-K, as required by Regulation S-K, that its matured, maturing and short-term extended commercial loan portfolio represented a material, but unquantified, risk to the stability of the Bank.

Despite modifications to its past due reporting practices in the first and second quarters of 2010, the Bank negligently continued to omit significant volumes of matured past due loans from its disclosures, repeated its false disclosures from prior periods, and made misleading supplemental disclosures concerning the Bank’s past due reporting and matured loan extension practices.

Finally, in its Form 10-Q for the third quarter of 2009 and its Form 10-K for 2009, the Bank also negligently failed, as required by GAAP, to properly disclose significant increases in the Bank’s nonaccruing loans according to its policy, and to properly account for updated collateral values and significant declines in commercial loan risk ratings in its loan loss provisions and reserves.

RESPONDENT

1. Wilmington Trust was, during the relevant period, a bank holding company based in Wilmington, Delaware and incorporated under the laws of the State of Delaware. Its securities were registered with the Commission pursuant to Section 12(b) of the Exchange Act, and its common stock traded on the New York Stock Exchange under the symbol “WL.” On May 16, 2011, Wilmington Trust was acquired by M&T Bank Corporation (“M&T”) in a stock-for-stock transaction, and Wilmington Trust’s securities were removed from registration. Wilmington Trust survives as a subsidiary of M&T.

OTHER RELEVANT ENTITY

2. M&T is a bank holding company headquartered in Buffalo, New York. On May 16, 2011, M&T acquired Wilmington Trust in a stock-for-stock transaction. M&T is the

successor-in-interest to Wilmington Trust. M&T did not commit any of the misconduct that is the subject of this Order, all of which preceded M&T's acquisition of Wilmington Trust.

FACTS

Past Due Loan Disclosure Guidelines

3. Under GAAP, banks are required to disclose their past due loans. Accounting Standards Codification ("ASC") Topic 310-10-50 stipulates certain disclosure requirements for loans. Specifically, ASC 310-10-50-7(b) requires disclosure of a bank's recorded investment in loans "past due 90 days or more and still accruing."⁴

4. Regulation S-K of the Securities Act, Item 303(a), requires the Management Discussion and Analysis ("MD&A") sections of an issuer's annual filings to disclose any "information that the registrant believes to be necessary to an understanding of its financial condition [or] changes in its financial condition." Item 303(b) requires quarterly filings to discuss material changes in information described in Item 303(a).⁵ Instruction 13 to Item 303(a) directs bank holding companies to the information called for by SEC Industry Guide 3 ("Guide 3"), which is a policy of the Division of Corporation Finance; the Commission has not adopted the Guide as a rule.⁶ Among other statistical disclosures, Item III.C.1 of Guide 3 specifies disclosure of "accruing loans which are contractually past due 90 days or more as to principal or interest payments."

Background to the Bank's Past Due Loans Disclosure Violations

5. From at least 2006 through the third quarter of 2009, the Bank routinely removed, or, using the Bank's terminology, "waived" loans from certain internal reports and from its public disclosures of accruing loans past due 90 days or more if the loan was matured, current for interest and either 1) a loan managed by the Bank's Loan Recovery (*i.e.*, workout) unit; or 2) a loan that the Bank claimed its loan officers were "working on" extending. The matured workout loans were waived automatically, with no further requirements; for a non-workout loan, the loan officer was asked summarily to confirm that he or she was "working on" an extension and the loan was then waived. No documents or actual progress toward an extension were required and, in practice, loan officers could simply note that the loan was matured, current for interest and should be waived. The Bank did not have written policies or procedures governing its past due reporting process or its waiver practices.

6. On the Bank's internal "Delinquency Report," showing past due loans, the Bank's credit department indicated past due loans that would be waived. The Bank's finance department

⁴ This standard was preceded by AICPA SOP 01-06 ¶13(g), which is substantively identical.

⁵ 17 C.F.R. § 229.303.

⁶ SEC Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, 57 F.R. 36442.

then removed the indicated loans from a second internal report, the “Past Due and Nonperforming Loans Report.” This report was then incorporated in the Bank’s “accruing loans past due 90 days or more” table disclosure in its SEC filings. The summary past due loan amount also was disclosed in the notes to the financial statements in the Bank’s Form 10-K annual reports.

7. Equities and credit ratings analysts viewed loans 90 days or more past due as nonperforming, even if the Bank maintained them as unimpaired loans. High levels of past due loans were interpreted by the market as a signal of probable increased credit deterioration.

8. As early as August 2007, the Bank recognized that it had a mounting problem with matured loans that it needed to resolve. As the real estate market softened, the Bank was concerned by the growing volume of waived matured loans and about potential scrutiny from auditors, examiners and others concerning the waivers. However, even where loan officers had not taken meaningful steps toward extension, the Bank still waived such loans and omitted them from its public reporting.

9. As the real estate market continued to decline, more loans began to mature without repayment or completion of the underlying projects. Updated appraisals and financial statements required for re-underwritten extensions were also revealing significant deterioration. Borrowers balked at providing updated information and at the more onerous terms required by re-underwritten extensions. Some loan officers, particularly those managing the Bank’s Delaware Commercial Real Estate (“CRE”) portfolio, were reluctant to pursue the required documents to support re-underwritten extensions because of concerns that the underwriting analysis and new terms would lead to borrower nonperformance and loan downgrades. Loan officers voiced their concerns about this, and their related inability to properly underwrite loan extensions. The Bank was aware that the volume of matured loans it claimed was “in the process of extension” rose significantly through 2008 and into 2009.

10. The Bank purported to comply with GAAP and the disclosures required by Regulation S-K and called for by Industry Guide 3, but failed to do so accurately and completely. In all relevant filings, the Bank included in its MD&A section concerning credit risk a table disclosing its purported volume of accruing loans past due 90 days or more and supplemental disclosures describing them. It also disclosed the purported volume of accruing past due loans in the notes to the financial statements in its Form 10-Ks. In each period the Bank also claimed in its filings that it mitigated credit risk by employing “rigorous loan underwriting standards,” disciplined monitoring of its loan portfolio, and regular “review [of] all past due loans.”

Understated Past Due Loans Disclosures in the Third Quarter of 2009

11. On or about October 7, 2009, the Bank waived \$338.9 million in matured, interest current loan balances that were accruing but past due 90 days or more from the Bank’s Delinquency Report, and subsequently removed the waived loans from the Bank’s Past Due and Nonperforming Loans Report. On October 23, 2009, the Bank released its earnings and filed its Form 8-K, which incorporated the past due numbers from the Past Due and Nonperforming Loans

Report, omitted the \$338.9 million in matured loans, and disclosed only \$38.7 million in accruing loans past due 90 days or more.

12. During the third quarter of 2009 and prior to the filing of the Bank's Form 10-Q, certain senior managers voiced their concerns to senior officers about the growing number of matured loans that the Bank was claiming were "in the process of extension" but had not, in reality, been extended for protracted periods of time. Certain Bank personnel were concerned about the possibility of scrutiny from the Bank's auditors and bank examiners relating to its treatment of matured loans.

13. Concerns around matured and waived loans became heightened in late October 2009, after the Bank entered into an agreement with the Federal Reserve Bank of Philadelphia ("FRB") that required Bank management to provide enhanced reporting to the FRB of loans "past due as to principal or interest more than 90 days." In response, prior to the filing of the third quarter Form 10-Q, the Bank initiated several steps, discussed below, to begin phasing out its waiving of matured loans, and to attempt to extend some of these loans by year end.

14. Nevertheless, the Bank filed its Form 10-Q on November 9, 2009, again disclosing only the \$38.7 million in accruing past due loans and improperly omitting the \$338.9 million that had been waived. The supplemental disclosures did not provide any information about the Bank's matured or waived loans.

Understated Past Due Loans Disclosures and Extension Push in the Fourth Quarter and Year End 2009

15. In the fourth quarter, the Bank decided to continue to waive matured loans if an extension was "internally approved." The new criteria purported not to allow a non-workout loan to be waived where an extension was just being "worked on," as had sufficed in earlier quarters. Accordingly, a matured past due loan would be waived from the noted internal reports and omitted from public filings if the Bank had approved a lending officer's proposal to extend the loan, regardless of whether the loan had actually been extended by the borrower. The Bank continued the automatic waiver of matured, current for interest workout loans.

16. The Bank initiated an abbreviated extension process to facilitate the "internal approval" of short-term extensions of matured loans by year end. In combination with the amended waiver practice, this allowed loans for which the Bank lacked updated appraisals or financial documentation or was still negotiating terms with the borrower either to be extended temporarily or "internally approved" and waived so that they would not be reported as past due. The Bank was aware that executing long-term extensions would be difficult particularly for its Delaware CRE loans, because poor market conditions meant the Bank needed borrowers to pay down principal or increased interest rates as a part of long-term loan modifications. Certain of the Bank's senior officers and managers were informed that these borrowers were in distressed situations that could not be quickly remedied, and they recognized that the failure to accomplish long-term modifications could result in the Bank and its "shareholders get[ting] the crap knocked out of us by analysts and regulators."

17. In early January 2010, the Bank prepared a Delinquency Report indicating that \$330.2 million in matured loans 90 days or more past due would be waived; of this amount, \$177.3 million was more than 180 days past due. Accordingly, prior to releasing its earnings, the Bank was aware that the \$330.2 million in waived past due loans would be omitted from the Bank's public disclosures. A Bank manager raised concerns that the waived loans would be "a disclosure issue" for the Bank's public reporting. The Bank knew that many of the waived loans would require significant structural modifications if they were to be extended, and that the waived loans required thorough analysis and new maturity dates commensurate with the level of risk posed by the loan. The Bank also knew that it did not expect to be complete this process until the second quarter of 2010. The Bank was aware that it had an additional \$432 million in loans that would mature in the first quarter of 2010 that would also require the same process if they were to be extended.

18. Nevertheless, the Bank released its earnings and Form 8-K on January 29, 2010, disclosing only \$30.6 million in accruing loans past due 90 days or more and omitting the \$330.2 million in matured past due loans. The Bank's Form 10-K for 2009, which was filed on February 22, 2010, again disclosed only \$30.6 million accruing loans past due 90 days or more in both the footnotes to the financial statements and in the MD&A. Neither the earnings release nor the Form 10-K disclosed the Bank's problems with its matured, maturing and temporarily extended loan portfolio.

19. In mid-January 2010, shortly before releasing its earnings, the Bank decided to attempt to raise additional capital. On February 22, 2010, the Bank announced its common stock offering; the false and misleading Form 10-K was incorporated by reference in the final Prospectus Supplement, which was filed on February 25, 2010. In the offering, which closed on March 2, 2010, the Bank sold \$287 million in common stock, netting \$274 million after costs and commissions.

Understated Past Due Loans Disclosures and Extension Push in the First Quarter of 2010

20. In the first quarter of 2010, the Bank continued to phase out the waiver practice by determining that an "internal approval" of a loan extension would no longer suffice to waive matured loans from certain of the Bank's internal reports and its public past due reporting; rather, in order to be waived, a valid extension document had to be signed by the Borrower and received by the Bank. However, the Bank decided that matured workout loans would still be waived automatically and, as a result, excluded from the Bank's public disclosures of accruing loans past due 90 days or more.

21. The Bank had uncovered significant issues in ongoing reviews of matured and maturing loans that were resulting in the Bank's continued inability to fully analyze and appropriately re-underwrite those loans. Bank staff recommended that such loans be eligible for yet additional short-term extensions on an expedited basis without full underwriting analysis.

22. As described above, a large number of Delaware CRE loans had been waived from past due reporting at the end of the fourth quarter of 2009 on the basis that the Bank had “internally approved” extension proposals; however, many of these loans were not actually extended – *i.e.*, there was no extension agreement executed between the Bank and the borrower – for most of the first quarter. In the last two days of the first quarter of 2010, the Bank “internally approved” new extension proposals for at least 117 of these loans, because the Bank needed yet more time to do appropriate analysis and gather documentation to re-underwrite the loans. The majority of these extension proposals contemplated short-term extensions of loans that had been waived from past due reporting in multiple prior quarters; some of the loans had been matured for over a year.

23. Notwithstanding the Bank’s expedited extension practices, at quarter end, a significant volume of matured loans remained. Despite its purported use of stricter waiver criteria, the Bank subsequently waived at least \$48.1 million of these matured loans past due 90 days or more from certain of its internal reports. The Bank’s press release reporting earnings and Form 8-K (filed on April 23, 2010) and its Form 10-Q (filed on May 10, 2010) both omitted the \$48.1 million in waived loans and disclosed only \$39.7 million in accruing loans past due 90 days or more.

24. The Bank’s public filings for the first quarter also presented the materially understated accruing past due loan amounts previously reported for the fourth quarter of 2009 (and other periods) for comparison, and did not disclose that the current period’s past due loans were based on materially different criteria than in prior periods. The earnings press release and Form 10-Q noted an increase in past due loans and stated that the increase was due to matured loans for which “underwriting extensions” were in progress. However, there was no disclosure to inform investors of the Bank’s significant, ongoing problems with its matured and short-term extended loans. This information would have been important to investors to know, because without it they could not understand the true condition of the Bank’s loan portfolio.

Understated Past Due Loans Disclosures in the Second Quarter of 2010

25. The Bank continued to adjust its criteria for waiving loans and, after the second quarter of 2010, decided that matured, interest current workout loans should no longer be waived. In effect, by this point, the Bank had changed its practices such that all matured loans that were actually past due at the end of the quarter were to be reported as past due.

26. Before the Bank filed its current and quarterly reports for the second quarter of 2010, the Bank was aware that the market was interested in banks’ loan extension and restructuring practices, including the practice of extending loans multiple times. The Bank was aware that a large volume of both its matured loans that were reported as past due as well as loans that were current had not been fully analyzed or appropriately re-underwritten, but had been waived or extended multiple times.

27. Nevertheless, the Bank’s disclosures of accruing loans past due 90 days or more in its press release reporting its earnings and its Form 8-K (filed on July 23, 2010) and again in its Form 10-Q (filed on August 5, 2010), omitted \$24 million in matured past due loans that had

extensions that were executed after the close of the quarter. The filings also presented the materially understated accruing past due loan amounts previously reported for the fourth quarter of 2009 (and other periods) for comparison. There were no disclosures about the high volumes of multiple extensions without re-underwriting or waivers the Bank had granted.

28. Although the Bank was aware of the effect of its changed waiver practices (*i.e.*, the phasing out of matured loan waivers) on the past due loan disclosures over time, the Bank did not disclose the changes in its practices and made no effort to analyze the impact the changed practices would have had in prior periods. In addition, during the second quarter conference call, the Bank's statements concerning its past due reporting were misleading and the Bank also omitted information necessary to make the statements not misleading. The Bank's statements and omissions, considered together, were materially misleading because they obscured the true condition of the Bank's credit portfolio.

Understated Nonaccruing Loans Disclosures in Form 10-Q for the Third Quarter of 2009

29. According to the Bank's nonaccrual policy, loans that were rated "substandard-accruing" and also had interest payments being paid by an interest reserve or a second loan to the same borrower were to be classified as nonaccruing (and therefore impaired according to the Bank's application of ASC 310). In early October 2009, after the end of the third quarter, a senior Bank manager responsible for nonaccrual recommendations identified three construction projects that had loans that fit these criteria as of the third quarter of 2009. The three loans had total outstanding balances of \$24.1 million. The manager concluded that the loans for all of these projects required nonaccrual classification, based on the Bank's nonaccrual policy and conditions that existed as of the third quarter of 2009.

30. The manager informed other senior Bank officers that these loans required nonaccrual (and thus, impaired) classification in late October 2009, and informed them that her belated identification of these loans as nonaccruing was due to the Bank's ineffective process for tracking interest reserve loans. The Bank approved the manager's nonaccrual recommendations, which totaled \$24.1 million out of \$36 million of nonaccrual classifications approved.

31. The GAAP standard governing subsequent events, ASC 855-10-25-1, states that "An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements." The conditions underlying the nonaccrual designations – the loans' substandard ratings, and the fact that their interest was being paid via interest reserve – existed as of the date of the third quarter of 2009 balance sheet. Therefore, in accordance with GAAP, the nonaccruals should have been recognized in the third quarter financial statements.

32. On November 9, 2009, the Bank filed its Form 10-Q for the third quarter. Although the Bank stated in its Form 10-Q that it had evaluated subsequent events through the date of the filing, the Bank did not account for the three loans as nonaccruing in its Form 10-Q. The Bank reported a total of \$365.9 million in nonaccrual loans. The additional \$24.1 million in nonaccruing

loans would have represented a material 6.6% increase in the total nonaccruals for the quarter. Properly including this amount of nonaccruing loans would have caused the quarter over quarter difference in reported nonaccrual loans to increase materially, from \$67.1 million to \$91.2 million, or a difference of 35.9%.

Understated Loan Loss Provision and Reserves in Form 10-Q for the Third Quarter of 2009

33. The Bank's Form 10-Q filed on November 9, 2009 improperly failed to incorporate the information from four newly-obtained appraisals into its calculation of the Bank's loan loss provision and reserves. Significantly prior to the filing date, the Bank's appraisal department received appraisals that reflected material collateral value declines for impaired loans related to four construction projects, including two described in Paragraph 29 above.

34. However, Wilmington Trust's deficient internal controls prevented timely consideration of the effect of the updated collateral values on the Bank's reserve. Credit Risk Management staff tasked with allowance calculations did not obtain the updated appraisals in a timely fashion and there were no effective procedures to assure that Credit Risk Management staff were informed of updated collateral value information that was received after the end of the quarter, but prior to filing the periodic SEC reports. Nor did the Bank's disclosure controls assure that updated collateral values that Credit Risk Management staff received prior to period public filings were appropriately considered for subsequent events reporting according to GAAP.

35. Taken together, the updated appraisals for impaired loans received prior to the filing of the third quarter 2009 Form 10-Q required a supplemental provision to the reserve of \$12.8 million. This was a material understatement, because the additional required provision would have increased the recorded \$38.7 in provision to \$51.5 million, or 33%, and would have increased the \$16.6 million loss before income taxes and noncontrolling interest to \$29.4 million, or 77%.

Understated Loan Loss Provision and Reserves in the Fourth Quarter 2009 Earnings Release and 10-K for 2009

36. In January 2010, before the Bank issued its fourth quarter 2009 earnings press release and filed its Form 8-K, the Bank's ongoing review of its Delaware CRE projects revealed deterioration trajectories in ten highly significant borrower relationships. A senior Bank manager concluded, and informed certain senior officers, that downgrades were required for the ten relationships, which would result in an "overall provision increment ... [of] \$10.5MM." The loan reviews also resulted in the identification of 20 other loans that required downgrades which would have required an additional provision of \$1.6 million. The Bank was aware that these downgrades were not reflected in the loan loss provision and reserves that previously had been calculated for the fourth quarter.

37. The Bank represented to its Board of Directors that the loan reviews that resulted in the downgrades were rigorous and complete with respect to the relevant loans. However, a senior Bank officer directed that the downgrades not be formalized, and therefore neither the downgrades

nor the increased reserves described in Paragraph 36 above were incorporated into the Bank's quarterly earnings release and Form 8-K or its Form 10-K, which were filed on January 29, 2010 and February 22, 2010, respectively.

38. The total provision supplement associated with the downgrades was \$12.1 million. In both of its SEC filings, the Bank recognized a provision of \$82.8 million for the fourth quarter; the additional \$12.1 million in provision would have increased it materially, to \$94.9 million, or by 14.6%. The Bank recorded a loss before income taxes and noncontrolling interest of \$37.3 million; the increased provision would have deepened the loss by 30%.

VIOLATIONS

As a result of the conduct described above, Wilmington Trust violated:

- a. Section 17(a)(2) of the Securities Act, which prohibits, directly or indirectly, in the offer or sale of securities, obtaining money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;
- b. Section 17(a)(3) of the Securities Act, which prohibits any person from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities;
- c. Exchange Act Section 13(a) and Rules 13a-1, 13a-11, 13a-13 and 12b-20 thereunder, which require that every issuer of a security registered pursuant to Exchange Act Section 12 file with the Commission information, documents and annual and quarterly reports as the Commission may require and mandate that periodic reports contain such further information as may be necessary to make the required statements not misleading;
- d. Exchange Act Section 13(b)(2)(A), which requires reporting companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets; and
- e. Exchange Act Section 13(b)(2)(B), which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Wilmington Trust's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent Wilmington Trust shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

B. Respondent shall, within 10 days of the entry of this Order, pay disgorgement of \$16,000,000.00 and prejudgment interest of \$2,545,896.16, for a total of \$18,545,896.16, to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Wilmington Trust as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Michael J. Osnato, Jr., Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, NY, NY 10281.

By the Commission.

Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9606 / June 25, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 72471 / June 25, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3560 / June 25, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-15946

In the Matter of

JEFFREY C. KUEHR AND
MICHAEL J. WILLOUGHBY,

Respondents.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 8A OF THE SECURITIES ACT
OF 1933 AND SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS, CEASE-AND-
DESIST ORDERS, AND PENALTIES**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Jeffrey C. Kuehr ("Kuehr") and Michael J. Willoughby ("Willoughby") (collectively, the "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-And-Desist Proceedings Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act Of 1934, Making Findings and Imposing Remedial Sanctions, Cease-And-Desist Orders, and Penalties, as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

SUMMARY

This proceeding arises from the misconduct of the Respondents and Thomas A. Neely, Jr., ("Neely") while employed by Regions Bank and its parent holding corporation, Regions Financial Corporation ("Regions"). During the quarter ended March 31, 2009, in accordance with Regions' policies and procedures, personnel within Regions Bank's Special Asset Department ("SAD") who reported up to the Respondents, initiated the procedures to place approximately \$168 million of certain commercial loans (the "Loans") into non-accrual status. In March 2009, the Respondents and Neely, arbitrarily and without supporting documentation, took steps to keep the Loans in accrual status. Such steps by the Respondents and Neely to evade existing policies and procedures constituted a fraudulent scheme, prevented Regions from appropriately measuring impairment in accordance with Generally Accepted Accounting Principles ("GAAP"), rendered Regions' financial statements for the quarter ended March 31, 2009 materially misstated and not prepared in conformity with GAAP, and evidenced a failure by Regions to maintain a system of internal accounting controls sufficient to provide reasonable assurances that the Loans were recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

RESPONDENTS

1. Jeffrey C. Kuehr, 50, was formerly an Executive Vice President and the head of Regions' SAD. During the relevant period, Kuehr reported to Willoughby who at the time was Regions' Chief Credit Officer ("CCO"). Kuehr's employment with Regions concluded on December 29, 2010.

2. Michael J. Willoughby, 68, was formerly a Senior Executive Vice President and Regions' CCO. As CCO, Willoughby directly reported to Regions' Chief Risk Officer. Willoughby's employment with Regions concluded on November 30, 2010.

RELATED PERSON AND ENTITY

3. Thomas A. Neely, Jr., 53, was formerly an Executive Vice President for Regions' Risk Management Credit Division where he reported to Willoughby. Neely also oversaw Regions' Risk Analytics Group and together with Kuehr functionally controlled Regions' SAD. Neely's employment with Regions concluded on November 30, 2010.

4. Regions Financial Corporation is a Delaware financial holding corporation headquartered in Birmingham, Alabama. Regions conducts its banking operations through its subsidiary Regions Bank, which is a member of the Federal Reserve System. Regions' common stock is registered with the Commission pursuant to Section 12(b) of the Securities Act and trades on the New York Stock Exchange under the symbol "RF." As of December 31, 2013, Regions had approximately \$117 billion in assets.

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

FACTS

Regions' Tracking of Non-Accrual Loans

5. Throughout the relevant time-period, including the quarter ended March 31, 2009, Region's tracked and recorded its non-performing loans ("NPLs") as part of both internal performance metrics and its regular financial reporting. NPLs at Regions primarily consisted of loans in a non-accrual status.²

6. Regions' policies and procedures required that loans be placed on non-accrual status when it was determined that payment of all contractual principal and interest was in doubt, or the loan was past due 90 days or more as to principal and interest, unless the loan was well-secured and in the process of collection. When a loan was placed in non-accrual status, uncollected interest accrued during the current year would be reversed and reduce Regions' interest income. In addition, placing a loan on non-accrual status served as a trigger for Regions to consider whether the specific loan was impaired and thus how to determine an allowance for loan and lease losses in accordance with GAAP.

7. Regions' policies and procedures provided that the decision to place a loan in non-accrual status was to be made by Relationship Managers ("RMs") within SAD. RMs were responsible for reviewing loan file details, monitoring payments and communicating with borrowers. Under Regions' policies and procedures, RMs had the greatest degree of knowledge within SAD of the relevant loan status and a borrower's ability to make payments of principal and interest.

8. Regions' policies and procedures required that when RMs initiated an action to place a loan on non-accrual status, they would submit a supporting form to their regional manager that showed their conclusion and justified how they determined a loan should be placed in non-accrual status. Regions' policies and procedures then provided for the regional manager to conduct a detailed review of the loan with the responsible RM, after which the approval was granted by the regional manager.

9. Once approval for non-accrual classification was granted by the regional manager, Regions' policies and procedures specified that any subsequent exception to classifying the loan in non-accrual status was required to be fully documented and justified on an approved "Recommendation to Continue Accrual Status" form.

10. Once the RM and the regional manager recommended that a loan should be classified in non-accrual status, it was then listed by SAD managers in the Asset Quality Forecast report ("AQF"). The AQF identified which loans had been recommended by the RM and regional manager for being placed on non-accrual status, and it forecasted charge-offs and nonperforming assets for the quarter.

² GAAP does not provide guidance regarding placing loans on a non-accrual status.

11. The AQF was a principal forecasting tool of SAD that was prepared under the direction of the Respondents and Neely. The AQF was discussed weekly at meetings regularly conducted and attended by the Respondents. Neely and Willoughby also regularly utilized the AQF in presentations to Regions' Executive Council, which consisted of, among others, Regions' Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), in discussing current trends in NPLs.

12. The SAD, under the control of the Respondents and Neely, had authority over the preparation, content, and dissemination of the AQF. Once a loan recommended for non-accrual status by the RMs and regional managers was included on the AQF, the responsible RMs would complete information required for a processing list and submit it to Regions' Risk Analytics Group. The processing list was designed as an electronic record documenting the specific actions for individual loans to be formally taken by Regions and reflected in Regions' accounting systems. Neely maintained final authority over the processing list. Following Neely's approval, his subordinates would submit the processing list for the identified loans to be recorded as non-accrual in Regions' accounting systems.

Respondents' Misclassification of Loans and Evasion
of Regions' Policies and Procedures during the Quarter Ended March 31, 2009

13. As of the beginning of March 2009, Regions' AQF identified NPLs of approximately \$1.6 billion. Kuehr, Neely and Willoughby had discussed between themselves the then current AQF and NPLs. The AQF and related NPLs tracking for the quarter were made available to Regions' CEO and CFO.

14. On or about March 13, 2009, Kuehr, Neely and Willoughby were informed by a subordinate that an error had resulted in an underreporting of NPLs by an amount approximating \$200 million, or 13% as reported in the AQF data made available to Regions' CEO and CFO.

15. On or about March 17, 2009, Willoughby was actively tracking and calculating how NPLs could be decreased by approximately \$200 million so as to more closely approach the previously identified NPL target.

16. On or about March 17, 2009, Neely suggested to Willoughby and Kuehr that a \$6.8 commercial million loan be recorded as an accruing loan despite being recommended for non-accrual status by the assigned RM and regional manager. This loan was prevented by Neely, without objection from Willoughby and Kuehr, from being placed on the AQF or a processing list and was classified by Regions as being in accrual status as of March 31, 2009. Contrary to Regions' policies and procedures, Respondents prevented the subject loan from being classified as non-accrual without any documentation or justification.

17. On or about March 18, 2009, Neely and Willoughby instructed subordinates to take specific actions to remove from the AQF approximately \$150 million of commercial loans that had been recommended by the assigned RMs and regional managers, in accordance with Regions' policies and procedures, as being classified as non-accrual. Neely and Willoughby issued such instructions to their subordinates without any documentation or justification supporting the removal of these loans from the AQF, in direct contravention of Regions' policies

and procedures. Kuehr, then head of SAD, thereafter was made aware of and did not object to this action by Neely and Willoughby. The ultimate effect of these instructions was the improper classification of the Loans, representing approximately \$168 million, as being in accrual status. Had Regions classified the relevant loans on non-accrual status in accordance with its policies, it would have prompted a determination that the identified loans were impaired in accordance with GAAP. That determination would have resulted in Regions recording a higher allowance for loan and lease losses.

18. On or about March 23, 2009, Willoughby and Neely attended a meeting at which they provided false information regarding NPLs for the quarter to certain senior executives, including Regions' CFO.

19. In taking the undocumented and unjustified steps above, Respondents and Neely collectively circumvented Regions' policies and procedures regarding the classification of loans into non-accrual status. Respondents and Neely's scheme directly resulted in the improper classification of the Loans pursuant to Regions' policies, and further prevented Regions from appropriately determining those Loans were impaired in accordance with GAAP at the quarter ended March 31, 2009.

20. In accordance with Regions' policies and procedures, the Loans were required to have been classified in non-accrual status at the quarter ended March 31, 2009. Had Regions classified the Loans on non-accrual status with its policies, it would have prompted a determination that the Loans were impaired in accordance with Statement of Financial Accounting Standard No. 114, Accounting by Creditors for Impairment of a Loan ("SFAS No. 114").³

Impact of Respondents' Misconduct on Regions' Financial Statements

21. Respondents circumvented Regions' internal accounting controls through their recording and reporting of the Loans in a manner that was not in accordance with Regions' policies and procedures. As a result, Regions failed to maintain a system of internal accounting controls sufficient to provide reasonable assurances that the Loans were recorded as necessary to permit preparation of financial statements in conformity with GAAP.

22. Respondents' misconduct resulted in Regions' failing to make and keep books, records, and accounts, in reasonable detail, which accurately and fairly reflected the Loans. Further, Regions' accounts were falsified through the misconduct of the Respondents.

23. The books, records and accounts reflecting the Loans were incorporated into Regions' consolidated financial statements for the quarter ended March 31, 2009. As a result of failing to properly account for the Loans in accordance with GAAP, for the quarter ended March 31, 2009, Regions' income before income taxes was overstated by \$16 million, its net income

³ See SFAS No. 114, which states that "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement" and it requires lenders to measure impairment based on the present value of expected cash flows or an observable fair value of the collateral (i.e., an appraisal) if the loan is collateral dependent.

applicable to common shareholders was overstated by approximately \$11 million, and its earnings per common share was overstated by approximately \$.02 per share.

24. The above misstatements were included in Regions' April 21, 2009 press release included in its Form 8-K dated April 21, 2009 and filed with the Commission on April 21, 2009, in its exhibits to its Form 8-K dated May 20, 2009 and filed with the Commission on May 20, 2009, in its March 31, 2009 Form 10-Q filed May 11, 2009, and two subsequent amendments to its March 31, 2009 Form 10-Q filed on May 13, 2009 and June 9, 2009, in a Form S-4 filed on May 20, 2009 and in three subsequent amendments to this registration statement on May 22, 2009, June 4, 2009, and June 9, 2009, and in a Form S-8 filed on August 28, 2009 (collectively, the "Public Filings").

25. The Public Filings did not include other information as was necessary to ensure that the statements made in the Public Filings were not, under the circumstances, materially misleading.

26. The Respondents, through false statements and/or misleading omissions in sub-certification letters they signed in April 2009 in connection with the preparation of the reports on Form 10-Q above, misled Regions' Controller and Chief Accounting Officer and its Director of Internal Audit, both accountants, regarding Regions' books, records, accounts, and internal controls.

VIOLATIONS

27. Section 17(a) of the Securities Act prohibits any person, in the offer or sale of any security, from using the means and instrumentalities of interstate commerce and of the mails, directly or indirectly, to: (a) employ any device, scheme, or artifice to defraud; (b) obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (c) engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

28. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraudulent conduct in connection with the purchase or sale of securities.

29. Section 20(b) of the Exchange Act makes it unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the Exchange Act or any rule or regulation thereunder through or by means of any other person.

30. Section 13(a) of the Exchange Act and Rules 13a-11, 13a-13 and 12b-20 thereunder, requires every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information, documents, and current and quarterly reports as the Commission may require, and mandate that current and periodic reports contain such further material information as may be necessary to make the required statements not misleading.

31. Section 13(b)(2)(A) of the Exchange Act requires reporting companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

32. Section 13(b)(2)(B) of the Exchange Act requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

33. Section 13(b)(5) of the Exchange Act prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls, and from knowingly falsifying any book, record, or account, required under Section 13(b)(2) of the Exchange Act.

34. Rule 13b2-1 of the Exchange Act prohibits any person from directly or indirectly falsifying or causing to be falsified any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act.

35. Rule 13b2-2 of the Exchange Act prohibits, among other things, officers of issuers from directly or indirectly making or causing to be made a materially false or misleading statement, or omitting to state any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with any quarterly review or the preparation or filing of any document or report required to be filed with the Commission.

36. As a result of the Respondents' scheme to misclassify the Loans as in accrual status as of the quarter ended March 31, 2009, the Respondents violated Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities, and Exchange Act Section 10(b) and Rule 10b-5 thereunder, which prohibits fraudulent conduct in connection with the purchase or sale of securities.

37. As a result of the conduct described above, the Respondents acted through Regions to make material misrepresentations in the Public Filings, and as a result, violated Sections 20(b) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

38. As a result of the conduct described above, the Respondents caused Regions to violate Section 13(a) of the Exchange Act and Rules 13a-11, 13a-13 and 12b-20 thereunder because its financial statements for the quarter ended March 31, 2009, included in current and quarterly reports, failed to record the Loans in conformity with GAAP.

39. As a result of the conduct described above, the Respondents caused Regions to violate Section 13(b)(2)(A) of the Exchange Act because it did not keep books, records or accounts that accurately reflected the Loans.

40. As a result of the conduct described above, the Respondents caused Regions to violate Section 13(b)(2)(B) of the Exchange Act because it failed to maintain a system of internal accounting controls sufficient to provide reasonable assurances that the Loans were recorded as necessary to permit preparation of its financial statements in accordance with GAAP.

41. As a result of the conduct described above, the Respondents violated Section 13(b)(5) of the Exchange Act when they knowingly circumvented Regions' system of internal

accounting controls and knowingly falsified Regions' books, records, and accounts related to the Loans.

42. As a result of the conduct described above, the Respondents violated Rule 13b2-1 of the Exchange Act by directly or indirectly falsifying or causing to be falsified Regions' books, records and accounts relating to the Loans, which were subject to Section 13(b)(2)(A) of the Exchange Act.

43. As a result of the conduct described above, the Respondents violated Rule 13b2-2 of the Exchange Act when they directly or indirectly made or caused to be made materially false or misleading statements, or omitted to state material facts necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to accountants in connection with the preparation or filing of documents and reports which were required to be filed with the Commission.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in each Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Respondent Kuehr cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, including committing or causing any such violations directly or indirectly through or by means of any other person, as prohibited by Section 20(b) of the Exchange Act, and cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, 13b2-1, and 13b2-2 thereunder.

B. Respondent Kuehr be, and hereby is prohibited for a period of five (5) years from entry of this Order, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

C. Respondent Kuehr shall pay a civil money penalty in the amount of \$70,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$5,833.37 is due on the first of the month following entry of this Order, followed by eleven (11) additional payments of \$5,833.33 due on the first of each consecutive following month, constituting twelve (12) payments totaling \$70,000. Payment of the entire remaining balance may be made at any point in time on or before it would otherwise be due under the terms of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Jeffrey C. Kuehr as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Aaron W. Lipson, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Road, N.E., Atlanta, GA 30326-1382.

D. Respondent Willoughby cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, including committing or causing any such violations directly or indirectly through or by means of any other person, as prohibited by Section 20(b) of the Exchange Act, and cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 12b-20, 13a-11, 13a-13, 13b2-1, and 13b2-2 thereunder.

E. Respondent Willoughby be, and hereby is prohibited for a period of five (5) years from entry of this Order, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

F. Respondent Willoughby shall pay a civil money penalty in the amount of \$70,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$5,833.37 is due on the first of the month following entry of this Order, followed by eleven (11) additional payments of \$5,833.33 due on the first of each consecutive following month, constituting twelve (12) payments totaling \$70,000. Payment of the entire remaining balance may be made at any point in time on or before it would otherwise be due under the terms of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Michael J. Willoughby as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Aaron W. Lipson, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Road, N.E., Atlanta, GA 30326-1382.

By the Commission.

Jill M. Peterson
Assistant Secretary

**UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA**

SECURITIES AND EXCHANGE COMMISSION)
100 F Street, N.E.)
Washington, D.C. 20549,)

Plaintiff,)

v.)

Case No. _____

RPM INTERNATIONAL INC. and)
EDWARD W. MOORE,)

Defendants.)

COMPLAINT

Plaintiff Securities and Exchange Commission (“SEC”) alleges as follows:

SUMMARY OF THE ACTION

1. This is a disclosure and accounting fraud case arising from the failure of RPM International Inc. (“RPM”) to timely disclose a loss contingency, or record an accrual for, an investigation by the U.S. Department of Justice (the “DOJ investigation”). A public company facing a loss contingency, such as a lawsuit or government investigation, is required under accounting principles and the securities laws to (1) disclose the loss contingency if a material loss is reasonably possible, and (2) record an accrual for the loss contingency if a material loss is probable and reasonably estimable. In connection with the DOJ investigation, RPM faced a material loss that was probable and reasonably estimable, but RPM failed to disclose the loss contingency or record an accrual on its books when required to do so.

2. The DOJ investigation began in 2011 in response to a complaint filed under the False Claims Act against RPM and its wholly-owned subsidiary, Tremco, Inc. (“Tremco”), and concerned whether Tremco overcharged the federal government on certain government

contracts. In 2013, RPM settled the DOJ investigation and the underlying litigation for nearly \$61 million.

3. Defendant Edward W. Moore, RPM's General Counsel and Chief Compliance Officer, oversaw RPM's response to the DOJ investigation, but failed to disclose material facts about the investigation to RPM's Chief Executive Officer, Chief Financial Officer, Audit Committee, and independent auditors (the "Audit Firm"). For example, Moore knew but failed to inform them: (1) that RPM sent DOJ several analyses estimating that Tremco overcharged the government by at least \$11.9 million on the contracts under investigation; (2) that RPM agreed to submit a settlement offer by a specific date to resolve the DOJ investigation; and (3) that, prior to submitting the settlement offer, RPM's overcharge estimates increased substantially to at least \$27-28 million. Additionally, Moore made material misrepresentations to the Audit Firm about the DOJ investigation in connection with the Audit Firm's reviews and audits of RPM's financial statements and SEC filings.

4. As a result of Moore's misstatements and his failure to disclose key facts regarding the DOJ Investigation, from October 2012 through December 2013 RPM submitted multiple materially false and misleading filings to the SEC. For example, RPM's SEC filings from October 2012 through January 2013 failed to disclose any information about the DOJ investigation, including any loss contingency or accrual on RPM's financial statements, as required by the governing accounting principles and securities laws. Those filings also did not disclose any material weakness in RPM's internal controls over financial reporting or its disclosure controls when in fact such weakness existed.

5. Moreover, even after RPM disclosed the DOJ investigation and recorded an accrual in April 2013, the company's SEC filings continued to be misleading. For example, RPM's

filings from April to December 2013 indicated that RPM timely disclosed and accrued for the DOJ investigation when in fact disclosure and accrual were required in earlier reporting periods. In addition, those SEC filings still failed to disclose any material weakness in RPM's internal controls over financial reporting or its disclosure controls.

6. Because of RPM's false and misleading SEC filings, investors were not timely informed that a material loss relating to the DOJ investigation was reasonably possible or probable. Investors also were not timely notified of a material weakness in RPM's internal control over financial reporting and its disclosure controls.

7. In August 2014, RPM restated its financial results for three quarters that occurred during the DOJ investigation and filed amended SEC filings for those quarters. RPM's amended SEC filings – unlike the original filings – disclosed the DOJ investigation and recorded accruals in each quarter showing the company's best estimates of probable losses related to the investigation. Further, in connection with the restatement, RPM admitted that it made "errors" relating to the "timing of disclosure and accrual" for the DOJ investigation and that the company had a material weakness in its internal control over financial reporting and its disclosure controls. RPM's restatement thus confirmed that the company's original SEC filings referenced above were materially false and misleading.

8. By engaging in the conduct described herein, RPM violated antifraud, reporting, books and records, and internal controls provisions of the securities laws, including Sections 17(a)(2) and (a)(3) of the Securities Act of 1933 (the "Securities Act") [15 U.S.C. §§ 77q(a)(2) and 77q(a)(3)]; Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)]; and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1,

240.13a-11, and 240.13a-13]. Unless restrained and enjoined, RPM will violate those provisions again in the future.

9. Moore violated antifraud, books and records, and misleading accountant or auditor provisions of the securities laws, including Sections 17(a)(2) and (a)(3) of the Securities Act [15 U.S.C. §§ 77q(a)(2) and 77q(a)(3)], and Exchange Act Rules 13b2-1 and 13b2-2(a) [17 C.F.R. §§ 240.13b2-1 and 240.13b2-2(a)]. Unless restrained and enjoined, Moore will violate those provisions again in the future.

10. The SEC therefore seeks a judgment against RPM and Moore providing permanent injunctive relief and ordering RPM and Moore to pay disgorgement with prejudgment interest and civil money penalties.

JURISDICTION AND VENUE

11. The SEC brings this action, and this Court has jurisdiction, pursuant to Securities Act Sections 20(b), 20(d), and 22(a) [15 U.S.C. §§ 77t(b), (d), and 77v(a)], and Exchange Act Sections 21(d)(1) and 27 [15 U.S.C. §§ 78u(d)(1) and 78aa].

12. Defendants directly or indirectly, singly or in concert with others, made use of the means or instruments of transportation and communication in interstate commerce, or of the mails, or of the facilities of a national securities exchange in connection with the acts, transactions, and practices alleged in this Complaint.

13. Venue is proper in this district pursuant to Securities Act Section 22(a) [15 U.S.C. § 77v(a)] and Exchange Act Section 27 [15 U.S.C. § 78aa] because Defendants transact business in this district and violations of the securities laws alleged in this Complaint occurred within this district, including the filing of false and misleading documents with the SEC.

DEFENDANTS

14. **RPM International Inc.** is a Delaware corporation with its principal place of business in Medina, Ohio. RPM, through its subsidiaries, manufactures and sells various chemical product lines, including paints, protective coatings, roofing systems, sealants, and adhesives. One of RPM's wholly-owned subsidiaries is Tremco, a company that provides roofing materials and services. At all relevant times, RPM's common stock was registered with the SEC pursuant to Section 12(b) of the Exchange Act and traded continuously on the New York Stock Exchange under the ticker symbol "RPM." RPM's fiscal year runs from June through May.

15. **Edward W. Moore**, age 59, is a resident of Ohio and a lawyer admitted to the Ohio bar since 1982. From 1982 to 2006, Moore practiced corporate and securities law at a law firm. From 2007 to the present, Moore has served as RPM's General Counsel and Corporate Secretary. Beginning in 2011, and continuing to the present, Moore also has served as RPM's Chief Compliance Officer. At all relevant times, Moore was responsible for reviewing RPM's SEC filings and ensuring that the filings complied with applicable laws and regulations. Additionally, at all relevant times, Moore acted within the course and scope of his employment by RPM.

FACTS

A. The FCA Complaint is Filed Against RPM and Tremco

16. The False Claims Act ("FCA"), 31 U.S.C. §§ 3729 – 3733, is a civil fraud statute that allows triple damages and penalties against a party who submits a false claim to the government. *See* 31 U.S.C. § 3729(a). The *qui tam* provisions of the FCA allow a plaintiff, known as a "relator," to bring an action in federal court in the name of the government. *See* 31 U.S.C. § 3730(b). When a relator files a complaint under the FCA, the complaint is filed under

seal and provided to DOJ so that DOJ may investigate the relator's allegations. *See id.* After the investigation, DOJ informs the court whether DOJ will intervene and litigate the case or decline to intervene and allow the relator to litigate the case alone. *Id.*

17. In July 2010, a former Tremco employee filed a *qui tam* complaint under the FCA (the "FCA complaint") in federal court against RPM and Tremco. The FCA complaint alleged that Tremco overcharged the government under certain government contracts by, among other things, failing to provide required price discounts. The FCA complaint was filed under seal and provided to DOJ so that DOJ could investigate the allegations and decide whether to intervene in the lawsuit.

B. The DOJ Investigation Begins

18. In March 2011, RPM learned of the DOJ investigation when Tremco received a subpoena from the government, requesting documents related to Tremco's government contracts.

19. As RPM's General Counsel and Chief Compliance Officer, Moore oversaw the response of RPM and Tremco to the DOJ investigation. Moore also was required to keep RPM's CEO, CFO, and Audit Committee reasonably informed, with timely and accurate information, regarding the status of the DOJ investigation. Additionally, Moore was responsible for updating the Audit Firm on the status of the DOJ investigation.

20. Moore was responsible for providing RPM's CEO and CFO with timely and accurate information about the DOJ investigation so that, among other things, the CEO and CFO could evaluate RPM's disclosure and accrual obligations before certifying the accuracy of certain SEC filings, including RPM's quarterly reports on Forms 10-Q, annual reports on Forms 10-K, and the financial information therein.

21. Soon after learning of the DOJ investigation in March 2011, RPM retained a law

firm (“RPM’s counsel”) to represent RPM in connection with the DOJ investigation. From the outset of that engagement, RPM’s counsel and RPM understood that, in order to settle an FCA matter, DOJ generally required at least two times the amount of actual damages sustained from the false claims. RPM’s counsel that worked on the DOJ investigation did not act as RPM’s securities disclosure counsel for SEC filings; instead, a different law firm served as RPM’s disclosure counsel.

22. At RPM’s quarterly Audit Committee meeting on April 5, 2011, which was attended by RPM’s CEO and representatives from the Audit Firm, Moore discussed the DOJ investigation. Once the Audit Firm became aware of the DOJ investigation in April 2011, its auditors asked Moore on at least a quarterly basis whether any new developments had occurred in the DOJ investigation.

C. Disclosure and Accrual Provisions Relating to the DOJ Investigation

23. Once RPM became aware of the DOJ investigation, the company had to ensure that it complied with certain disclosure and accrual provisions of the federal securities laws in connection with the investigation. For example, Regulation S-X requires that financial statements included with an issuer’s SEC filings must comply with Generally Accepted Accounting Principles (“GAAP”), and provides that financial statements filed with the SEC that are not prepared in accordance with GAAP are presumed to be misleading. *See* 17 C.F.R. §210.4-01. Accounting Standards Codification (“ASC”) 450-20 codifies GAAP regarding “loss contingencies.”¹ A loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to a possible loss that will be resolved when one or more future events occurs or fails to occur. *See* ASC 450-20-20. Loss contingencies include, among other things,

¹ The ASC became effective in 2009. Prior to the ASC, GAAP regarding loss contingencies was set forth in the Statement of Financial Accounting Standards No. 5, which was often referred to as “FAS 5.”

(i) actual or possible claims and (ii) pending or threatened litigation. *See* ASC 450-20-05-10.

Under GAAP, an issuer must disclose a loss contingency if a material loss is reasonably possible, *see* ASC 450-20-50-3, and an issuer must record an accrual for a loss contingency, as a charge against income, if a material loss is probable and reasonably estimable, *see* ASC 450-20-25-2.

From at least March 2011 through August 2013, the DOJ investigation represented a loss contingency.

24. Additionally, under Item 303 of Regulation S-K (“Item 303”), which addresses Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) for Forms 10-K and 10-Q, an issuer must describe any known trends or uncertainties that have had, or that the issuer reasonably expects will have, a material unfavorable impact on net sales, revenues, or income from continuing operations. *See* 17 C.F.R. § 229.303.

25. Moreover, under Exchange Act Rule 12b-20, along with the information expressly required to be included in an SEC filing, an issuer must also disclose such further material information as may be necessary to make the required statements, in light of the circumstances, not misleading. *See* 17 C.F.R. § 240.12b-20.

D. The Audit Firm Suggests that RPM Consider Disclosing the DOJ Investigation, But RPM and Moore Decide Not to Disclose

26. On June 7, 2012, the Audit Firm sent an e-mail to Moore regarding the Form 10-K that was scheduled to be filed in July 2012. The e-mail stated in part: “As we head into year-end and start thinking about disclosures, etc. I wanted to pass along the attached, which is a document with an example disclosure related to . . . government investigations.” The Audit Firm attached to the e-mail sample language used by another public company to disclose a government investigation in an SEC filing.

27. Despite the Audit Firm providing sample disclosure language, RPM and Moore

decided not to disclose the DOJ investigation at that time.

E. DOJ Provides a Copy of the FCA Complaint to RPM

28. On August 9, 2012, DOJ provided a copy of the FCA complaint, which had been partially unsealed, to RPM. Only a small group of RPM personnel, including Moore, reviewed the FCA complaint.

29. Moore did not disclose the FCA complaint to the Audit Firm.

F. RPM Informs DOJ that Tremco Did Not Comply with the Government Contracts Under Investigation, and Produces Estimates of Overcharges

30. On September 12, 2012, with Moore's knowledge and authorization, RPM's counsel met with DOJ to discuss the DOJ investigation. During that meeting, RPM's counsel informed DOJ that Tremco had not complied with the pricing terms of its government contracts. RPM's counsel also discussed with DOJ an analysis prepared by a consultant for RPM and Tremco, which calculated that Tremco overcharged the government by at least \$11 million during part of the time period under investigation. Soon after concluding the September 12 meeting with DOJ, RPM's counsel told Moore what transpired during the meeting, including that the \$11 million overcharge analysis was discussed with DOJ.

31. On or around September 28, 2012, in connection with the Audit Firm's first quarter review of RPM, the Audit Firm asked Moore about the status of the DOJ investigation. In response, Moore falsely told the Audit Firm that "no claim has been asserted" and the matter was "investigative in nature and not in litigation." In fact, Moore knew the FCA complaint had been filed against RPM and Tremco in federal court.

32. On October 1, 2012, about two weeks after the September 12 meeting with DOJ, Moore sent a management representation letter to the Audit Firm in connection with the first quarter review of RPM. In the letter, Moore stated that, "since June 1, 2012, neither I, nor any of

the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, material loss contingencies” exceeding \$1.2 million. That representation was materially false and misleading because Moore knew that he and RPM’s counsel represented RPM in connection with the DOJ investigation, and that RPM’s potential loss relating to the DOJ investigation was at least \$11 million.

33. That same evening, on October 1, 2012, with Moore’s knowledge and authorization, RPM sent DOJ a written analysis, estimating that Tremco overcharged the government by approximately \$11.4 million during part of the time period under investigation. That analysis set forth in writing the information that had been shared orally with DOJ at the meeting on September 12, and did not include any damages multiplier under the FCA. Moreover, as the \$11.4 million overcharge estimate related to only part of the time period under investigation and to only one of the contracts under investigation, and additional overcharge analyses were planned or underway, Moore knew or should have known that the total amount by which Tremco overcharged the government likely was greater than \$11.4 million.

34. The next morning, on October 2, 2012, RPM’s Audit Committee held its quarterly meeting, which was attended by, among others, the CEO, the CFO, representatives from the Audit Firm, and Moore. During the meeting, however, Moore failed to disclose the \$11.4 million overcharge estimate that had been sent to DOJ.

35. As of October 2, 2012, the date of the Audit Committee meeting, RPM had not yet submitted its SEC filings for the fiscal first quarter ended August 31, 2012. Even without considering the effect of any possible multiplier under the FCA, the \$11.4 million overcharge estimate sent to DOJ was material because it equaled approximately 30% of RPM’s net income for the first quarter.

G. RPM's First Quarter SEC Filings Do Not Disclose Any Information or Accrual Relating to the DOJ Investigation

36. On October 3, 2012, RPM filed a Form 8-K, signed by Moore, which attached a press release concerning RPM's financial results for the fiscal first quarter ended August 31, 2012. The next day, October 4, 2012, RPM filed a Form 10-Q for the fiscal first quarter.

37. By the dates of those SEC filings on October 3 and 4, 2012, Moore knew or should have known it was not only reasonably possible, but probable and reasonably estimable, that RPM would incur a material loss in connection with the DOJ investigation. Similarly, by the dates of those SEC filings, Moore knew it was reasonably likely that the DOJ investigation would have a material unfavorable impact on RPM's income in the future because the likely floor for RPM's range of loss was at least \$11.4 million, even before considering the impact of any damages multiplier under the FCA.

38. Nevertheless, despite the disclosure duties imposed by ASC 450-20 (requiring the disclosure of a material loss contingency or accrual), Item 303 (requiring the disclosure of a trend or uncertainty reasonably expected to have a material unfavorable impact), and Rule 12b-20 (requiring the disclosure of additional material information needed to make the statements in an SEC filing not misleading), neither the Form 8-K nor the Form 10-Q disclosed any information or accrual relating to the DOJ investigation.

39. RPM's Form 8-K filed October 3, 2012 purported to provide the company's financial results for its fiscal first quarter but misleadingly failed to disclose the material impact of the DOJ investigation on those results. As shown by RPM's subsequent restatement, contrary to the originally reported first quarter results, RPM was required to record an accrual for the DOJ investigation as a charge against income in its first quarter.

40. Although RPM's Form 10-Q filed October 4, 2012 discussed "contingencies" in the

notes to the company's financial statements and in the MD&A section, RPM omitted any information about the DOJ investigation, which was necessary to make the discussion regarding contingencies not misleading. RPM's Form 10-Q also stated that, "We are party to various claims and lawsuits" and "we record provisions when we consider the liability probable and reasonably estimable," but misleadingly failed to disclose that in fact a material loss relating to the DOJ investigation was probable and reasonably estimable by October 4, 2012, when the Form 10-Q was filed.

41. Additionally, RPM's Form 10-Q falsely and misleadingly stated that, as of the end of RPM's first quarter, "our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports we file or submit under the Exchange Act (1) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and (2) is accumulated and communicated to our management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosure." In fact, as RPM later admitted in connection with its restatement, its disclosure controls and procedures were not effective at the end of the first quarter.

42. On October 19, 2012, about two weeks after RPM's first quarter SEC filings, RPM filed with the SEC a Prospectus Supplement for a \$300 million notes offering. Moore oversaw the notes offering and reviewed the Prospectus Supplement before it was filed with the SEC. The Prospectus Supplement stated to investors that "[i]t is important for you to read and consider all information . . . incorporated by reference in this prospectus supplement . . . in making your investment decision." The Prospectus Supplement incorporated by reference RPM's SEC filings, including the materially misleading first quarter Form 10-Q filed on October 4, 2012.

RPM's sale of the notes closed on or around October 23, 2012.

H. Moore's Awareness of Negative Repercussions from Disclosing the DOJ Investigation or Recording an Accrual

43. Around the time of RPM's first quarter SEC filings in October 2012, Moore was aware of pressure to avoid, or at least postpone, recording another one-time charge on RPM's books. In RPM's Form 8-K filed on October 3, 2012, which related to RPM's first quarter results, the company disclosed two one-time charges that were unrelated to the DOJ investigation: a \$45 million charge for certain work in India, and another \$11 million charge for other work overseas. According to the Chairman of RPM's Audit Committee, at the Audit Committee meeting on October 2, 2012, the Committee communicated that "we're not going to be accepting of ongoing extraordinary charges or one-time charges. We didn't think that that would bode well for the company and . . . the impression of our shareholders and others of how we run the business, and we made that clear." Similarly, at RPM's annual shareholder meeting on October 4, 2012, RPM's CEO told the shareholders that RPM would not "water torture them" with additional one-time "charges quarter after quarter."

44. Moore also was aware that disclosing the DOJ investigation or recording an accrual could negatively affect RPM's stock price. According to Moore, disclosing the DOJ investigation in RPM's first quarter SEC filings could have caused "uncertainty" and "depress[ed] the value of the stock." Moore had a personal interest in RPM's stock price because, as of August 31, 2012, he owned 65,952 shares of RPM stock – worth more than \$1.8 million – plus 65,000 RPM stock options.

45. In addition, Moore was aware that disclosing the DOJ investigation might cause reputational harm to RPM and Tremco. According to Moore, disclosing the DOJ investigation in RPM's first quarter SEC filings could have caused "harm to [RPM's] roofing business." Further,

according to Moore, if the FCA complaint “became public and everybody read about these really scandalous allegations,” that could “really damage [Tremco’s] business, possibly irreparably.”

I. DOJ Conveys a Deadline for Intervention in the FCA Case, and RPM Says It Will Submit a Settlement Offer

46. On November 5, 2012, DOJ notified RPM by e-mail that the seal on the FCA complaint would expire on January 17, 2013, and thus DOJ “want[ed] to make sure that the parties are in an appropriate posture by that date (i.e., this matter is resolved or the United States is prepared to inform the Court of its intervention determination).” RPM’s counsel conveyed DOJ’s message to Moore.

47. On November 29, 2012, Moore attended a seminar regarding the FCA. According to Moore, during that seminar it was discussed that DOJ typically seeks to settle FCA cases for at least two times the amount of damages sustained from the false claims.

48. On December 14, 2012, with Moore’s knowledge and authorization, RPM sent DOJ another analysis, calculating that Tremco overcharged the government by an additional \$487,000 on its government contracts. Therefore, by December 14, 2012, Moore knew that Tremco had overcharged the government by at least \$11.9 million, and that RPM was working on additional overcharge calculations, so the total overcharge amount likely would continue to rise.

49. On December 19, 2012, with Moore’s knowledge and authorization, RPM informed DOJ that RPM would submit a settlement offer to resolve the DOJ investigation and the underlying FCA case by January 11, 2013. No later than December 19, 2012, with Moore’s knowledge and authorization, RPM’s counsel began preparing a written settlement offer.

50. Two days later, on December 21, 2012, RPM’s counsel and certain RPM personnel, including Moore, held a conference call to discuss the DOJ investigation and RPM’s planned settlement offer. During the call, the participants discussed the components of the planned

settlement offer and those components totaled \$27-28 million. That figure represented the amount that RPM calculated Tremco had overcharged the government on the contracts under investigation, without considering any damages multiplier under the FCA.

51. One week later, on December 28, 2012, Moore sent another management representation letter to the Audit Firm in connection with the second quarter review of RPM. In the letter, Moore stated that, “since June 1, 2012, neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, material loss contingencies” exceeding \$1.2 million. That representation was materially false and misleading because Moore knew that he and RPM’s counsel represented RPM in connection with the DOJ investigation; that RPM was planning to submit a settlement offer to resolve the DOJ investigation by January 11, 2013; and that estimates for the settlement offer were approximately \$27-28 million.

52. Also on or around December 28, 2012, as part of the second quarter review of RPM, the Audit Firm again asked Moore about the status of the DOJ investigation. During that conversation, Moore falsely stated that “no claim has been filed” and “no loss contingency exists.” Contrary to that statement, however, Moore knew the FCA complaint had been filed against RPM and he knew about the DOJ investigation.

53. On January 4, 2013, four days before RPM was scheduled to file its Form 10-Q for the fiscal second quarter, RPM’s Audit Committee held its quarterly meeting. That meeting was attended by, among others, RPM’s CEO, CFO, the Chairman of the Audit Committee, representatives from the Audit Firm, and Moore. During the meeting, Moore purported to provide an update on the current status of the DOJ investigation. But Moore’s update was materially inaccurate because he did not disclose: (1) any of the overcharge estimates that had

been sent to DOJ, which by this time totaled nearly \$12 million; (2) that RPM had told DOJ a settlement offer would be submitted by January 11, 2013; or (3) that calculations for the settlement offer had reached \$27-28 million. Indeed, Moore did not disclose that information to RPM's CEO, CFO, the Chairman of the Audit Committee, or the Audit Firm at any time prior to RPM's second quarter SEC filings on January 8, 2013. Additionally, prior to January 8, 2013, Moore did not disclose the underlying FCA complaint to the Audit Firm.

J. RPM's Second Quarter SEC Filings Do Not Disclose Any Information or Accrual Relating to the DOJ Investigation

54. On January 8, 2013, RPM filed a Form 8-K, signed by Moore, which attached a press release concerning RPM's financial results for the fiscal second quarter ended November 30, 2012. That same day, RPM also filed a Form 10-Q for the fiscal second quarter.

55. By the date of those SEC filings on January 8, 2013, Moore knew or should have known it was not only reasonably possible, but probable and reasonably estimable, that RPM would incur a material loss in connection with the DOJ investigation. Similarly, by January 8, Moore knew it was reasonably likely that the DOJ investigation would have a material unfavorable impact on RPM's income in the future because the likely floor for RPM's range of loss was at least \$27-28 million, even before considering the impact of a damages multiplier under the FCA.

56. But again, in violation of the disclosure duties imposed by ASC 450-20, Item 303, and Rule 12b-20, neither RPM's Form 8-K nor its Form 10-Q disclosed any information or accrual relating to the DOJ investigation.

57. RPM's Form 8-K filed January 8, 2013 purported to provide the company's financial results for its fiscal second quarter but misleadingly failed to disclose the material impact of the DOJ investigation on those results. As shown by RPM's subsequent restatement,

contrary to the originally reported second quarter results, RPM was required to record an accrual for the DOJ investigation as a charge against income in its second quarter.

58. RPM's Form 10-Q filed January 8, 2013 again discussed "contingencies" in the notes to RPM's financial statements and in the MD&A section but omitted any information about the DOJ investigation, which was necessary to make the statements made regarding contingencies not misleading. Also, the Form 10-Q again stated that RPM records accruals for claims and lawsuits "when we consider the liability probable and reasonably estimable," but misleadingly failed to mention that in fact a material loss relating to the DOJ investigation was probable and reasonably estimable by January 8, 2013, when the Form 10-Q was filed.

59. Additionally, RPM's Form 10-Q falsely and misleadingly stated that, as of the end of RPM's second quarter, the company's "disclosure controls and procedures were effective." But, as RPM later admitted in connection with its restatement, its disclosure controls and procedures were not effective at the end of the second quarter.

60. As of January 8, 2013, when RPM's second quarter Form 10-Q was filed with the SEC, Moore had only told the Audit Firm that the range of loss for the DOJ investigation was approximately \$5 million. That representation was materially false and misleading because Moore knew that RPM had submitted overcharge estimates to DOJ totaling nearly \$12 million (without considering any damages multiplier under the FCA), and that RPM was planning to submit a settlement offer of approximately \$27-28 million in a matter of days.

K. RPM Submits a Settlement Offer to DOJ and Records an Accrual

61. On January 10, 2013, two days after RPM's second quarter Form 10-Q was filed with the SEC, Moore told RPM's CEO for the first time that the potential range of loss for the DOJ investigation had grown from \$5 million to \$28 million. Upon learning that information,

the CEO was surprised and angry and asked Moore, “How the hell could this happen?”

According to the CEO, it was “impossible” for the range of loss to have grown so significantly between January 8 and 10, 2013.

62. The next day, January 11, 2013, RPM submitted a 44-page settlement proposal to DOJ, offering to settle the DOJ investigation and the underlying FCA case for \$28.3 million – the amount that RPM estimated Tremco overcharged the government without any damages multiplier under the FCA.

63. RPM’s CFO did not learn that the company made a settlement offer of \$28.3 million until eleven days later, at a Board of Directors meeting on January 22, 2013. The CFO was shocked to learn that RPM’s offer, and its financial exposure in the DOJ investigation, were so high. The CFO did not know the true amount or range of RPM’s reasonably possible or probable loss in the DOJ investigation prior to that Board meeting because Moore failed to inform him of material developments in the investigation.

64. On March 29, 2013, DOJ conveyed a settlement counter-offer of \$71 million, which included a damages multiplier of approximately 2.5 under the FCA. On April 1, 2013, RPM for the first time recorded an accrual for the DOJ investigation, in the amount of \$68.8 million, which was reflected on the company’s books as of the fiscal third quarter.

L. RPM Discloses the DOJ Investigation and Accrual

65. On April 4, 2013, RPM filed a Form 8-K, signed by Moore, which attached a press release concerning RPM’s financial results for the fiscal third quarter ended February 28, 2013, and publicly disclosed for the first time the DOJ investigation and related accrual. Later that day, RPM filed a Form 10-Q for its third quarter that also discussed the DOJ investigation and accrual. The Form 10-Q reported a net loss by RPM of \$42.2 million for the third quarter,

compared to net income of \$7.9 million for the same quarter one year earlier. According to the 10-Q, the “primary driver of the decline” was the \$68.8 million accrual for the DOJ investigation. Both the Forms 8-K and 10-Q misleadingly indicated that RPM had timely disclosed and accrued for the DOJ investigation in the fiscal third quarter, when in fact disclosure and accrual were required in the first and second quarters, as indicated by RPM’s subsequent restatement.

66. As of April 4, 2013, when RPM publicly disclosed the DOJ investigation, the underlying FCA complaint remained under seal. Thus, the fact that the complaint was sealed did not prevent RPM from disclosing the DOJ investigation in an SEC filing.

M. Moore Makes Further Misrepresentations to the Audit Firm About the DOJ Investigation

67. On June 10, 2013, in connection with RPM’s fiscal year audit and the preparation of its Form 10-K, the Audit Firm met with Moore and asked about the timing of RPM’s accrual for the DOJ investigation. During the meeting, Moore stated that, after RPM’s Form 10-Q was filed on January 8, 2013, RPM completed additional pricing calculations for certain years under investigation and the government threatened to unseal the FCA complaint, and therefore RPM decided to make a settlement offer of \$28 million on January 11, 2013.

68. Moore’s June 10, 2013 statements to the Audit Firm were materially false and misleading because on December 19, 2012 – weeks before RPM’s Form 10-Q was filed on January 8, 2013 – RPM told DOJ a settlement offer would be submitted by January 11, 2013. Further, Moore’s June 10, 2013 statements to the Audit Firm were misleading because Moore still did not disclose the overcharge estimates that RPM had sent to DOJ prior to submitting the settlement offer or that RPM’s estimates of the contractual overcharges had grown to \$27-28 million by the time RPM’s second quarter Form 10-Q was filed on January 8, 2013.

N. RPM's Form 10-K Discusses the DOJ Investigation, But Fails to Disclose Any Material Weakness in RPM's Controls and Misleadingly Indicates that RPM Timely Disclosed and Accrued for the DOJ Investigation

69. On July 24, 2013, RPM filed its Form 10-K for the fiscal year ended May 31, 2013. The Form 10-K discussed the DOJ investigation and the related accrual that RPM recorded in its third quarter ended February 28, 2013. The Form 10-K, however, misleadingly indicated that RPM timely disclosed and accrued for the DOJ investigation in the third quarter, when in fact disclosure and accrual were required in the first two quarters. Additionally, the Form 10-K misleadingly failed to disclose any material weakness in RPM's internal control over financial reporting at any point during the fiscal year, when in fact such weakness existed. Instead, the Form 10-K misleadingly stated that RPM's internal controls were effective.

70. In July 2013, RPM paid Moore a cash bonus of \$300,000 for the fiscal year ended May 31, 2013. That bonus was based in part on RPM's financial performance during the fiscal year, including the company's net income, which was bolstered by the October 2012 notes offering.

71. In August 2013, RPM settled the DOJ investigation and the underlying FCA case for approximately \$61 million. DOJ issued a press release announcing the settlement on August 28, 2013.

72. On December 5, 2013, RPM filed with the SEC a Prospectus Supplement for a \$200 million notes offering. The underwriters exercised an option to purchase additional notes, bringing the total amount of the offering to \$205 million. Moore oversaw the notes offering and reviewed the Prospectus Supplement before it was filed with the SEC. The Prospectus Supplement incorporated by reference RPM's SEC filings, including the materially misleading Form 10-K filed on July 24, 2013, and stated that it was "important" for investors to consider this information. RPM's sale of the notes closed on or around December 9, 2013.

O. The Audit Firm Learns New Facts About the DOJ Investigation

73. On March 31, 2014, RPM sent the SEC staff a written chronology of events related to the DOJ investigation. Moore reviewed and authorized the chronology before it was sent to the SEC.

74. The chronology discussed RPM's communications with DOJ in 2012 and 2013. Among other things, the chronology stated that, "[o]n December 19, 2012, RPM and Tremco informed the DOJ that a settlement proposal would be submitted by January 11, 2013."

75. On April 5, 2014, the Audit Firm received a copy of RPM's chronology and learned for the first time that, on December 19, 2012, RPM told DOJ a settlement offer would be submitted by January 11, 2013. Upon learning that new information, the Audit Firm was concerned. Shortly after reviewing RPM's chronology, on April 5, 2014, the Audit Firm sent an e-mail to Moore and RPM's CFO, stating in part: "We had an Audit Committee meeting on January 4, 2013 and the November 30, 2012 10-Q was filed January 8 I believe. At this time, we were told the whole matter was still a \$5 million issue."

P. The Audit Firm Asks Additional Questions About the DOJ Investigation, and Moore Makes Additional Misrepresentations

76. On April 8, 2014, members of the Audit Firm met with Moore and RPM's CFO to discuss the chronology that RPM submitted to the SEC and a Form S-3 registration statement for which RPM needed the Audit Firm's consent before filing with the SEC. During the meeting, Moore told the Audit Firm that: (1) on December 19, 2012, the range of reasonably possible loss for the DOJ investigation was \$0 to \$10 million; (2) the range of reasonably possible loss continued to be \$0 to \$10 million through January 8, 2013, when RPM's second quarter Form 10-Q was filed; and (3) the range of loss went from \$0 to \$10 million up to \$28 million, and became probable, between January 8 and 11, 2013.

77. Moore's April 8, 2014 statements to the Audit Firm were materially false and misleading because Moore knew that: (1) by December 19, 2012, the overcharge estimates RPM had sent to DOJ totaled nearly \$12 million without any damages multiplier under the FCA; (2) by January 8, 2013, RPM's calculations for its settlement offer had reached \$27-28 million; and (3) RPM's range of reasonably possible or probable loss had reached \$27-28 million by December 21, 2012 – it did not jump to that amount between January 8 and 11, 2013. Based on Moore's misrepresentations, the Audit Firm provided its consent for the Form S-3, which RPM filed with the SEC.

78. In July 2014, RPM paid Moore a cash bonus of \$400,000 for the fiscal year ended May 31, 2014. That bonus was based in part on RPM's financial performance during the fiscal year, including the company's net income, which was bolstered by the December 2013 notes offering.

Q. RPM Restates its Financial Statements

79. During the summer of 2014, the Audit Firm learned additional facts about the DOJ investigation, including the overcharge estimates that RPM sent to DOJ in 2012. As a result of that new information, on or around July 17, 2014, the Audit Firm told RPM that the Audit Firm would not sign off on RPM's Form 10-K for the fiscal year ended May 31, 2014, unless RPM conducted an independent investigation regarding its disclosure and accrual for the DOJ investigation. In response, RPM's Audit Committee hired a law firm to conduct an investigation (the "Audit Committee investigation"). The Audit Committee investigation took place from late July through early August 2014.

80. On August 10, 2014, the findings of the Audit Committee investigation were shared with the Audit Firm in a conference call. Those findings included, among other things, that by

the end of the third week of December 2012, it became “known to Ed Moore” that RPM’s financial exposure in the DOJ investigation was “going to jump” from around \$11 million to around \$28 million; that RPM’s securities “[d]isclosure counsel [was] not aware” of the overcharge estimates sent to DOJ; and that Moore made “mistakes,” including “no disclosure to [the Audit Firm] or audit committee” at the Audit Committee meeting on January 4, 2013.

81. The next day, August 11, 2014, the Audit Committee directed RPM to restate the first, second, and third quarters of fiscal year 2013. RPM determined that its restated financial statements would reflect an \$11.4 million accrual for the DOJ investigation in the first quarter (which corresponded to the \$11.4 million estimate sent to DOJ on October 1, 2012), and an additional \$16.9 million accrual for the investigation in the second quarter (for a total accrual of \$28.3 million, which corresponded to RPM’s settlement offer to DOJ on January 11, 2013). RPM also restated its third quarter to reduce the accrual in that quarter from \$68.8 million to \$40.5 million, since \$28.3 million was accrued in the restated first and second quarters.

82. On August 14, 2014, RPM filed a Form 8-K, signed by Moore, to announce the restatement. The Form 8-K stated that RPM made “errors” in disclosing and accruing for the DOJ investigation. The restatement was necessary because RPM’s disclosure and accounting errors were material. Moreover, RPM’s Form 8-K also disclosed that “the restatement reflects a material weakness in the Company’s internal control over financial reporting and that its disclosure controls and procedures were not effective” as of the first and second fiscal quarters ended on August 31 and November 30, 2012.

83. Also on August 14, 2014, RPM filed amended Forms 10-Q for the first quarter ended August 31, 2012, and the second quarter ended November 30, 2012. The amended Forms 10-Q, unlike the originals, disclosed the DOJ investigation and reflected accruals showing

RPM's "best estimate of the amount of probable loss" associated with the DOJ investigation.

84. RPM's restatement and amended SEC filings thus confirmed that RPM's original SEC filings in 2012 and 2013, referenced above, were materially inaccurate. By filing amended Forms 10-Q that disclosed the DOJ investigation and related accruals, RPM essentially admitted not only that a material loss was reasonably possible by October 4, 2012 and January 8, 2013, when the original Forms 10-Q were filed, but also that a material loss was probable and estimable by those dates.

FIRST CLAIM FOR RELIEF
Violations of Securities Act Section 17(a)(2)
(Against RPM and Moore)

85. All of the foregoing paragraphs are incorporated by reference herein.

86. By the conduct alleged herein, RPM and Moore, in the offer or sale of RPM securities, by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly, and acting at least negligently, obtained money or property by means of untrue statements of material fact and material omissions.

87. By reason of the foregoing, RPM and Moore violated Section 17(a)(2) of the Securities Act [15 U.S.C. § 77q(a)(2)].

SECOND CLAIM FOR RELIEF
Violations of Securities Act Section 17(a)(3)
(Against RPM and Moore)

88. All of the foregoing paragraphs are incorporated by reference herein.

89. By the conduct alleged herein, RPM and Moore, in the offer or sale of RPM securities, by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly, and acting at least negligently, engaged in transactions, practices, or courses of business that operated or would operate as a fraud or

deceit upon the purchaser of the securities.

90. By reason of the foregoing, RPM and Moore violated Section 17(a)(3) of the Securities Act [15 U.S.C. § 77q(a)(3)].

THIRD CLAIM FOR RELIEF
Violations of Exchange Act Section 13(a) and
Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13
(Against RPM)

91. All of the foregoing paragraphs are incorporated by reference herein.

92. Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 13a-1, 13a-11, and 13a-13 thereunder [17 C.F.R. §§ 240.13a-1, 240.13a-11, and 240.13a-13] require issuers of registered securities to file with the SEC factually accurate annual reports (on Form 10-K), quarterly reports (on Form 10-Q), and current reports (on Form 8-K). Exchange Act Rule 12b-20 [17 C.F.R. § 240.12b-20] provides that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading.

93. By reason of the foregoing, RPM violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

FOURTH CLAIM FOR RELIEF
Violations of Exchange Act Section 13(b)(2)(A)
(Against RPM)

94. All of the foregoing paragraphs are incorporated by reference herein.

95. Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)] requires issuers to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions of the company and dispositions of its assets.

96. By reason of the foregoing, RPM violated Section 13(b)(2)(A) of the Exchange Act.

FIFTH CLAIM FOR RELIEF
Violations of Exchange Act Section 13(b)(2)(B)
(Against RPM)

97. All of the foregoing paragraphs are incorporated by reference herein.

98. Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)] requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain the accountability of assets.

99. By reason of the foregoing, RPM violated Section 13(b)(2)(B) of the Exchange Act.

SIXTH CLAIM FOR RELIEF
Violations of Exchange Act Rule 13b2-1
(Against Moore)

100. All of the foregoing paragraphs are incorporated by reference herein.

101. Rule 13b2-1 under the Exchange Act [17 C.F.R. § 240.13b2-1] provides that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Exchange Act.

102. By reason of the foregoing, Moore violated Rule 13b2-1 under the Exchange Act.

SEVENTH CLAIM FOR RELIEF
Violations of Exchange Act Rule 13b2-2(a)
(Against Moore)

103. All of the foregoing paragraphs are incorporated by reference herein.

104. Rule 13b2-2(a) [17 C.F.R. § 240.13b2-2(a)] provides that no director or officer of an issuer shall, directly or indirectly, make or cause to be made a materially false or misleading statement to an accountant or omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with any audit, review, or

examination of the financial statements of the issuer or the preparation or filing of any document or report required to be filed with the SEC.

105. By reason of the foregoing, Moore violated Rule 13b2-2(a) under the Exchange Act.

PRAYER FOR RELIEF

Accordingly, the SEC respectfully requests that the Court enter a final judgment:

A. Permanently enjoining RPM from further violations of Sections 17(a)(2) and (a)(3) of the Securities Act [15 U.S.C. §§ 77q(a)(2) and 77q(a)(3)]; Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)]; and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13];

B. Permanently enjoining Moore from further violations of Sections 17(a)(2) and (a)(3) of the Securities Act [15 U.S.C. §§ 77q(a)(2) and 77q(a)(3)], and Exchange Act Rules 13b2-1 and 13b2-2(a) [17 C.F.R. §§ 240.13b2-1 and 240.13b2-2(a)];

C. Ordering RPM and Moore to disgorge their ill-gotten gains as a result of the conduct alleged in this Complaint, plus prejudgment interest thereon;

D. Ordering RPM and Moore to pay civil money penalties pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]; and

E. Granting such other and further relief as the Court deems appropriate.

JURY DEMAND

Pursuant to Federal Rule of Civil Procedure 38, the SEC demands a trial by jury on all issues so triable.

Of Counsel:

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Respectfully submitted,

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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dated: September 9, 2016

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74998 / May 20, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16546

In the Matter of

**BHP Billiton Ltd. and BHP
Billiton Plc,**

Respondents.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against BHP Billiton Ltd. and BHP Billiton Plc (collectively, “BHPB” or “Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondents’ Offers, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

Summary

1. This matter concerns BHPB's failure to devise and maintain sufficient internal controls over a global hospitality program that the company hosted in connection with its sponsorship of the 2008 Beijing Summer Olympic Games. BHPB invited approximately 176 government officials and employees of state-owned enterprises (collectively, "government officials") to attend the Olympics at BHPB's expense. The majority of these invitations were extended to government officials from countries in Africa and Asia that had well-known histories of corruption. The three to four day hospitality packages included event tickets, luxury hotel accommodations, meals, other hospitality, and, in many instances, offers of business-class airfare for government officials and their guests. BHPB informed its employees that "[o]ne of the core objectives [of the Olympic sponsorship] is to maximize the commercial investment made in the Games through assisting [BHPB] to strengthen relationships with key local and global stakeholders, e.g.: Government Ministers, Suppliers and Customers," and that the hospitality program was "a primary vehicle to ensure this goal is achieved."

2. BHPB recognized that inviting government officials to the Olympics created a heightened risk of violating anti-corruption laws and the company's own Guide to Business Conduct, but the internal controls it developed and relied upon in an effort to address this risk were insufficient. As a result, BHPB invited government officials who were directly involved in, or in a position to influence, pending contract negotiations, efforts to obtain access rights, regulatory actions, or business dealings affecting BHPB in multiple countries. In addition, BHPB's books and records, namely certain internal forms that employees prepared in order to invite a government official to the Olympics, did not, in reasonable detail, accurately and fairly reflect BHPB's pending negotiations or business dealings with the government official at the time of the invitation.

3. As a result of this conduct, BHPB violated the internal controls and books and records provisions of the Foreign Corrupt Practices Act ("FCPA").

Respondent

4. **BHP Billiton ("BHPB")** is a combination of two companies: BHP Billiton Limited, which is headquartered in Melbourne, Australia, and BHP Billiton Plc, which is headquartered in London, England. Since 2001, BHPB has operated under a Dual Listed Company structure, under which BHP Billiton Limited and BHP Billiton Plc operate as a single economic entity, run by a unified Board of Directors and management team. BHP Billiton Limited American Depositary Shares ("ADSs") and BHP Billiton Plc ADSs are registered with the Commission pursuant to Section 12(b) of the Exchange Act and listed on the New York Stock Exchange under the tickers "BHP" and "BBL" respectively.

Background

5. BHPB is a global resources company that is among the world's leading producers of major commodities, including iron ore, coal, oil and gas, copper, aluminum, manganese, uranium, nickel, and silver. As of June 30, 2014, the end of its most recently completed fiscal year, BHPB had a market capitalization of approximately \$190 billion, with over 140 locations, operations in 25 countries, and a workforce of more than 128,000 employees and contractors.

6. During the relevant period, BHPB operated through different business divisions, called Customer Sector Groups ("CSGs"). These CSGs included Iron Ore, Aluminium, Petroleum, Base Metals, Diamonds and Specialty Products, Stainless Steel Materials, Manganese,

Metallurgical Coal, and Energy Coal. Each CSG had its own president, which reported to a member of BHPB's Group Management Committee.² BHPB also had a Minerals Exploration Group ("MinEx") that assisted the CSGs with exploration activities.

7. Under BHPB's operating model during the relevant period, each CSG President was responsible for ensuring their businesses' compliance with the company's Guide to Business Conduct. Every CSG President also was required to certify annually that they had read and understood the Guide, confirmed that their direct reports had done the same, and discussed it with their direct reports. BHPB had a centralized legal department. In addition, it had an advisory body with internal and external membership called the Global Ethics Panel ("Ethics Panel"), which advised business leaders on compliance with the Guide to Business Conduct and other business ethics issues. BHPB did not have an independent, centralized compliance group within its legal department, or otherwise.

BHPB's Hospitality Program for the 2008 Beijing Summer Olympic Games

A. The Scope and Goals of BHPB's Olympic Hospitality Program

8. In December 2005, BHPB and the Beijing Organizing Committee announced their agreement for BHPB to become an official sponsor of the 2008 Beijing Olympic Games. Under this agreement, BHPB paid a sponsorship fee and supplied the raw materials used to make the Olympic medals. In exchange, BHPB received the rights to use the Olympic trademark and other intellectual property in public announcements and advertisements, as well as priority access to tickets, hospitality suites, and accommodations in Beijing during the August 2008 Games.

9. BHPB established an Olympic Sponsorship Steering Committee ("OSSC") to plan, oversee, and implement its sponsorship program, which involved multiple different branding, promotion, and relationship-building initiatives. The chair of the OSSC, who also was the chair of the Ethics Panel, reported directly to BHPB's CEO.

10. One of BHPB's objectives for the sponsorship was "to reinforce and develop relationships with key stakeholders" in China and in "product and investor markets, and regions where we have or would like to have operations." BHPB's strategy for accomplishing its objectives included "[u]tiliz[ing] Olympic hospitality to motivate China-based stakeholders, including customers, suppliers, government and media, to enhance business opportunities for BHP Billiton in China" and "[u]tiliz[ing] Olympic hospitality to build relationships with stakeholders from product and investor markets, and regions where we have or would like to have operations."

11. One of the company's sponsorship-related initiatives was a global hospitality program under which BHPB invited guests from around the world, including foreign government officials and representatives of state-owned enterprises, to attend the Beijing Olympics on three to four day hospitality packages. The hospitality packages included luxury hotel accommodations, meals, event tickets, and sightseeing excursions, at a cost of approximately \$12,000 to \$16,000 per package. In addition, BHPB executives approved the offer of round trip business class airfare to approximately 51 foreign government officials, as well as the airfares for 35 of these government

² In 2012 and 2013, BHPB re-organized to consolidate the CSGs into five business units: Petroleum and Potash; Copper; Iron Ore; Coal; and Aluminium, Manganese and Nickel.

officials' spouses or guests. Apart from BHPB's desire to enhance business opportunities by strengthening relationships with its guests, these trips had no other business purpose.

12. An internal e-mail to CSG presidents and other senior BHPB business managers emphasized the importance of the hospitality program to the success of BHPB's sponsorship, stating, "[a]s you know we have made a commitment to support the Beijing Olympic Games in 2008. One of the core objectives is to maximise the commercial investment made in the Games through assisting [BHPB] to strengthen relationships with key local and global stakeholders, e.g.: Government Ministers, Suppliers and Customers. The BHP Billiton Hospitality Program is a primary vehicle to ensure this goal is achieved."

13. In early 2007, BHPB employees prepared country-specific Olympic Leverage Plans, which summarized BHPB's business and Olympic-related objectives. In a number of instances, these plans discussed inviting key stakeholders, including government officials, to help BHPB develop relationships with a view to increasing or maintaining its business opportunities. For example, the Olympic Leverage Plan prepared for one country stated that BHPB's business objectives in that country included "gaining access to regions that will provide growth for [BHPB's] business" and "gaining port access." The plan further stated that the hospitality program would "provide useful relationship building opportunity for . . . stakeholders" and that the invitees would include the country's Minister of Mines and Minister of Transport. The Olympic Leverage Plan for another country, while not specifically addressing the hospitality program, stated that one of the goals for the sponsorship was "us[ing] Olympics program to strengthen and build the govt's confidence and relationship with [BHPB], to help facilitate approvals for future projects."

14. After Olympic Leverage Plans were prepared for each country, BHPB business managers submitted lists of potential invitees and were instructed to rank them in order of importance, with "Category A" being those "most critical to the business." Internal BHPB presentations discussed the need to establish "the business benefit" of an Olympic invitation.

15. Eventually, BHPB invited approximately 650 people to attend the Beijing Olympics, including 176 government officials, 98 of whom were representatives of state-owned enterprises that were BHPB customers or suppliers. BHPB also invited the spouses of 102 of these government officials. Most of the invited government officials were from countries in Africa and Asia where there was a known risk of corruption. Sixty of these government officials ultimately attended, 24 of them with their spouses or guests. A number of other invited government officials accepted their invitations, but then cancelled before the Olympics began.

B. BHPB's Insufficient Internal Controls over the Olympic Hospitality Program

16. Early in its planning for the Olympics, BHPB identified the risk that inviting government officials to the Olympics could potentially violate anti-corruption laws and the company's own Guide to Business Conduct. The company relied on its existing operating model and an Olympic-specific internal approval process to address this risk. However, these internal controls, and BHPB's implementation of them, were insufficient.

17. BHPB developed a hospitality application which business managers were required to complete for any individuals, including government officials, whom they wished to invite. These applications included the following questions:

9. What business obligation exists or is expected to develop between the proposed invitee and BHP Billiton?

10. Is BHP Billiton negotiating or considering any contract, license agreement or seeking access rights with a third party where the proposed invitee is in a position to influence the outcome of that negotiation?

11. Do you believe that the offer of the proposed hospitality would be likely to create an impression that there is an improper connection between the provision of the hospitality and the business that is being negotiated, considered or conducted, or in any way might be perceived as breaching the Company's Guide to Business Conduct?

If yes, please provide details.

12. Are there other matters relating to the relationship between BHP Billiton and the proposed invitee that you believe should be considered in relation to the provision of hospitality having regard to BHP Billiton's *Guide to Business Conduct*?

18. BHPB required each such application to be filled out and signed by an employee with knowledge of the invitee's relationship with the company, and approved in writing by the president of the relevant CSG or the BHPB country president.³ A cover sheet that accompanied the blank forms included a short description of anti-bribery provisions in the Guide to Business Conduct and urged employees to re-read the section of the Guide concerning travel, entertainment, and gifts before completing the form. However, the controls did not adequately address the anti-bribery risks associated with offering expensive travel and entertainment packages to government officials.

19. First, BHPB did not require independent legal or compliance review of hospitality applications by someone outside the CSG that was submitting the application, and did not clearly communicate to its employees the fact that the Ethics Panel was not reviewing and approving each invitation to a government official. On the one hand, BHPB's internal website stated that the hospitality applications were subject to "scrutiny by the Ethics Panel [steering committee]," and the hospitality applications themselves stated that, "[r]equests for travel and accompanying spouses will be approved by the Olympic Sponsorship Steering Committee and the Global Ethics Panel Sub-Committee." E-mails sent to some BHPB business managers by a member of the OSSC staff stated that the Ethics Panel had "approved" their applications.

20. However, other than reviewing approximately 10 hospitality applications for government officials in mid-2007 in order to assess the invitation process, the OSSC and the Ethics Panel subcommittee did not review the appropriateness of individual hospitality applications or airfare requests. The Ethics Panel's charter stated that its role simply was to provide advice on ethical and compliance matters, and that "accountability rest[ed] with business leaders." Members of the Ethics Panel understood that, consistent with their charter, their role with respect to implementation of the hospitality program was purely advisory. As a result, business managers had sole responsibility for reconciling the competing goals of inviting guests – including

³ In countries where multiple CSGs operated, BHPB had employees designated as "country presidents" or "country managers" to coordinate the activities of the various business units.

government officials – who would “maximize [BHPB’s] commercial investment made in the Olympic Games” without violating anti-bribery laws.

21. Second, some hospitality applications were not accurate or complete. Many applications identified an employee of a state-owned enterprise as a “Customer,” but failed to identify the invitee as a “Representative of Government.” In addition, a number of applications contained “No” responses to Question 10, even when BHPB had pending negotiations, efforts to obtain access rights, regulatory actions, or other business dealings in which the government official was directly involved or in a position to influence. Furthermore, in a number of instances, BHPB business people were provided with examples of language that had been used by other employees when responding to Questions 10 and 11 in order to explain why an invitation was appropriate, even when there was a “Yes” response to Questions 10-12. As a result, many hospitality applications contained the exact same statements in response to Questions 10 and 11, rather than a description of the specific facts and circumstances relating to that government official.⁴

22. Third, while BHPB had an annual Guide to Business Conduct review and certification process, and generalized training, it did not provide its employees and executives with any specific training on how to fill out the hospitality forms or how to evaluate whether an invitation to a government official complied with the Guide. During the relevant period, this portion of the Guide included a case example concerning a negotiation between BHPB and a Ministry for Planning in a particular country, in which the Minister indicated that it would help his consideration of the company’s application if the Minister and his wife could visit BHPB’s operations in Australia. The example stated that “this kind of situation requires the utmost caution and you must consult senior management. You must not offer to provide anything that could be reasonably regarded as an attempt to unduly influence the Minister’s decision. This means that you must not pay for travel by the Minister’s wife.” However, BHPB did not provide any guidance to its senior managers on how they should apply this portion of the Guide when determining whether to approve invitations and airfares for government officials’ spouses.

23. Fourth, although the form asked whether any business was “expected to develop” with the invitee, BHPB did not institute a process for updating hospitality applications or reassessing the appropriateness of invitations to government officials if conditions changed. Almost all of the hospitality applications relating to government officials were approved and submitted in mid-2007. However, BHPB did not require hospitality forms to be updated, or invitations to be reconsidered, in those situations when government officials subsequently became involved in negotiations, attempts by BHPB to obtain access rights, or other pending matters.

24. Fifth, hospitality applications were submitted by individual CSGs, and generally only reflected negotiations between the government official and that CSG. While lists of invitees were circulated among senior BHPB business managers, BHPB had no process in place to

⁴ For example, a number of hospitality forms included the following response to Question 10: “Yes, the invitee is in a position to influence the outcome of the pending contract, however, this is an organization that we have been conducting business with for over five years. Negotiations and contract outcomes are a regular occurrence but due to the lengthy relationship with BHP Billiton there is evidence [of] a long term commitment that would not necessarily be influenced by this gesture. It is a way of rewarding the business that has previously been conducted with BHP Billiton.”

determine whether the invited government official also was involved in other CSGs' negotiations, efforts to obtain access rights, or other business dealings.

C. As a Result of its Insufficient Internal Controls, BHPB Invited Government Officials who were Directly Involved in, or in a Position to Influence, Pending Negotiations, Regulatory Actions, or Business Dealings with BHPB

25. As a result of its failure to design and maintain sufficient internal controls over the Olympic global hospitality program, BHPB invited a number of government officials who were directly involved with, or in a position to influence, pending negotiations, efforts by BHPB to obtain access rights, or other pending matters.

Republic of Burundi

26. In mid-2007, BHPB's MinEx group submitted a hospitality application form to invite the as-yet-unidentified Burundi Minister of Mines and spouse to the Olympics, with airfare included. Because BHPB was not currently in negotiations with the Minister of Mines at the time, the hospitality application form contained a "No" response to Question 10. However, BHPB had a joint venture ("JV") in Burundi with an entity that was in danger of losing a nickel exploration permit unless it made a substantial near-term financial investment in the project or negotiated a renewal or amendment of the permit. Under Burundi law, the Minister of Mines was responsible for reviewing an application to renew or amend a mining permit and presenting the application to the country's Council of Ministers for final approval.

27. In late 2007 and early 2008, BHPB began to negotiate directly with the newly-appointed Minister of Mines to extend and modify the JV's nickel exploration permit. However, BHPB employees did not update the hospitality application or take steps to re-review the appropriateness of the invitation after these negotiations began. As noted above, no such re-review was required by the internal controls that BHPB relied upon for the Olympic hospitality program. The Minister of Mines and his wife attended the Olympics as BHPB's guests for four days.

Republic of the Philippines

28. In July 2007, BHPB became embroiled in a dispute with a local JV partner concerning a prospective nickel mining operation in the Philippines. The JV partner sued BHPB in local court and filed requests with the country's Secretary of Department of Environment and Resources ("DENR"), requesting reversion of the mining rights that the JV partner had assigned to the JV.

29. In October 2007, a BHPB employee from the Stainless Steel Materials CSG submitted a hospitality application to invite the Secretary and his spouse to attend the Olympics, with airfare included. The completed application contained a "Yes" response to Question 10, but only described a technical services agreement that BHPB was considering submitting to the DENR for the Secretary's approval. Question 10 of the hospitality form did not explicitly require, and the employee's response did not provide, any information about the Secretary's role in reviewing the JV partner's reversion request or the fact that the President of the Philippines had designated the Secretary to mediate the dispute between BHPB and its JV partner. The form included a "No" response to Question 11.

30. The Secretary accepted BHPB's invitation in December 2007. In March 2008, he issued a decision denying the JV partner's reversion request and continued during the ensuing months to mediate the parties' dispute. In late July, BHPB became concerned that the company's

JV partner had learned about the Olympics invitation. As a result, BHPB withdrew the invitation shortly before the Olympics began.

Democratic Republic of the Congo

31. In mid-2007, MinEx submitted a hospitality application form to invite the Governor of the Katanga Province in the Democratic Republic of the Congo (the “DRC”) and his spouse, with airfare included. Following its June 2007 review of 10 invitations to government officials, the Ethics Panel subcommittee advised MinEx to provide more detail about whether the invitation involved Gecamines, a state-owned entity with which BHPB was attempting to negotiate a copper exploration deal. In response, MinEx submitted a revised application that contained a “No” response to Question 10, stating, “[t]he issuing and management of mineral titles and negotiations with third parties in DRC have nothing to do with the Governor’s roles and responsibilities. Although [BHPB] are currently engaged in negotiations with State copper company, Gecamines, the Governor of Katanga will have no influence in these dealings.”

32. Later in 2007, however, BHPB employees held several meetings with the Governor. Internal summaries of these meetings noted that the Governor was “a close ally of [the DRC] President” and that having the Governor as BHPB’s ally “could be the key to unlock a successful entry in a deal with Gecamines.” In spite of obtaining this information after making the initial decision to invite the Governor of Katanga and his wife to the Olympics, BHPB employees did not update the hospitality application form or take steps to re-review the appropriateness of the invitation. No such re-review was required under the internal controls that BHPB relied upon for the Olympic hospitality program. The Governor accepted the invitation, but then cancelled before the Olympics.

Republic of Guinea

33. In May 2007, MinEx submitted a hospitality application to invite the Guinea Minister of Mines and his spouse to the Olympics, with airfare included. The application contained a “No” response to Question 10, and in response to Question 11 it stated, “No. A sound professional relationship with the Guinea Ministry of Mines is key for the success of the [BHPB] exploration and mining business in this country.” Following its June 2007 review of 10 invitations to government officials, the Ethics Panel subcommittee advised MinEx to provide additional information concerning this invitation. The MinEx employee who had prepared the original form asked BHPB’s Guinea country president to respond to the request for information concerning any pending negotiations with the Minister. The country president replied that “of course” there would be “further negotiations” regarding the upcoming renewal of a bauxite mining concession held by BHPB and the government’s intention to review all existing mining concessions, but that the response to Question 11 was “key in that regard.”

34. This information was not passed along to the Ethics Panel subcommittee, however, and the form was not updated to accurately reflect the pending negotiations across all of the CSGs operating in Guinea. Because they received no response to the Guinea country president’s email, MinEx officials mistakenly understood that the Ethics Panel had approved the invitation. The Minister accepted the invitation on behalf of himself and his wife in January 2008, but cancelled shortly before the Olympics began.

Legal Standards and FCPA Violations

35. Under Section 21C(a) of the Exchange Act, the Commission may impose a cease-and-desist order upon any person who is violating, has violated, or is about to violate any provision of the Exchange Act or any rule or regulation thereunder, and upon any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation.

36. Under Section 13(b)(2)(A) of the Exchange Act, issuers are required to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer.

37. Under Section 13(b)(2)(B) of the Exchange Act, issuers are required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

38. As a result of the conduct described above, BHPB violated Section 13(b)(2)(A) because its books and records, namely certain Olympic hospitality applications, did not, in reasonable detail, accurately and fairly reflect pending negotiations or business dealings between BHPB and government officials invited to the Olympics. BHPB violated Section 13(b)(2)(B) because it did not devise and maintain internal accounting controls over the Olympic hospitality program that were sufficient to provide reasonable assurances that access to assets and transactions were in executed in accordance with management's authorization.

BHPB's Cooperation and Remedial Efforts

39. In response to the Commission's investigation, BHPB retained outside counsel to assist it with conducting an extensive internal investigation into potential improper conduct in the jurisdictions that were the subject of the staff's inquiry. BHPB provided significant cooperation with the Commission's investigation by voluntarily producing large volumes of business, financial, and accounting documents from around the world in response to the staff's requests, and by voluntarily producing translations of key documents. BHPB's counsel conducted scores of interviews and provided the staff with regular reports on the findings of its internal investigation.

40. BHPB also has undertaken significant remedial actions. BHPB has created a compliance group within its legal department that is independent from the business units. This compliance group is responsible for FCPA compliance, among other things, and reports directly to BHPB's general counsel and Audit Committee. In addition, it has reviewed its existing anti-corruption compliance program and implemented other changes. These include embedding independent anti-corruption managers into its businesses and further enhancing its policies and procedures concerning hospitality, gift giving, use of third party agents, business partners, and other high-risk compliance areas. BHPB also has enhanced its financial and auditing controls, including policies to specifically address conducting business in high-risk markets. BHPB has

conducted extensive employee training on anti-corruption issues and overhauled its processes for conducting internal investigations of potential violations of anti-corruption laws.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents BHP Billiton Ltd.'s and BHP Billiton Plc's Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

B. Respondents shall, within 10 days of the entry of this Order, pay a civil money penalty totaling \$25,000,000 to the Securities and Exchange Commission for remission to the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

- (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying BHP Billiton Ltd. and BHP Billiton Plc as Respondents in these proceedings, and the file number of these proceedings. A copy of the cover letter and check or money order must be sent to Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

C. During a one-year term as set forth below, Respondents shall report to the Commission staff on the operation of BHPB's FCPA and anti-corruption compliance program. If Respondents discover credible evidence, not already reported to the Commission staff, that: (1) questionable or corrupt payments or questionable or corrupt transfers of property or interests may have been offered, promised, paid, or authorized by Respondents, or any entity or person while working directly for Respondents, to any government official; (2) that related false books and records have been maintained; or (3) that Respondents' internal controls failed to detect and prevent such conduct, Respondents shall promptly report such conduct to the Commission staff. During this one-year period:

- (1) Respondents shall submit to the Commission staff a written report within 180 calendar days of the entry of this Order on the operation of BHPB's FCPA and anti-corruption compliance program (the "Initial Report"). The Initial Report shall be transmitted to Alexander Koch, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5041. Respondents may extend the time period for issuance of the Initial Report with prior written approval of the Commission staff.
- (2) Respondents shall undertake one follow-up review, incorporating any comments provided by the Commission staff on the Initial Report, to further monitor and assess the operation of its FCPA and anti-corruption compliance program and whether Respondents' policies and procedures are reasonably designed to detect and prevent violations of the FCPA and other applicable anti-corruption laws (the "Final Report").
- (3) The Final Report shall be completed by no later than 180 days after the Initial Report, and shall be transmitted to Alexander Koch, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5041. Respondents may extend the time period for issuance of the Final Report with prior written approval of the Commission staff.
- (4) The reports submitted by Respondents will likely include proprietary, financial, confidential, and competitive business information. Public disclosure of the reports could discourage cooperation, impede pending or potential government investigations or undermine the objectives of the reporting requirement. For these reasons, among others, the reports and the contents thereof are intended to remain and shall remain non-public, except (a) pursuant to court order, (b) as agreed by the parties in writing, (c) to the extent that the Commission staff determines in its sole discretion that disclosure would be in furtherance of the Commission's discharge of its duties and responsibilities, or (d) is otherwise required by law.

By the Commission.

Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 79193 / October 31, 2016

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3820 / October 31, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17651

In the Matter of

ADRIAN D. BEAMISH, CPA,

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 4C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Adrian D. Beamish, CPA ("Respondent" or "Beamish") pursuant to Section 4C of the Securities Exchange Act of 1934¹ ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.²

¹ Section 4C provides, in relevant part, that: "The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder."

² Rule 102(e)(1)(ii) provides, in pertinent part, that: "The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct."

II.

After an investigation, the Division of Enforcement and the Office of the Chief Accountant allege that:

A. Summary

1. Respondent Adrian D. Beamish repeatedly engaged in improper professional conduct during PricewaterhouseCoopers LLP's audits of Burrill Life Sciences Capital Fund III, LP, a \$283 million San Francisco-based venture capital fund. PricewaterhouseCoopers LLP, was first engaged to conduct the audits of the venture capital fund's year-end 2006 financial statements. As detailed below, Beamish, as the engagement partner, failed to comply with the relevant professional standards in connection with his audits of the fund's 2009, 2010, 2011, and 2012 year-end financial statements.

2. In the audit of the venture capital fund's year-end 2009 financial statements, Beamish became aware that the fund's founder, G. Steven Burrill, had arranged for the fund to pay millions of dollars to other companies that Burrill owned and controlled. From 2009 through 2011, Burrill characterized the payments as advances on future management fees that he would earn through the provision of future management services as the fund's manager. The payments were made many months—and even years—before the fees were to be earned. In each of these three years, Beamish failed to inquire whether Burrill had the authority to take the unusual payments, nor did he scrutinize the rationale for the payments, which Burrill needed to pay his own personal expenses and to fund his other businesses. Significantly, in conducting the year-end 2012 audit, Beamish learned that the advanced management fee payments that had been paid greatly exceeded any potential future management fee obligations the fund might owe.

3. Despite an advanced management fee balance rapidly growing over several years and not decreasing, and Beamish's own audit team's suggested financial disclosure language being rejected by management, Beamish improperly signed audit reports with unqualified opinions for the fund's year-end 2009, 2010, 2011, and 2012 financial statements, in violation of Generally Accepted Auditing Standards ("GAAS"). In addition, the fund's financial statements, for those same years, did not comply with Generally Accepted Accounting Principles ("GAAP"). Further, Beamish relied upon unreasonable bases as the supposed means for repayment of the advanced management fee balance.

B. Respondent

4. **Adrian D. Beamish, CPA**, age 44, is a resident of Los Altos, California. Beamish has been licensed as a Certified Public Accountant in California since November 2004, and has been a Chartered Accountant in England and Wales since 1995. Beamish was hired by PricewaterhouseCoopers' U.K. firm in 1995, and in 1998, he moved to PricewaterhouseCoopers' U.S.A. firm in San Jose, California, where he became an audit partner in 2006. Beamish conducts audits of both public and private entities for PricewaterhouseCoopers, and he specializes in the pharmaceutical life sciences and venture capital industries.

C. Related Persons and Entities

5. **G. Steven Burrill**, age 71, resides in San Francisco, California, and Eagle River, Wisconsin. From 1977 to 1993, Burrill was a partner at a large audit firm and focused on the biotechnology industry. Burrill began raising venture capital funds when he left the audit firm in 1993. In addition to venture capital funds, Burrill owned and controlled a number of affiliated businesses, including an investment adviser, a merchant banking firm, and a media company. On March 16, 2016, Burrill, a CPA, was suspended from appearing or practicing before the Commission as an accountant and was barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

6. **Burrill Capital Management, LLC (“BCM”)** is a Delaware limited liability company and filed reports as an exempt reporting adviser with the Commission from April 2012 to January 2015, when it withdrew its registration. Burrill Capital Management is wholly owned by Burrill and had its principal place of business in San Francisco, California. Now defunct, BCM acted as the adviser to several venture capital funds operated by Burrill. Burrill also used BCM as the operating entity through which he directed resources to his affiliated businesses. As of its last filing in March 2014, BCM reported \$358.6 million in total assets under management.

7. **Burrill Life Sciences Capital Fund III, LP (“Fund III” or the “Fund”)** is a Delaware limited partnership formed by Burrill in 2006. The Fund received \$283 million in venture capital funds to invest in life sciences companies. The Fund retained BCM as its investment adviser.

8. **Burrill Life Sciences Capital Fund III Partners, LP (“General Partner”)**, a Delaware limited partnership, was the General Partner of Fund III during the relevant time period. The General Partner’s Investment Committee included Burrill and four others. The General Partner was entitled to receive fees for managing the Fund, but also could designate an affiliate to receive the fees.

9. **Burrill Capital, LLC (“Management Company”)** is a Delaware limited liability company owned and controlled entirely by Burrill. As described further below, in its 2012 financial statements, the Fund stated that the Management Company was responsible for repaying the balance of the management fees that had been advanced to the General Partner.

10. **PricewaterhouseCoopers LLP (“PricewaterhouseCoopers” or “PwC”)** provides audit, assurance, tax, transaction, and advisory services throughout the United States, and throughout the world via their members firms. Auditors from its San Jose, California office conducted the audits of Fund III for fiscal years 2006-2012.

D. Formation of Fund and Retention of PricewaterhouseCoopers as Auditors

11. Burrill formed Fund III in 2006 to invest in life sciences companies. Established with a projected 10-year lifespan, Fund III was originally scheduled to expire in February 2016. Fund III is structured as a limited partnership. Investors in Fund III, which include public companies, pension funds, and institutional investors, are limited partners in the Fund. During the relevant period, Burrill Life Sciences Capital Fund III Partners, LP served as the Fund's General Partner. Five individuals, including Burrill, controlled the General Partner.

12. The rights and responsibilities of the General Partner and the limited partners of Fund III are governed by a limited partnership agreement ("LPA"). The LPA delineates, among other things, the manner and amount of the General Partner's fees for managing the Fund. According to the LPA, the General Partner or its designee is entitled to two percent of committed capital for six years, payable on the first day of each fiscal quarter for management services to be rendered during that quarter. After the initial six years, the General Partner or its designee is entitled to two percent of the cost basis of the investments, plus reserves. As enumerated in the LPA, the management fee was intended to be used by the General Partner to cover expenses in connection with the management of the fund, including salaries, travel, and rent. The LPA did not authorize the General Partner to take management fees more than one quarter in advance, and prohibited non-arm's length transactions between Fund III and the General Partner or its members without explicit approval of an advisory committee of limited partners.

13. The Fund's offering materials state that a major financial accounting firm would issue a report on the financial statements annually. In addition, the LPA similarly stipulated that the Fund would issue financial statements in accordance with GAAP, and would be audited annually by a public accountant of recognized national standing.

14. Beginning in 2006, the Fund issued annual financial statements and retained PricewaterhouseCoopers to serve as its auditor to conduct annual audits on the Fund. Beamish served as the PwC audit partner responsible for the audit team's compliance with the appropriate professional standards. As the engagement partner, Beamish had final authority over the planning, execution, and supervision of the audits and was responsible for audit reports issued by PwC on the Fund's financial statements.

15. For the year-end 2009 through year-end 2012 audits, Beamish authorized PricewaterhouseCoopers to issue audit reports with unqualified opinions stating that the Fund's financial statements were presented fairly, in all material respects, in accordance with GAAP and that the audits were conducted in accordance with GAAS. In reality, however, the Fund's financial statements failed to comply with GAAP and the audits failed to comply with GAAS.

E. Burrill Took "Advanced Management Fees" to Fund Other Businesses

16. In late 2007, Burrill and his affiliated businesses began to face cash flow shortages. Burrill Capital Management, the adviser to Fund III and the entity through which Burrill operated and funded his affiliated businesses, maintained records showing that the expenses of the Burrill affiliates far exceeded the revenue that the businesses were generating.

Even though he did not solely control the Fund's General Partner, Burrill unilaterally directed BCM's controller to take \$400,000 from Fund III to make up for the cash shortfall in BCM. Burrill justified the withdrawal as an "advance on management fees" that the General Partner expected to earn in the first quarter of 2008. The advance was recorded as a "prepaid expense" on the books of Fund III.

17. By mid-2008, Burrill, alone directing the General Partner, had begun to take routine and significant advances on management fees. Whenever BCM, or Burrill's affiliated entities, faced a cash shortfall, Burrill arranged to cover the shortfall by taking money from Fund III and recording it as a prepaid expense to BCM on the Fund's books. Advanced management fees from Fund III became a consistent cash source for the affiliates and for Burrill personally. Burrill used the money to pay for, among other things, salaries of employees of the related entities and his personal expenses. These advanced management fees appeared in the Fund's financial statements as "prepaid expenses" or "receivables," as described below.

F. During the Year-End 2009, 2010, and 2011 Audits, Beamish Failed to Scrutinize the Advanced Fees Appropriately

18. The amount of the advanced management fees taken by the General Partner was disclosed to the PricewaterhouseCoopers audit team. Through the audits, Beamish became aware that the balance of the advanced management fees increased by millions of dollars every year from 2009 through 2011:

- By the end of 2009, the advanced management fee balance totaled \$4,927,374, representing almost one year of advanced management fees.
- By the end of 2010, the advanced management fee balance had grown to \$9,259,317, or just under two years of advanced management fees.
- By the end of 2011, the advanced management fee balance had grown to \$13,374,569, or nearly three full years in advanced management fees.

19. These balances were significant, far surpassing PwC's internally-established threshold for materiality and were recognized by the PwC audit team, and by Beamish particularly, as unusual in the industry. According to the relevant GAAS standards that relate to the consideration of possibility of fraud, if an auditor becomes aware of significant and unusual transactions, the auditor should gain an understanding of "the business rationale of such transactions and whether that rationale (or lack thereof) suggests that such transactions may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets." AU § 316.66.³ Furthermore, in assessing the risk of material misstatement, the auditor must consider there is a risk that "involves significant non-routine transactions . . . outside the normal course of business for the entity, or that otherwise appear to be unusual." AU § 314.111.

³ "AU" and "AU-C" refer to Statements on Auditing Standards issued by the American Institute of Certified Public Accountants.

20. Despite the significant and unusual nature of the payment of the advanced management fees, Beamish and the PwC audit team took no steps to try to understand the business rationale for the payments. And even though the balance of the advanced fees grew steadily during 2009, 2010, and 2011, Beamish did not inquire into the rationale for the advances, nor did Beamish inquire as to why the amount grew.

21. Had Beamish made appropriate inquiries as required by professional standards, his audit team would have likely discovered that the fees advanced to the General Partner had been used for the business operations of affiliated Burrill entities, such as Burrill Securities LLC, and to pay for Burrill's own personal expenses. Further, Beamish did not attempt to obtain evidence about whether Burrill and the affiliated entities were authorized to receive such payments, as well as whether they had the ability to repay the amounts.

22. Generally Accepted Auditing Standards require auditors to exercise "due professional care" throughout an audit. AU § 230. Due professional care requires an auditor to exercise professional skepticism, "an attitude that includes a questioning mind and a critical assessment of audit evidence." AU § 230.07. "Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process." AU § 230.08. The auditor "should not be satisfied with less than persuasive evidence because of a belief that management is honest." AU § 230.09; *see also* AU § 316.13. This is particularly true with respect to related party transactions. Audit procedures for related party transactions "should extend beyond inquiry of management" and require an auditor to obtain an "understanding of the business purpose of the transaction." AU § 334.09.

23. Beamish failed to exercise the professional care required by GAAS in the audits of the Fund's 2009, 2010, and 2011 financial statements. Beamish took no steps to obtain audit evidence that the payments were properly approved and authorized, even as the balance continued to grow year to year. During the audit of the Fund's year-end 2011 financial statements, Beamish's audit team calculated the total future management fees due to the General Partner for the remaining life of Fund III. The audit team estimated there was approximately \$10.2 million left in future management fees to be earned by the General Partner over the remainder of the contractual life of Fund III, beyond the nearly \$13.4 million that had already been advanced. The audit team concluded that the General Partner could "earn down" the balance, through the provision of management services by the expected termination of the Fund in 2016.

24. The auditors' calculation of the amount of future fees available to the General Partner during the 2011 audit, however, was incorrect by a significant margin. If his audit team had correctly calculated the future management fees to be earned, using a conservative calculation, Beamish would have realized there was, at most, \$3.2 million in future fees to be earned—not the \$10.2 million that the PwC team had calculated. After the approximately \$3.2 million was paid, Fund III would have no contractual obligation to pay additional management fees to the General Partner or its designee for the remaining contractual term of the Fund. Had Beamish exercised the appropriate professional skepticism required of him as an auditor, especially in light of the ever increasing advanced management fee balance, he should have questioned and sought evidence for the premise that the advanced management fee balance

would likely be recovered simply through the provision of future management services by the General Partner.

25. From his audit, moreover, Beamish learned that the Fund described the advanced management fee balance as a “receivable,” or undocumented loan, to the General Partner in the year-end 2009, 2010, and 2011 financial statements. Generally Accepted Auditing Standards require special scrutiny of interest-free loans between related parties and loans with “no scheduled terms for when or how the funds will be repaid.” AU § 334.03. When confronted with such an undocumented loan, an auditor is required to “[d]etermine whether the transaction has been approved by those charged with governance.” AU § 334.09. Nonetheless, Beamish, and the PwC auditors working at his direction, took no steps to determine whether such a loan to the General Partner was permitted by the LPA. Nor did Beamish inquire whether the General Partner’s governing documents permitted Burrill to take the advanced fees without the consent of the General Partner.

G. The Fund’s Year-End 2009, 2010, and 2011 Financial Statements Failed to Disclose Fees Accurately

26. Generally Accepted Auditing Standards concerning related party transactions require that an “auditor should view related party transactions within the framework of existing [accounting] pronouncements, *placing primary emphasis on the adequacy of disclosure.*” AU § 334.02 (emphasis added). Furthermore, an auditor should apply procedures to obtain satisfaction about the related party transactions and the effect on financial statements. AU § 334.09. For each “material related party transaction . . . common ownership or management control relationship . . . the auditor should consider whether he has obtained sufficient appropriate audit evidence to understand the relationship of the parties and . . . the effects of the transaction on the financial statements.” AU § 334.11. Disclosures of related party transactions must include (1) the nature of the relationships involved; (2) a description of the transactions and other such information deemed necessary to an understanding of the effects of the transactions on the financial statements; and (3) the terms and manner of settlement. ASC 850-10-50-1.⁴

27. The Fund III year-end 2009, 2010, and 2011 financial statements inconsistently and inaccurately disclosed the nature of the advanced management fees. In none of the three year-end financial statements did the Fund adequately disclose that management fees were being advanced:

- The balance sheet in the Fund’s year-end 2009 audited financial statements included the amount of advanced management fees as an undefined part of a larger “prepaid expense” paid by the Fund. The balance sheets in the 2010 and 2011 financial statements similarly included the amount of advanced management fees as an undefined part of a larger amount of “prepaid expenses and other receivables,” but did not separately show a related party receivable on the balance sheet as required by GAAP (and in particular, ASC 850-10-50-2). The balance sheets did

⁴ “ASC” refers to the Accounting Standards Codification issued by the Financial Accounting Standards Board.

not further describe the nature of the “prepaid expenses” or “receivables,” and made no explicit reference to the payment of advanced management fees.

- The Related Party footnotes to the year-end 2009, 2010, and 2011 audited financial statements described the amount of the advanced management fees only as a “receivable from the General Partner.” The footnotes did not further describe the transaction nor the terms and manner of settlement of the so-called “receivable,” as required by GAAP. ASC 850-10-50-1.
- The Management Fee footnotes to the year-end 2009, 2010, and 2011 audited financial statements merely described the amount the General Partner was legally entitled to receive over the course of the calendar year in accordance with the LPA. The footnotes did not disclose that the Fund had actually paid advanced management fees, and contained no references to the amounts described as “prepaid expenses” and “receivables” on the balance sheets or a cross-reference to the Related Party footnotes. As a result, the footnotes further created a misleading picture of the Fund’s financial statements for each period.

28. The Fund’s audited financial statements materially misstated the nature of the related party payments. Beamish failed to obtain sufficient appropriate audit evidence to determine whether GAAP compliant disclosure of the payments made was adequate, as required by GAAS, when he authorized PricewaterhouseCoopers to issue audit reports with unqualified opinions on the Fund’s year-end 2009, 2010, and 2011 financial statements.

H. Beamish Issued a Clean Opinion on the Fund’s Year-End 2012 Financial Statements

29. By the first quarter of 2012, the General Partner was paid more in management fees from Fund III than the General Partner was contractually entitled to earn over the entire 10-year life of the Fund. At the end of 2012, the balance of the advanced management fees totaled \$17,922,059. Beamish was aware of the balance of advanced management fees in connection with the audit of the Fund’s 2012 financial statements. Under Beamish’s supervision, the PwC audit team calculated that the fund overpaid in excess of approximately \$7 million in management fees.

30. Aware that millions of dollars in excess management fees had been taken from the Fund, the audit team proposed to BCM management that the Fund provide the following additional disclosure in its year-end 2012 financial statements: “Prepaid expenses and other receivables at December 31, 2012 include \$17.9 million due from the General Partner. *This amount exceeds the expected future management fee expenses for the remaining contractual life of the fund.*” (Emphasis added.) When BCM management rejected the second sentence of Beamish’s proposal regarding the excessive amount, however, Beamish agreed that the additional disclosure need not be included in the Fund’s financial statements.

31. Shortly thereafter, BCM management told Beamish that Burrill had executed an unsecured promissory note for the full amount of the advanced management fee balance. The BCM controller provided PwC with the promissory note, which was dated December 31, 2012. After receiving the note, Beamish’s audit team suggested a revision to the proposed Related

Party footnote for the Fund's year-end 2012 financial statements to describe the terms of the note, the manner of settlement, and the interest rate. The auditors provided the suggestion to BCM management. Three days later, the BCM controller told Beamish that Burrill "strongly feels he does not want the footnote as currently worded to be included in the financials" and that the note had been "withdrawn." The reference to the promissory note was omitted from the year-end 2012 audited financial statements.

32. In April 2013, the Fund issued its year-end 2012 financial statements with an audit report with an unqualified audit opinion from PricewaterhouseCoopers. The audited financial statements materially misstated the nature of the related party payments. Beamish failed to obtain sufficient appropriate audit evidence to determine whether GAAP compliant disclosure of the payments was made, as required by GAAS, when he authorized PwC to issue its audit report with an unqualified opinion. The balance sheet identified the advanced management fees as part of a larger amount of "prepaid expenses and other receivables from related party" owed to the Fund, but did not separately show a related party receivable on the balance sheet as required by GAAP (and in particular, ASC 850-10-50-2).

33. In the Related Party footnote to the year-end 2012 financial statements, the Fund described the advanced management fees only as a "receivable" owed by the Management Company, Burrill Capital, LLC—not the General Partner, as had been disclosed in the year-end 2009, 2010, and 2011 financial statements. The footnote did not further describe the transaction nor the terms of the "receivable," as required by GAAP (and in particular, ASC 850-10-50-1).

34. The footnote further stated that the Management Company "intends to pay" the receivable "from future distributions to the General Partner" and from "Management Company funds." Beamish and his audit team, however, failed to obtain sufficient audit evidence of the receivable's collectability, as required by GAAS. An auditor "should design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence." AU-C § 500.06. Furthermore, an auditor should "obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for, and disclosed in the financial statements." AU-C § 550.09.

35. With respect to the collectability of the receivable "from future distributions to the General Partner," Beamish looked only to the Fund's capital account for the General Partner, which was fair valued at \$15.3 million as of December 31, 2012. As set forth in the LPA, the General Partner's right to use the capital account was conditioned on the performance of its management duties (including, among other things, not breaching its fiduciary duties nor engaging in willful or reckless misconduct or fraud). Significantly, the LPA provided that if the General Partner failed to make its required capital contributions to the Fund, its right to the capital account could be substantially impaired. As Beamish and the PwC audit team were aware, the General Partner had not made its required capital contributions from 2009 through 2012 and was instead adding the amount of the contributions to the advanced management fee balance each year. By relying only on the value of the General Partner's capital account, and failing to consider that the General Partner did not make its required capital contributions, Beamish failed to obtain sufficient appropriate audit evidence about the collectability of the receivable. Additionally, when faced with inconsistent audit evidence, "the auditor should determine what modifications or additions to audit

procedures are necessary to resolve the matter...” AU-C § 500.10. In this situation, Beamish failed to identify the contradictory audit evidence and thus did not consider additional audit procedures to test the collectability of the receivable.

36. Furthermore, Beamish relied on Burrill’s representations about the General Partner’s intent to pay the receivable through its future distributions without determining whether Burrill had authority to bind the entity. Beamish did not inquire whether the General Partner’s governing documents permitted Burrill to commit the future distributions of the General Partner. Nor did Beamish obtain evidence of the financial condition of the General Partner to determine whether the General Partner was encumbered by other financial obligations. Thus, Beamish’s failure to scrutinize the representations made by Burrill regarding the intent to pay the receivable “from future distributions to the General Partner” demonstrated a significant lack of professional skepticism by Beamish under the circumstances.

37. Nor did Beamish take any steps to verify whether the Management Company had the funds to repay the receivable. Had Beamish requested the Management Company’s balance sheet, he would have discovered that the Management Company had less than \$1,600 in cash on hand as of December 31, 2012, and that its remaining assets were illiquid and arose out of related party transactions with other Burrill entities. Generally Accepted Accounting Standards state that written representations “complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.” AU-C 580.04. Additionally, “if written representations are inconsistent with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter.” AU-C 580.23. Instead, in violation of the professional standards required by GAAS, Beamish relied only on Burrill’s representations about the sources and means of repayment.

38. As in the year-end 2009-2011 audited financial statements, the Management Fee footnote to the Fund’s year-end 2012 financial statements merely described the amount the General Partner was legally entitled to receive over the course of the calendar year in accordance with the LPA. The footnote did not disclose that the Fund had actually paid advanced management fees, and contained no references to the amounts described as “prepaid expenses” and “receivables” on the balance sheet and in the Related Party footnote.

39. With respect to the year-end 2012 audit specifically, Beamish was responsible for obtaining audit evidence that “significant related party transactions outside the entity’s normal course of business . . . have been appropriately authorized and approved.” AU-C § 550.24. This he did not do. Beamish and the audit team took no steps to determine whether the LPA permitted the payment of management fees in excess of what the General Partner would be entitled to earn, or loans to related parties without approval of an advisory committee of limited partners.

40. Beamish failed to maintain professional skepticism with respect to the audit of the Fund’s year-end 2012 financial statements, as required by GAAS (and in particular, AU-C § 200.08). Beamish did not inquire about the business rationale for taking advanced management fees, even after BCM management resisted his proposed additional disclosure and “withdrew” the promissory note, contrary to GAAS (and in particular, AU-C § 240.32 and AU-C §§ 315.28-29). By failing to make inquiry into these matters, and instead relying on the representations of BCM management, Beamish fell short of the professional standards required by GAAS.

I. PricewaterhouseCoopers Resigned as Auditor of the Fund

41. From the beginning of 2013 through the issuance of the Fund's year-end 2012 audited financial statements on April 4, 2013, Burrill, alone directing the General Partner, took an additional \$3.2 million in advanced management fees. After the audit opinion was issued, Burrill took another \$1.15 million in advanced management fees through July 2013.

42. In late August 2013, the Fund's investment committee became aware that virtually all the committed capital in Fund III had been spent. Emergency meetings of the investment committee were convened. Over the following weeks, the other members of the General Partner were informed that the Fund paid approximately \$18 million in advanced management fees. The amounts taken exceeded the amount to which the General Partner was entitled to receive over the contractual life of the Fund by millions of dollars.

43. In late October 2013, three members of the General Partner sent a letter to the advisory committee of the limited partners informing them of Burrill's misappropriation. In response, the advisory committee of the limited partners removed the General Partner, including Burrill, from managing the Fund.

44. On November 6, 2013, BCM management provided Beamish with several letters between BCM management and various limited partners regarding the misappropriation.

45. On or about November 11, 2013, PricewaterhouseCoopers resigned as the auditor of the Fund.

46. In 2014, the limited partners agreed to recycle distribution payments back into Fund III, in lieu of receiving individual distribution pay-outs. They used the recycled money to meet the Fund's financial commitments to its portfolio companies and to stabilize the Fund.

J. Violations

47. As a result of the conduct described above, Respondent engaged in improper professional conduct within the meaning of Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

48. Section 4C of the Exchange Act and Rule 102(e)(1)(ii) provide, in part, that the Commission may censure or deny, temporarily or permanently, the privilege of appearing or practicing before the Commission to any person who is found by the Commission to have engaged in "improper professional conduct." In relevant part, Section 4C(b)(2) and Rule 102(e)(1)(iv)(B) define "improper professional conduct" as one of two types of negligent conduct: (1) a single instance of highly unreasonable conduct in circumstances for which heightened scrutiny is warranted; or (2) repeated instances of unreasonable conduct that indicate a lack of competence.

49. As discussed above, Respondent's failures to conform to applicable professional standards found in GAAS, in connection with the audits of the year-end 2009, 2010, 2011, and 2012 Fund III financial statements, constitute repeated instances of unreasonable conduct. In addition, Respondent's failures to conform to the applicable professional standards found in

GAAS, in connection with the Fund's year-end 2012 financial statements, constitutes an instance of highly unreasonable conduct under circumstances that warranted heightened scrutiny, which is required under Rule 102(e)(1)(ii) in instances where significant and unusual transactions take place, such as taking millions of dollars in advanced fees beyond the life of Fund.

III.

In view of the allegations made by the Division of Enforcement and the Office of the Chief Accountant, the Commission deems it necessary and appropriate that public administrative proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and

B. Whether, pursuant to Section 4C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice, Respondent should be censured or denied, temporarily or permanently, the privilege of appearing or practicing before the Commission as an accountant.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310.

This Order shall be served forthwith upon Respondent as provided for in the Commission's Rules of Practice.

IT IS FURTHER ORDERED that, pursuant to Rule 360(a)(2)(A) of the Commission's Rules of Practice, the Administrative Law Judge shall issue an initial decision no later than 120 days from the occurrence of one of the following events: (A) The completion of post-hearing briefing in a proceeding where the hearing has been completed; (B) Where the hearing officer has determined that no hearing is necessary, upon completion of briefing on a motion pursuant to Rule 250 of the Commission's Rules of Practice, 17 C.F.R. § 201.250; or (C) The determination by the hearing officer that a party is deemed to be in default under Rule 155 of the Commission's Rules of Practice, 17 C.F.R. § 201.155 and no hearing is necessary.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

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Bankruptcy for Business Lawyers

2016 Business Law Institute

Bankruptcy for Business Lawyers

Bankruptcy Tools for Business Lawyers and Red Flags: When to Involve a Bankruptcy Lawyer¹

State Bar Center
Albuquerque, New Mexico
Friday, Nov. 18, 2016

The Bankruptcy Code offers powerful tools for businesses large and small, including sole proprietors, to get a “breathing spell” with an opportunity to reorganize for survival through challenging circumstances. In this session, presenters will discuss the basic bankruptcy options for businesses and their creditors and the “Red Flags” that may trigger the need for a bankruptcy lawyer.

Thomas D. Walker
Walker & Associates, P.C.
500 Marquette Ave., NW, Suite 650
Albuquerque, NM 87102

Materials prepared by Thomas D. Walker²

¹ These materials offer a general overview of selected topics. They are not intended to be comprehensive and are not intended to be legal advice to anyone or in any particular situation.

² Portions of these materials were adapted from the United States Administrative Office of the Courts’ “Bankruptcy Basics” available at www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics and from the article published in The New Mexico Lawyer “Chapter 11: A Lifeline for New Mexico Companies” Vol. 10, No. 4, November 2015 (Thomas D. Walker and Leslie D. Maxwell).

Chapter 11 Bankruptcy Generally

Introduction. Chapter 11 bankruptcy offers opportunities to struggling companies and individuals to reorganize finances and restructure operations in a single forum, where all parties can participate and have their claims and interests considered. Under the protection of the United States Bankruptcy Code, 11 U.S.C. §101, et seq., companies, partnerships, and sole proprietors have an opportunity to save their businesses from otherwise failing situations³This discussion focuses on a few of the most effective tools available in chapter 11 bankruptcy for the protection, preservation, and reorganization of a business enterprise.

Disclaimer. Chapter 11 Bankruptcy can be very disruptive to a company, its owners, its employees, and its community. It is complicated, expensive, detail intensive, and often challenging for those who are trying to make it happen. Employees, suppliers, lenders, and investors often suffer significant losses. It is and should be the “last resort,” in most cases. Usually, in cases of failing businesses, those losses would have happened with or without the bankruptcy. But if considered early enough, a reorganization through chapter 11 bankruptcy can allow a business to survive, employees to keep their jobs, and vendors to be repaid over time, in greater or lesser amounts, depending upon the circumstances. While the benefits of a bankruptcy reorganization must be weighed against the costs, pitfalls, and non-bankruptcy options, this overview is about the possibilities chapter 11 bankruptcy offers to help a failing business survive.

The “Mechanics” of Chapter 11. The details of how a bankruptcy case is prepared and presented, or even if a company is a good candidate for chapter 11, are beyond the scope of this discussion. It is sufficient for this topic to be aware of the following basic principles of chapter 11 bankruptcy:

- Chapter 11 is available to most corporations, including non-profit corporations, partnerships, and individuals. There are restrictions on who can file.
- Chapter 11 requires a lot of filings and activity at the beginning of the case. Pre-filing preparation is important although emergency filings are not uncommon. Once filed, the case and the courts move quickly.
- Chapter 11 is expensive and cash is required. Bankruptcy lawyers and the other professionals needed in most cases (accountants, appraisers, experts, etc.) rarely work on credit. Often a company must accumulate cash for the bankruptcy case at a time when it is desperately short of funds.
- Chapter 11 debtors must be available before and during the case to gather, organize, and present financial and transaction information, respond to requests, answer questions, and appear and testify in court.

³. “Chapter 11” refers to those sections of the Bankruptcy Code organized at 11 U.S.C. §1101, et seq. Many of the provisions discussed here appear elsewhere in the Bankruptcy Code.

- Chapter 11 debtors must provide a substantial amount of information early in the case, including schedules of assets and liabilities, current income and expenditures, and executory contracts and unexpired leases, along with a fairly detailed statement of financial affairs, setting forth the recent history of the business. Bankruptcy is generally considered a “full-disclosure” proceeding. It may not be a good option for companies and individuals that do not have financial records or cannot recreate them with reasonable accuracy. Similarly, bankruptcy is not the place to be if a company’s financial status or transactions need to be kept secret. For example, an individual may refuse to answer questions, exercising her Fifth Amendment right against self-incrimination, but at the same time she may be breaching her duty to disclose information in the bankruptcy proceeding and cause it to fail.
- Chapter 11 debtors usually propose a plan of reorganization to keep the business alive and pay creditors over time. Some of the benefits of a chapter 11 filing can be achieved without a plan. An example is the automatic stay, which may stop collection activities long enough to negotiate a work-out, or to permit time to organize a sale of assets, which also can often be accomplished without a plan.

Selected Bankruptcy Tools to Consider. The planning and reorganization provisions available in chapter 11 are made possible in many instances by the general protections and tools bankruptcy provides.

1. Automatic Stay. One of the most important and powerful tools is the automatic stay upon filing of a bankruptcy petition. 11 U.S.C. §362. The automatic stay is an automatic statutory injunction that stops, temporarily, most collection, foreclosure, and loan enforcement actions and gives the filer a “breathing spell” to stay in business while moving forward with negotiations, sales of assets, or preparing and prosecuting a reorganization plan.

The stay applies to most lawsuits, foreclosures, repossessions, garnishments, contract enforcement and collection actions and permits a business to defer payment on some obligations while it continues to use its assets, remain in business, and attempt to reorganize. This allows a company the opportunity to preserve going concern value for a reorganization or an organized sale of the going concern. Bankruptcy can preserve the basic business operation, name, goodwill, and customers that are often lost in a foreclosure, lock-out, or piecemeal liquidation.

NOTE: There are more exceptions to application of the stay than there are actions stayed. See below for a summary of some of the applications of the stay and exceptions. Investigate with a bankruptcy practitioner in advance to make sure this benefit applies to your client’s situation.

The stay should be considered temporary. Efforts to modify the stay or lift it entirely are common in bankruptcy cases. Motions for relief from stay are contested matters often resolved in an evidentiary hearing involving experts on asset valuation and detailed testimony about the debtor’s likelihood of success in the bankruptcy effort. The

stay may not apply at all depending upon the debtor's history. Prior filings can limit the duration of the stay or whether it is available at all. So-called "Single Asset Real Estate" cases have special statutory provisions that limit the stay. Third parties, such as co-debtors, guarantors, and codefendants, are not covered by the stay in chapter 11. So, the president of the company who guaranteed the debt can still be pursued despite the chapter 11 filing of the company.

Under 11 U.S.C. §362(a), acts stayed include:

- Commencement or Continuation of Proceedings Relating to Pre-Petition Claims (§ 362(a)(1)) (lawsuits and foreclosure actions; administrative hearings).
- Enforcement of Pre-Bankruptcy Judgment Against Debtor or Estate (§362(a)(2)).
- Obtaining Possession of Estate Property (§ 362(a)(3)).
- Acts to Create, Perfect or Enforce Lien Against Estate Property (§ 362(a)(4)).
- Acts to Create, Perfect or Enforce Lien Against Debtor's Property if Lien Secures Pre-Petition Claim (§ 362(a)(5)).
- Acts to Collect, Assess or Recover Pre-Petition Claim (§ 362(a)(6)).
- Setoff of any prepetition debt owed to the debtor against any claim against the debtor. (§ 362(a)(7)).
- The commencement or continuation of some proceedings before the US Tax court (§362(a)(8)).

Under 11 U.S.C. § 362(b), acts *not* stayed include:

- criminal actions
- civil actions relating to enforcement of domestic support obligations (§362(b)(2))
- under certain circumstances, actions to enforce in rem liens or security interests (§362(b)(20) and (d)(4))
- Action by lessor of non-residential real property to take possession of property where lease expired before or during case
- creation or perfection of lien for property tax that comes due after the case filing
- action to enforce lien or security interest in real property if the debtor is ineligible to file under §109(g) (362(b)(21))
- residential evictions may be continued where judgment for possession was obtained prepetition (which can be delayed if the debtor files a certain certification and pays into the court amounts to come due in the following 30 days) (§362(b)(22) and §362(l))
- residential eviction is not stayed in cases of endangerment to property or illegal use of controlled substances, also with a provision whereby the debtor can avoid the eviction under certain circumstances (§362(b)(23) and §362(m))

- setoff of a prepetition income tax refund against a prepetition income tax liability (§362(a)(26))

2. Debtor remains in possession of its business and assets; the “Debtor in possession.” The debtor filing under chapter 11 presumptively becomes a debtor in possession. This permits the debtor to continue operating, remaining in possession and control of its assets while undergoing a reorganization under chapter 11, without the appointment of a case trustee, and in most instances, in a regular and ordinary fashion. This is subject to interested parties’ rights to request appointment of a chapter 11 trustee or conversion of the case to one under chapter 7, whereupon the debtor is dispossessed of the business and its assets. The debtor in possession has many of the other powers and duties of a trustee, including the right, with the court’s approval, to employ attorneys, accountants, appraisers, auctioneers, or other professional persons to assist the debtor during its bankruptcy case.

A debtor will remain a debtor in possession until the debtor’s plan of reorganization is confirmed, the debtor’s case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as debtor in possession, operates the business and performs many of the functions that a trustee performs in cases under other chapters.

The benefits of being a debtor in possession may be greatly constrained depending upon the circumstances. For example, if a lender has a security interest in cash, accounts, receivables, and the like, that lender might not consent to use of its “cash collateral” in which case the debtor must go to court immediately (literally, on the first day of the case) to get permission to use cash and receipts from business operations. This is often the first big dispute in a chapter 11 case. Some lenders are willing to negotiate use of cash collateral prior to filing.

A debtor in possession is in the position of a fiduciary, with the rights and powers of a Chapter 11 trustee. The debtor in possession performs all the investigative functions and duties of a trustee, including investigating its own activities that occurred prior to filing. The duties include gathering and accounting for assets, examining and objecting to claims, bringing actions to recover fraudulent and preferential transfers, and filing periodic reports (the “monthly operating reports”). 11 U.S.C. §§ 1106, 1107; Fed. R. Bankr. P. 2015(a).

3. New Debt with Secured or Super-Priority Status. A Chapter 11 debtor in possession may be able to borrow money in bankruptcy and provide the lender with special protections, not ordinarily available outside of bankruptcy. In fact, an industry of “DIP Lenders” exists for this purpose. (“DIP” referring to debtor in possession.) Typically, the loans are for operating capital, which lenders are willing to provide, under the right circumstances, in exchange for court-approved “superpriority” status over other unsecured creditors or for a lien on property of the estate. See 11 U.S.C. § 364. Under some circumstances, existing lenders will consent to subordinate their prior liens to that of

the DIP lender in order to permit the debtor to survive long enough to sell assets, merge with another company, get an investor, or propose a reorganization. All of this depends upon the debtor's ability to convince creditors that a successful outcome is likely and will provide benefits to the creditors not otherwise available.

4. Subordinate debt and adjust interest rates. In some cases, chapter 11 debtors can recharacterize undersecured debt and eliminate or subordinate the unsecured portion. Secured creditors may agree or be compelled to reduce secured debt ("cram-down") to an amount equal to the value of their collateral. Other creditors may support the reorganization because they may get more than they would get in a liquidation. Sometimes unsecured debt is converted into an equity interest with a chance of having future value, which may be better than getting little or nothing now. Excessive or over-market interest rates on debts secured by personal and real property can be restated to better reflect market conditions and generally make the success of reorganization more likely. Note that cram-down, or reducing the secured amount of the debt to the value of the collateral, is not always available and is never available on an individual's primary residence.

5. Cure defaults and address accelerated debts. Chapter 11 debtors can cure defaults on contracts, including mortgages and leases. This permits debtors to return to pre-default terms, reverse default penalties, and get back in good standing with creditors. Similarly, in some instances, Chapter 11 debtors can negotiate extended payment terms on past due, unsecured tax debts. These benefits are ordinarily available only through a confirmed plan of reorganization.

6. Assumption or rejection of executory contracts and unexpired leases. Chapter 11 debtors may be able to reject certain equipment leases, real estate leases, or other unfulfilled contracts, and assume the obligations on others. Unprofitable locations and unproductive equipment may be returned to the lessors in order to improve cash flow and restore profitability. Multi-location businesses can consolidate operations into the most efficient structure; retail businesses can close unproductive locations and focus on those that generate profits. In Chapter 11, the debtor may be able to consolidate operations into the most valuable leased locations, improving the viability of the business or making the business more attractive to a buyer. Often, buyers will tell the debtor which locations or contracts they want or can use and sales of assets may be accomplished in multiple deals with different buyers.

7. Sales of property free and clear of liens, claims and interests. Chapter 11 debtors can sell assets, outside the ordinary course of business, free of claims, liens and interests of all kinds. 11 U.S.C. §363. This tool is very powerful. It is not limited to debtors in chapter 11 but is often used to create value for creditors that otherwise would not be available. These so-called "363 Sales" can be accomplished through a Chapter 11 plan or, with increasing approval, absent a confirmed plan. Buyers get clean title to property, while the liens and interests attach to the proceeds, under the protection of a federal court order. When this is combined with other tools, such as assumption and rejection of unexpired leases, the value of the overall enterprise may be improved dramatically. When successful, liens are stripped from the assets to be sold and attach to

the proceeds in the amount and with the priority and subject to the defenses that applied to the sold collateral. Note that the debtor in possession may use, sell, or lease estate property in the ordinary course of its business, without prior approval, unless the court orders otherwise. The sales of assets described here are those that are outside the ordinary course of business, are require court approval.

8. Avoidance and recovery actions. The Chapter 11 debtor has a trustee's power to avoid and recover certain pre-petition, preferential or fraudulent transfers. Such "avoidance actions" can be used to recover assets transferred or to undo liens to free up assets for distribution to creditors in accordance with the priorities described in the Bankruptcy Code, or for sale or use as additional loan collateral. The "avoiding" powers may be used to undo a transfer of money or property made during a certain period of time before the filing of the bankruptcy petition. By avoiding a particular transfer of property, the debtor in possession can cancel the transaction and force the return or "disgorgement" of the payments or property, which then are available to pay all creditors. Generally, and subject to various defenses, the power to avoid transfers is effective against transfers made by the debtor within 90 days before filing the petition. But transfers to "insiders" (i.e., relatives, general partners, and directors or officers of the debtor) made up to a year before filing may be avoided. 11 U.S.C. §§ 547 and 548. In addition, the DIP may use state law to avoid transfers, which often provides for longer time periods. 11 U.S.C. § 544.

9. Creditor's Committees. In many cases, particularly larger ones, one or more committees will be formed to represent the common interests of the members. The committee's attorney, accountant, and other financial consultants, are paid by the debtor's estate, if approved by the court. While this creates a burden on the debtor, it offers an opportunity to negotiate with many creditors through one committee and attorney.

10. Reorganization Plan. Ultimately the most potent tool available to a Chapter 11 debtor is the plan itself, which is only available in bankruptcy. Generally, a plan of reorganization with a written disclosure statement must be filed sooner or later in order to avoid dismissal of the case or conversion to a case under chapter 7. Plans can be liquidating plans or proposed reorganizations. The debtor has 120 days, unless extended, during which only the debtor can file a plan. Thereafter, a creditor, committee, or case trustee may file a plan.

The plan may include any number of proposals to preserve value, enhance operations, or generate cash to pay claims. It must describe the various classes of claims and how each will be treated under the plan. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders. The accompanying disclosure statement supports the plan and discloses information about assets, liabilities, business affairs, liquidation value, and the proposed actions under the plan to permit creditors to make informed decisions about the plan. The plan is sent out, after approval of the disclosure statement, for voting, but only creditors whose claims are "impaired" (those whose contractual rights are to be modified or who will be paid less than the full value of their claims under the plan) are permitted to vote. After the plan is confirmed, the debtor is required to perform as the

confirmed plan provides, including by making plan payments, transferring property, or otherwise consummating the plan, which is a binding, court-ordered agreement. The confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts. Crafting a plan that can be confirmed, and will work, is technically challenging, and is beyond the scope of this discussion.

11. Discharge. The discharge is a huge benefit for a debtor that has successfully negotiated or prosecuted a bankruptcy case. The discharge results in a permanent, federal court injunction against collection, enforcement, or recovery of discharged obligations. Code § 1141(d)(1) provides generally that confirmation of a plan discharges a debtor from any debt that arose before the date of confirmation. There are, of course, exceptions to the general rule that an order confirming a plan operates as a discharge. Confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge by 11 U.S.C. § 523. Also, the discharge is not available to an individual debtor unless and until all payments have been made under the plan. 11 U.S.C. § 1141(d)(5). Confirmation does not discharge the debtor who is not an individual if the plan is a liquidation plan, as opposed to one of reorganization. Finally, discharge may be denied by the court under certain circumstances.

BANKRUPTCY

I. Overview of Bankruptcy

A. The purpose of the Bankruptcy system is twofold:

1. Bankruptcy law provides a mechanism for a debtor who is unable to pay creditor to resolve his debts through either the division of assets among creditors or through a repayment plan; and
2. This supervised division also allows the interests of all creditors to be treated with a measure of fairness and equality.

B. Bankruptcy law is federal statutory law contained in Title 11 of the United States Code.

C. Bankruptcy proceedings are supervised by and litigated in the United States Bankruptcy Courts.

1. These courts are a part of the District Courts of The United States.
2. Proceedings in bankruptcy courts are governed by the Bankruptcy Rules which were promulgated by the Supreme Court under the authority of Congress.

D. There are two basic types of Bankruptcy proceedings:

1. A filing under Chapter 7 is called liquidation. It is the most common type of bankruptcy proceeding. Liquidation involves the appointment of a trustee who collects the non-exempt property of the debtor, sells it and distributes the proceeds to the creditors.
2. Bankruptcy proceedings under Chapters 11, 12, and 13 involve the reorganization of the debtor to allow him or her to use future earnings to pay off creditors.
 - a. Under Chapter 7, 12, 13, and some 11 proceedings, a trustee is appointed to administer the bankruptcy estate.

E. A bankruptcy case is initiated by the filing of a bankruptcy petition. A bankruptcy proceeding can either be entered into voluntarily by a debtor or initiated by creditors.

1. Involuntary cases require 3 or more entities with an aggregated claim of \$13,475 (unless there are fewer than 12 total creditors, then it only takes one)
2. Generally an involuntary case can only be commenced if the debtor is in default on debts
3. If an involuntary bankruptcy is commenced against a debtor, they should immediately retain bankruptcy counsel to either get the case dismissed or take control of the case

F. After a bankruptcy petition is filed, the Automatic Stay under § 362 of the Bankruptcy Code takes effect. Creditors, for the most part, may not seek to collect their debts outside of the bankruptcy proceeding. The bankruptcy stay:

1. Stays judicial or other proceedings against the debtor
2. Stays the enforcement of a judgment obtained before the bankruptcy
3. Stays any act of “debt collection,” or any attempt to obtain property of the estate

G. The “bankruptcy estate” consists of all legal or equitable interests of the debtor in property. The debtor is not allowed to transfer property that has been declared part of the estate without Court approval. Furthermore, certain pre-proceeding transfers of property, secured interests, and liens may be delayed or invalidated (“avoided”), as discussed later. Contacting a bankruptcy attorney prior to engaging in any such transfers is suggested if a bankruptcy in the near future is possible.

II. The Major Players in Bankruptcy

A. Debtor

B. U.S. Trustee’s Office

1. Established by Congress to handle many of the supervisory and administrative duties of bankruptcy proceedings.
2. A component of the Department of Justice that seeks to promote the efficiency and protect the integrity of the Federal bankruptcy system.
3. Monitors the conduct of bankruptcy parties and private estate trustees, oversees related administrative functions, and acts to ensure compliance with applicable laws and procedures.
4. Identifies and helps investigate bankruptcy fraud and abuse in coordination with United States Attorneys, the Federal Bureau of Investigation, and other law enforcement agencies.

C. Creditors

1. Secured
 - a. Debt is secured by a lien on property in which the estate has an interest
 - b. By far the preferred position to be in as a creditor; creditors should ensure that they perfect security interests in collateral
2. Unsecured – not secured by collateral that is property of the estate

III. Treatment of Creditors

A. Secured

1. Receive first priority
2. However deficiency amounts are an unsecured claim
3. Certain liens can be stripped in bankruptcy

B. Priority Claims (§ 507), including:

1. Domestic Support
2. Administrative expenses
3. Employee wages
4. Taxes

5. Claims for death or personal injury related to drunk driving

C. General Unsecured

1. Pro rata share of what is left in the estate
2. Unsecured creditors committee

IV. Creditor's Claims

A. Filing Proof of Claim

1. Is it necessary?
 - a. In a chapter 7, 12 or 13: a proof of claim must be filed to receive a distribution from the estate
 - b. In a Chapter 11:
 - i. Any creditor *may* file
 - ii. Any creditor whose claim is not scheduled, or is disputed, contingent, or unliquidated *must* file to be treated as a creditor in the case
2. When must it be filed?
 - a. Chapter 7 / 12 / 13: within 90 days after 341 meeting (Rule 3002)
 - b. Chapter 11: Court sets time for filing (Rule 3003)
 - c. Court may extend the time to file
3. How / What is filed?
 - a. Proof of Claim form is filed with the court
 - b. Identifies the creditor, the nature of the claim, and the amount owed
 - c. Supporting documents when the claim is based on a writing, including evidence of a perfected security interest if there is one (Rule 3001)
 - d. Must provide enough information to determine if a valid claim in the correct amount has been filed
 - e. An experienced bankruptcy attorney can advise on the documents necessary to prove a valid claim

B. What are allowable claims? (§ 502)

1. All claims are deemed allowed unless a party in interest objects. The Debtor may object to claims, as may the Trustee or other creditors.
2. Claims are allowed, except:
 - a. those unenforceable under an agreement or law
 - b. unmatured interest
 - c. ... proof of claim is not timely filed
 - d. etc.

C. Objections to Claims (Rule 3007)

1. Objections must be in writing and filed with the court
2. A copy of the objection and notice of a hearing about the objection must be mailed or otherwise delivered to the claimant at least 30 days prior to the hearing

D. Transfer of Claims

1. If a claim has been transferred before the proof of claim has been filed, the transferee can file it
2. If a claim is transferred after a POC has been filed, evidence of the transfer shall be filed by the transferee

V. Relief from the Automatic Stay

A. Timing – when must it be filed?

B. The motion for relief – why the court will grant it (§ 362(d))

1. “For cause” including lack of adequate protection
2. If (1) the debtor does not have equity in the collateral AND (2) it is not necessary to an effective reorganization
3. Single asset real estate
4. Creditor seeking stay relief and debtors defending against stay relief should seek out experienced bankruptcy counsel to help navigate the process

C. Adequate Protection

1. Is the property deteriorating in value? Is there a risk of harm to it?

a. Lack of insurance

2. An equity cushion can be adequate protection

a. However, if that cushion is shrinking, it may not be adequate

D. Filing a bankruptcy petition does not operate as a stay of all proceedings, things that are not stayed include:

1. The commencement or continuation of a criminal action

2. Civil suits for establishing paternity, establishing or modifying domestic support, custody or visitation proceedings, divorce proceedings (except as relating to the division of property of the estate), and suits regarding domestic violence

3. Proceedings for the withholding, suspension, or restriction of a driver's license or professional license

4. An action under the police powers of the government

5. Any act to obtain possession by a lessor to the debtor of non-residential real property under a lease that has expired

6. Any act to obtain possession by a lessor to the debtor of residential property based on endangerment of the property or the illegal use of controlled substances on the property

7. Any action related to licensure or accreditation of the debtor as an educational institution

8. Withholding of the debtor's income as authorized by the debtor for a pension, profit sharing, or other plan

E. Other Stay Issues of Interest:

1. The stay only operates on acts against property of the estate as long as it remains property of the estate

2. The stay operates until the earliest of:

a. The time the case is closed;

b. The time the case is dismissed; or

c. The time a discharge is granted or denied

3. The stay can be lifted without a hearing if it is necessary to prevent irreparable damage which will be suffered before there is an opportunity for notice and a hearing
4. An individual damaged by a willful violation of the stay may be able to recover actual damages, including costs and attorney fees, and punitive damages in certain circumstances

VI. Avoidance Actions

A. Avoidance Actions (§ 544):

1. Allows the Trustee, as the representative of creditors, to “avoid,” or set aside and unravel, certain transactions the debtor engaged in before bankruptcy
 - a. Including some transactions that were perfectly valid
 - b. The Trustee can avoid post-petition actions under § 549
2. Gives the Trustee the same rights as lien creditors or Bona Fide Purchasers
3. The Trustee may also avoid statutory liens under § 545
4. It is best to consult with a bankruptcy attorney before the transfer is effected to determine if it is likely to be avoided

B. Preferences (§ 547):

1. Allows the Trustee to avoid any transfer or payment to a creditor made:
 - a. While the debtor was insolvent;
 - b. On or within 90 days prior to filing the bankruptcy petition (or up to 1 year for insiders);
 - c. And enable the creditor to receive more than it would have under a Chapter 7.

2. In addition to transferring money or property, granting a security interest in property can also be an avoidable transaction as it modifies the payment scheme by placing that creditor ahead of others

3. Prevents the debtor from picking and choosing which creditors to pay

a. Ensures that similarly situated creditors share the pot *pro rata*

4. Defenses to preferences:

a. Transactions in the ordinary course of business

b. Pays for or secures new value

C. Fraudulent Transfers (§ 548):

1. “Actual fraud” (intent to defraud) - Trustee can avoid any transfer within two years prior to the bankruptcy filing if the debtor:

a. Made the transfer or incurred an obligation to hinder, delay, or defraud any entity

b. Received less than a reasonably equivalent value in exchange to the transfer or obligation

2. “Constructive Fraud” (no evidence of intent, § 544(b)) - Trustee must show:

a. Debtor was insolvent at the time of transfer; or

b. Debtor engaged in a business activity for which his remaining property was “unreasonably small capital;” or

c. Debtor intended to incur debts beyond his capacity to repay.

d. This section also allows the Trustee to void transfers such as bulk sales

VII. Objections to Discharge or Dischargeability

A. Under § 727, the court shall grant a debtor a discharge unless the debtor:

1. Fraudulently transferred of property of the estate

2. Made a false oath or statement in connection with the bankruptcy case

3. Concealed, destroyed, or failed to keep records

4. Withheld recorded information from an officer of the estate
5. Failed to satisfactorily explain any loss of assets
6. Refused to obey a lawful order of the court
7. Debtor has been granted a discharge within previous 8 / 6 years
8. Debtor failed to complete financial management course

B. Under § 523, certain debts are not discharged, notably:

1. Some debts for a tax or customs duty
2. For money, services, or credit obtained by false pretenses or fraud
3. Any debt for fraud in a fiduciary capacity
4. Domestic support obligations and divorce or separation agreements
5. Intentional torts (willful and malicious injury to another)
6. Claims for death or personal injury related to drunk driving
7. A fine, penalty, or forfeiture payable to and for the benefit of a governmental unit
8. Student loans (except in rare occasions)
9. Debts for malicious or reckless failure to fulfill any commitment to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution
10. Debts incurred to pay fines or penalties under federal election law
11. Debts owed to a pension, profit-sharing, stock bonus, or other plan

VIII. Moving for Conversion or Dismissal

A. Creditors can move for conversion or dismissal of a case

B. Reasons for moving for conversion depend on the situation:

1. Creditor will be better off in another chapter of bankruptcy
2. Debtor is too well off to be in a 7, should be in a 13 or 11

C. “Cause” for conversion or dismissal includes:

1. Substantial or continuing loss to or diminution of the estate
2. Gross mismanagement of the estate
3. Failure to maintain insurance
4. Unauthorized use of cash collateral
5. Failure to comply with an order of the court, attend meetings, etc.
6. Failure to file or confirm a Chapter 11 plan
7. Other

TREATMENT OF TAXES

I. General Rules:

A. **The “3/2/240” rule:** Applies to taxes that are on or measured by income or gross receipts. The tax debt can be discharged if:

3: Return was due at least 3 years before the petition date (11 U.S.C. § 507(a)(8)(A)(i));

2: A return or equivalent notice was filed at least 2 years before the petition date (11 U.S.C. § 523(a)(1)(B)); **AND**

240: The tax claim was assessed at least 240 days before the petition date (11 U.S.C. § 507(a)(8)(A)(ii)).

B. **Fraud and tax exasion:** Tax debts are not dischargeable if it is determined that the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax (11 U.S.C. § 523(a)(1)(C)).

C. **Assessable but not assessed:** Income taxes that were not assessed before the petition date, but were assessable as of the petition date, are not dischargeable (11 U.S.C. § 507(a)(8)(A)(iii)).

D. **Property taxes:** Property taxes incurred before the commencement of the case and due at least one year before the petition date are dischargeable (11 U.S.C. § 507(a)(8)(B)).

E. **Payroll taxes:** A tax required to be collected or withheld and for which the debtor is liable in any capacity is nondischargeable (11 U.S.C. § 507(a)(8)(C)).

Relevant Bankruptcy Code section excerpts:

11 U.S. Code § 507 - Priorities

(a) The following expenses and claims have priority in the following order:

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

(A) **a tax** on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition—

(i) **for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;**

(ii) **assessed within 240 days before the date of the filing of the petition,** exclusive of—

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in section 523 (a)(1)(B) or 523 (a)(1)(C) of this title, **not assessed before, but assessable**, under applicable law or by agreement, after, the commencement of the case;

(B) **a property tax** incurred before the commencement of the case and last payable without penalty after **one year** before the date of the filing of the petition;

(C) **a tax required to be collected or withheld and for which the debtor is liable in whatever capacity**;

...

(G) **a penalty** related to a claim of a kind specified in this paragraph and **in compensation for actual pecuniary loss**.

11 U.S. Code § 523 - Exceptions to discharge

(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title **does not discharge an individual debtor from any debt—**

(1) **for a tax or a customs duty—**

(A) **of the kind and for the periods specified in section 507 (a)(3) or 507 (a)(8) of this title**, whether or not a claim for such tax was filed or allowed;

(B) **with respect to which a return**, or equivalent report or notice, if required—

(i) **was not filed or given**; or

(ii) **was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition**; or

(C) **with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax**;

II. Limitations on late filed “returns” – see *Mallo v. IRS (In re Mallo)*, 774 F.3d 1313 (10th Cir. 2014) (opinion included in materials).

A. The “hanging paragraph” at the end of 11 U.S.C. § 523(a):

For purposes of this subsection, **the term “return” means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986**, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

B. 10th Circuit held that “the plain and unambiguous language of § 523(a) excludes from the definition of “return” all late-filed tax forms, except those prepared with the assistance of the IRS under § 6020(a) [of the Internal Revenue Code].” *Id.*

26 U.S. Code § 6020 - Returns prepared for or executed by Secretary

(a) Preparation of return by Secretary

If any person shall fail to make a return required by this title or by regulations prescribed thereunder, but shall consent to disclose all information necessary for the preparation thereof, then, and in that case, the Secretary may prepare such return, which, being signed by such person, may be received by the Secretary as the return of such person.

(b) Execution of return by Secretary

(1) Authority of Secretary to execute return

If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

(2) Status of returns

Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.

III. Tax Debt in Chapter 13 Cases

A. Same general rules apply.

B. However, chapter 13 contains a “superdischarge” upon completion of the plan, found in 11 U.S.C. § 1328(a):

11 U.S. Code § 1328 – Discharge (excerpt)

(a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, **the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt—**

(2) of the kind specified in section 507 (a)(8)(C) or in paragraph (1)(B), (1)(C), (2), (3), (4), (5), (8), or (9) of section 523 (a);

C. Relevant exceptions to the superdischarge therefore are:

1. Payroll taxes;
2. Late filed returns or return was not filed; and
3. Fraud and tax evasion.

IV. Tax Debt in Chapter 11 Cases

- A. To confirm a plan, debtor must pay priority tax debts in full in “regular installments” over a period ending not later than 5 years after the bankruptcy case was filed
- B. With interest

V. Tax Liens

- A. As with other liens, even if the debt is dischargeable, the lien is not discharged.
- B. Not avoidable under 11 U.S.C. § 522(f), therefore not strippable in chapter 7 cases.
- C. Like other liens, tax liens may be stripped in reorganization cases (chapters 11, 12, and 13).

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Immigration Issues for All Businesses-I-9 Compliance

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*I-9 Compliance, U.S. Immigration and Customs Enforcement (ICE), and U.S. Office
Special Counsel (OSC) Actions*

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Immigration Issues for All Businesses—I-9 Compliance

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WHAT IS I-9 VERIFICATION?

Form I-9 requirements come out of the Immigration Reform and Control Act of 1986 (IRCA). IRCA prohibits employers from hiring and employing workers for employment in the United States knowing that these workers are not authorized to work in the United States. Employers are prohibited from continuing to employ an individual knowing that he or she is unauthorized for employment.

This law also prohibits employers from hiring *anyone* (including all U.S. citizens) for employment in the United States without verifying his or her identity and employment authorization on Form I-9.

Employers who violate this law may be subject to:

- Civil fines
- Criminal penalties (when there is a pattern or practice of violations)
- Debarment from government contracts

USCIS will publish the revised Form I-9, Employment Eligibility Verification, by Nov. 22, 2016. Employers may continue using Form I-9 dated 03/08/2013 N. through Jan. 21, 2017. By Jan. 22, 2017, employers must use the revised form. Employers should continue to retain and store previously completed forms for existing and former employees in accordance with guidance provided on I-9 Central.

COMPLETING FORM I-9

Excerpt from Noble & Vrapı *I-9 EEV Compliance Procedures & Manual*:

Completing Section 1

Complete Section 1 of the Form I-9. A new hire must complete and sign Section 1 of the Form I-9 *no earlier* than the date he or she accepts a job offer and *no later* than the day he or she starts work or otherwise first performs services for pay. An employee cannot be required to complete Section 1 of the Form I-9 before the day he or she actually starts work, but an employee may do so if it is convenient for both the employee and the Company.

In Section 1:

- If the employee does not have “Other Names Used,” the employee *must* write N/A in that blank.
- The employee is not required to provide: (1) Social Security Number; (2) email address; and (3) telephone number.
- **If an employee’s work authorization has expired or does not yet exist, he or she is not eligible to work.**
- An employee who refuses to complete Section 1 of the Form I-9 by the day he or she starts work must be terminated immediately upon receiving approval from the hiring manager.

- The employee *must* provide each of the following items of information in Section 1 of the Form I-9.

1. Name:

- i. Surname / Family name
- ii. Given / First name
- iii. Middle Initial, if any
- iv. Other Names Used (*if any*)—This includes maiden name. If employee has no “Other Names Used,” the employee must write N/A in this field.

2. Complete mailing address in the United States

3. Date of birth

4. Attestation to citizenship. The employee must check one of the four boxes.

- i. If “A citizen of the United States” is checked, no additional information is needed on the attestation portion.
- ii. If “A noncitizen national of the United States” is checked, no other information is needed
- iii. If “A Lawful Permanent Resident” is checked, the employee must provide the:

a) Alien number assigned by the Federal government.

(An Alien number begins with the letter A and contains either 8 or 9 digits.)

iv. If “An alien authorized to work” is checked, the employee must provide two more items:

a) Expiration Date for his or her work authorization (*if applicable*), and

b) Alien number supplied by the Federal government **or**

c) Form I-94 Admission Number (the 11-digit Admission / Departure Number from the Form I-94 Arrival / Departure record).

5. The employee must complete and sign Section 1.

i. If a Preparer or Translator helps with Section 1:

a) If someone helps the employee to complete this Section (for example, if English is not the employee’s first language, the employee is disabled, or the employee is under the age of 18), that person must provide all the information requested in the “Preparer and/or Translator Certification” portion.

- b) Even if the employee has help from a Preparer or Translator, the employee should fill out as much of Section 1 as possible and should sign Section 1 if possible. Making any sort of mark will suffice.
- c) If the employee is incapable of signing Section 1 or making his or her mark, the HR staff member must complete a memo-to-file noting why the employee was unable to sign and must inform management in case further documentation to ensure I-9 Compliance is warranted.

Understanding Attestation Choices

There can never be more than one citizenship attestation box checked. If two or more citizenship attestation boxes are checked, then the Company is out of compliance with the law. When conducting I-9 Employment Eligibility Verification, before the employee leaves the office, the HR professional must ensure:

- That there is one box checked under the attestation of citizenship.
- That there is NOT more than one box checked under the attestation of citizenship.

- That the documents provided by the employee do not contradict the citizenship attestation box selected by the employee.
- That any blanks following a checked citizenship attestation box are completed.

If an employee checks “A noncitizen nation of the United States” and then provides the HR staff member with a Lawful Permanent Resident card (“Green Card”), the attestation is at odds with the document. If an employee has a Lawful Permanent Resident card (“Green Card”) that person is “A lawful permanent resident” and must select that attestation in Section 1.

Completing Section 2

Complete and certify Section 2 of the Form I-9. An employee must present **unexpired** identification and work authorization document(s) in person so that the HR staff member can complete Section 2 of the Form I-9 **within three business days** of the date the new employee first reports for work. (Exception: An employee hired to work for a duration of less than three business days must complete both Sections 1 and 2 of the Form I-9 *no later than the day he or she starts work.*)

- The Form I-9 Employment Eligibility Verification Compliance trained Company employee must complete each of the following items of information in Section 2 of the Form I-9. The same employer-representative (the trained Company staff member) must certify and sign Section 2. The staff member who actually examines the original documents must be the person attesting to the Certification in Section 2. See complete

lists of acceptable documents for the Form I-9, Employment Eligibility Verification, page 9.

Items to Complete:

1. Document Title
2. Issuing Authority. The Issuing Authority should be recorded as it appears on the document.
3. Document Number
 - i. Document number is the driver's license number, social security number, ID card number, or other main number associated with the document.
 - ii. If the document is an immigration document, for document number, provide the 8- or 9-digit Alien number from an I-551 stamp **or** Machine Readable Immigrant Visa (MRIV) with temporary I-551 language **or** the 11-digit number from the Form I-94 Arrival/Departure Record.
4. Expiration Date (if any) for each document.
 - i. The expiration date is generally listed as such and states when a driver's license or ID card expires. Social Security cards do not have an expiration date, and one should write N/A in the expiration date blank for a Social Security card.

- ii. If the document is an immigration document, for expiration date, provide the expiration indicated on the Form I-94 or if D/S is indicated, the expiration date indicated on the Form I-20 or DS-2019.
 - iii. The expiration dates for these documents may not be obvious. Sometimes passports carry updated name and expiration date information on internal pages.
 - iv. Determine the expiration date for the I-551 stamp/MRIV . . . [reference to portion of the *Manual* not reproduced here].
 - v. The expiration date for the Form I-94 may be a fixed date or may be given as “D/S” (Duration of Status).
5. The date employment began, or will begin. (The actual date the employee begins work for pay.)
6. Signature and date. Do not sign the Form until Section 2 is complete.
7. If a discrepancy requires explanation, add a Memo-to-File in the Form I-9 file.

Requesting Documents:

To request documents, use the Lists of Acceptable Documents that establish identity and/or employment eligibility, Page 9 of Form I-9.

- Let the employee choose which documents to provide from the lists.

- Do not ask for or accept more than the minimum required number of documents. Do not ask for specific documents. You can say which documents you see most often.
- If the employee submits a document that requires additional documents to be an acceptable verification document, you can explain what would be required for such a document to be valid for either identity or employment eligibility based on the mandates of Form I-9.
- **The documents presented must appear to be valid, genuine, and relate to the person presenting them.** [This is a low bar. The employer or employer agent is not expected to be an expert in immigration or other documents].
- If you cannot certify Section 2 of the Form I-9 based on the documents presented, contact Manager/Owner/Counsel immediately....
- If the employee provides a List B document, the document must include a photograph to be acceptable. List B documents must be issued within the United States with one exception: Canadian drivers' licenses.

Determining Acceptability:

Determine if the documents presented are acceptable (see Form I-9, Page 9, Lists of Acceptable Documents). The employee must provide documents establishing identity **and** work authorization.

- If an employee presents too many documents, accept the first valid combination of documents you encounter. However, if you determine that those documents:

- Do not appear on the Lists of Acceptable Documents, OR
- Do not form a valid combination from the Lists of Acceptable Documents,
OR
- Do not appear to be genuine (that is, they appear to be forged), OR
- Do not appear to relate to the person presenting them (i.e. the picture is not of the person presenting the document), then you must reject the document(s) and ask the employee for other, valid documents.

Do not certify Section 2 of the Form I-9 if the documents submitted appear unacceptable. Certain documents not listed on the Lists of Acceptable Documents are acceptable as receipts for those documents

- If you are uncertain whether documents are valid, genuine, or relate to the employee, contact **Manager/Owner/Counsel**_____.
- Determine if the documents presented contain special provisions.
 - If the employee is a nonresident alien, the type of work he or she is permitted to do may be restricted by his or her immigration status, by the category on his or her Employment Authorization Card, or by the endorsements on another work authorization document.
 - Also, some documents require accompanying documents to be valid, restrict the employee to certain jobs, or have other special provisions.

Assessing Contradictions:

Determine if the documents presented contradict each other or contradict information provided in Section 1.

Names:

- If the name provided in Section 1 does not match Social Security Administration's records, the employee must correct it.
- If a discrepancy is found between the name provided in Section 1 and the documents presented for Section 2, the employee must provide a reasonable explanation, or the documents must be rejected. Record any explanation by adding a memo-to-file to the Form I-9.
- If a contradiction among documents or between documents and Section 1 is not explained, contact Manager/Owner/Counsel_____ immediately to determine whether the employee is eligible to work
 - For example, the names given on each document must agree, or the employee must offer a reasonable explanation, such as a name change.
- If an employee submits documents in more than one name without credible explanation always contact Manager/Owner/Counsel_____.
- The information in Section 1 and the information in the documents presented for Section 2 should also agree. If it does not, ask the employee to correct Section 1 or, if

the employee provides a credible explanation, note the discrepancy and the explanation in a memo-to-file.

Dates of Birth:

- For example, if birth dates in Section 1 and on a driver's license differ, an explanation is required.

Addresses:

- If the address provided in Section 1 differs from the address on a document, make sure the address in Section 1 is the employee's current U.S. address. Never accept a foreign address.

Citizenship Attestation:

The information from Section 1 that is most helpful in ruling out contradictory documents is the citizenship attestation. Certain documents are only available based on citizenship status. For example, if an employee checks "A noncitizen nation of the United States" and then provides the HR staff member with a Lawful Permanent Resident card ("Green Card"), the attestation is at odds with the document. If an employee has a Lawful Permanent Resident card ("Green Card") that person is "A lawful permanent resident" and must select that attestation in Section 1.

Besides **names**, **addresses**, **birth dates**, and **citizenship attestation**, two other pieces of information in Section 1 should be checked against the documents presented for Section

2, whenever possible (never ask for specific documents, but cross-check the documents accepted with Section 1).

- **Social Security Number:** If a Social Security Card is presented and accepted, check it against a Social Security Number entered in Section 1, if any. The two numbers should be the same.
- **Alien (A) number or Admission/Departure Number:** If a document with an Alien (A) number or Admission/Departure Number is presented for Section 2, and the same type of number is supplied in the citizenship attestation in Section 1, the two numbers should be the same.

Work Authorization Expiration Date (if any): Determine the work authorization expiration date and verify it against the information provided in Section 1. If the employee is a non-resident alien you should determine the work authorization expiration date from the documents and confirm that it matches the date provided in the citizenship attestation in Section 1.

- Employment Authorization Card (Form I-688, I-688A, I-688B, or I- 766).
- Form I-94 Arrival / Departure document, a Form I-20, DS-2019, or I-797.

You may encounter the following issues when determining the work authorization expiration date:

- **Sometimes there is no expiration date.** Employees who are U.S. citizens, asylees, refugees, and certain citizens of the Federated States of Micronesia or the Republic of Marshall Islands may present an unrestricted Social Security Card as his or her list “C” work authorization document. If such document is presented, there is no expiration date and so none is entered (best practice is to enter “N/A”).
 - For such employees, reverification does not apply unless they choose to present in Section 2 evidence of employment authorization that does contain an expiration date.
- **Sometimes the work authorization date may be updated on the back of the form or on a separate page.**
 - If the employee presents one of the older, still valid DHS Employment Authorization Documents (Form I-688 Temporary Resident Card or Form I-688A or I-688B Employment Authorization Card) as a list “A” identity and work authorization document, the form will clearly list a work authorization beginning date and expiration date on the face of the card. However, an updated expiration date may appear on an official sticker on the back of the card.
 - Foreign passports usually list the expiration date on the main page with the individual’s name and birth date but may also record a name change or an updated expiration date on a separate page.

- **Sometimes the work authorization expiration date must be determined based on several documents.** This may be the case when an employee presents a foreign passport with a Form I-94 Arrival/Departure record or a DHS Employment Authorization Card (Form I-766) as a List “A” document to prove identity and work authorization.
- **Sometimes the work authorization expiration date may be updated in a separate publication by DHS.** If the most recent DHS Employment Authorization Card (Form I-766) is presented, the form will clearly list the work authorization beginning date and expiration date on the face of the card, and an updated expiration date may appear on an official sticker on the back of the card. However, the expiration date may also be extended to a date (not listed on the card) announced by DHS in the Federal Register and published in a DHS a press release. Or, DHS may have announced a procedure extending the work authorization under specific circumstances.

If you cannot determine the work authorization expiration date, or if the expiration date in Section One seems incorrect, contact Manager/Owner/Counsel_____.

HOW MANY DOCUMENTS?

- If the employee provides a **List A** document, only **one** document will be entered.
 - The second and third document sections under column “A” are only used when a foreign passport is presented.

- If the employee provides a **List B** and a **List C** document, be sure that each is listed in the proper column. A total of **two** documents will be entered.

If the employee provides more than the required document(s), the HR staff member will advise the employee that only one List A OR one List B and one List C documents are being requested. The **employee** must decide which document(s) to present.

Record the required information in Section 2

Record the required information in Section 2 for each document you accept.

- The document title,
- issuing authority,
- document number, and
- expiration date, if any.

Record list “A” documents in column “A”, list “B” documents in column “B”, and list “C” documents in column “C”. The document expiration date is the most current expiration date printed on the document. Some documents do not carry expiration dates.

Certification

Always Record the “employee’s first day of employment” in Section 2.

This is the date the employee first begins work for pay for the Company. If this date changes, the Form I-9 must be updated. ... If this date is unknown, Section 2 cannot be certified.

- Verify all the information requested in the Certification portion of Section 2. Sign and date the Form I-9.
- The same Company representative must complete all of Section 2. If Section 2 is begun, but only partially completed, the person who completes it must see the employee in person and verify the original documents (this should be avoided).
- If you think there might be an error or omission in Section 1; that there is a problem with the documents presented for Section 2; you are uncertain as to the “employee’s first day of employment;” or you think the work authorization expiration date in Section 1 is in error, do not sign and date Section 2 yet. Instead, **contact Manager/Owner/Counsel_____** for assistance.
- Sign and date Section 2 only when it is complete.

If Section 1 and Section 2 of the Form I-9 are not complete at the end of the second business day following the date employment began, the employee must be placed in leave status or terminated from employment by the end of the next business day.

These deadlines apply regardless of the employee’s work schedule. Example: In a regular business week, an employee who starts work on Monday must complete a Form I-9 by the end of business Wednesday or else be placed in leave status or terminated by Thursday.

Receipt Rule

Receipt rule: If an employee who is hired for employment expected to last at least three business days provides one of the following instead of a valid document, the employee is granted extra time to provide the actual document:

- A receipt for a lost, stolen, or damaged document (but not a receipt showing an application for a new, never-before-issued document or renewal of an expired document),
- Arrival portion of the Form I-94 or I-94A containing a Temporary I-551 stamp (indicating temporary evidence of permanent resident status) and a photograph of the individual,
- Departure portion of the Form I-94 or I-94A containing an unexpired refugee admission stamp.

When an employee presents one of these items instead of a valid document, complete the Form I-9 using the receipt or Form I-94 information in place of the missing document. Write the word “receipt” and its document number in the “Document Number” field in the correct column. Record the last day that the receipt is valid in the “Expiration Date” field.

The receipt rule does not apply if employment is for less than three business days.

Employees hired to work for less than three business days must complete Sections 1 and 2 of the Form I-9 no later than the day they start work and must provide valid documents—not receipts—for Section 2.

By the end of the receipt validity period, the employer must:

- Cross out the word “receipt” and any accompanying document number and expiration date.
- Record the number and other required document information from the actual document presented
- Initial and date the change.

Please note:

- For receipts for lost, stolen, or damaged documents, the employee must present the actual document within 90 days from the date of hire.
- For arrival portion of Form I-94 with a temporary I-551 stamp, the employee must present the actual Permanent Resident Card (Form I-551) by the expiration date of the temporary I-551 stamp, or, if there is no expiration date, within one (1) year from the date of issue.
- For departure portion of Form I-94 with a refugee admission stamp, the employee must present an unexpired Employment Authorization Document (Form I-766) or a combination of List B document and an unrestricted Social Security card within 90 days.

Completing Section 3: Reverification & Rehires

It is the Company’s responsibility to update and re-verify Forms I-9 for employees when work authorization expires, receipts “expire,” or an issue or

discrepancy is discovered. The Company requires a new Form I-9 or completion of Section 3, Reverification and Rehires, for employees re-hired after any break in service.

There are several different circumstances in which a Form I-9 initially completed at the time of hire, must be updated or re-verified:

Task	Timing
Enforce the Form I-9 Receipt Rule	Immediately after hire (and as noted by receipt rule)
Update a Form I-9 Work Authorization	Before expiration of work authorization
Replace Missing Forms I-9	Upon discovery of problem
Correct Errors and Omissions	Upon discovery of problem

Enforce the Form I-9 Receipt Rule

If the receipt deadline arrives, and the employee has not provided the replacement document(s), the Company must terminate employment or place the employee in leave status and have the employee cease all work for the Company until the employee provides the document(s). No employee may continue to work

for the Company without providing required documents after the time-period allowed by the receipt rule has ended.

Update a Form I-9 Work Authorization

The Company may remind each non-resident alien employee to renew his or her work authorization six months before the work authorization expires, but the Company has no obligation to remind the foreign national employee with temporary work authorization that the employee is six months from work authorization expiration.

The Company *does* have to reverify work authorization prior to the expiration of such an employee's current authorization to work.

Update the Form I-9 if the employee presents an updated work authorization.

1. Follow the same process used to check documents for Section 2. Compare the work authorization to Section 1 and Section 2. Ask the employee to explain any discrepancies.
2. If the original Form I-9 Section 3 is blank, follow the instructions on the Form I-9 and use Section 3 to record the work authorization document title, document number, and expiration date. If the employee's name has changed on the work authorization document, record the new name in the space provided in Section 3. An employee can have only one legal name.
3. If the original Form I-9 Section 3 has already been used, do the following:

- a) Complete a new Form I-9.
- b) Record the required information in Section 3 of the new Form I-9 and attach it to the original Form I-9. If the employee's name has changed, record the old name from the previous Form I-9 in Section 1 and the new name in Section 3. You must document in a memo the reason for the name change (i.e. marriage).

Take the employee off payroll if the work authorization expires. If the expiration date arrives and the authorization has not been renewed the employee must be terminated or placed in leave status and the employee must cease all work for the Company until the work authorization is renewed. No employee may continue to work for the Company after the employee's work authorization expires.

Replace Missing Forms I-9

If you are unable to locate a Form I-9 for an employee, the employee, if hired after November 6, 1986 [(employees continuously employed since November 6, 1986 or earlier are not required to complete Forms I-9), must complete Section 1 of the Form I-9 again and supply identity and work authorization documents again as soon as possible following the discovery that the Form I-9 is missing or, if the employee is on leave, as soon as possible after returning to work.

Additionally, a signed and dated memo-to-file must be created and attached to the replacement Form I-9 detailing the discovery that the Form I-9 was missing and the creation of the replacement I-9.

It is the Company's policy to make every effort to complete any replacement Form I-9 within three business days of discovering that the document is missing. If there is no progress in completing the replacement form within a reasonable period of time, the employee should be placed in leave status or terminated from employment.

Correct Errors and Omissions

[...] If you find a problem with a Form I-9, the Form must be corrected as soon as possible. It is the Company's policy to try and correct any errors or omissions within three business days of discovery.

Corrections to Forms I-9 must always be signed and dated by the person making the correction. Corrections to Section 1 of the Form I-9 must be made by the employee. Corrections to the rest of the form must be made by a designated Company representative (other than the employee). If a correction is so extensive and a new Form I-9 must be completed, the old form(s) will be retained and attached to the employee's new Form I-9. If an error or omission calls into question an employee's identity and/or authorization to work, immediately report the error or omission to **Manager/Owner/Counsel _____**.

[End Excerpt.]

I-9 EMPLOYMENT ELIGIBILITY VERIFICATION COMPLIANCE

With hints that ICE is ramping up its I-9 compliance enforcement efforts, ICE will likely be issuing Notices of Inspection and subpoenas around the State.

Right now is a great time to conduct an internal I-9 audit (or to advise your clients to) and to make sure employer I-9 Employment Eligibility verification compliance policies are in place.

ICE (U.S. Immigration and Customs Enforcement) will likely be issuing about 20 Notices of Inspection before the end of this fiscal year. Its targets are almost always service industries, like food service and construction. Employers have a maximum of 72 hours (3 business days) to respond to the subpoena and Notice of Inspection. Generally the initial subpoena is for the I-9s of all current employees and for former employees who fall within the I-9 retention period established by law.

With the short amount of time given by ICE for employers to comply with the subpoena. It is imperative that the employer not waive its right to that 72 hour period. Preparing front of house managers or other front line contacts for the potential of encountering an ICE officer or auditor is a great policy to have in place.

“Best Practice” Tips:

- Establish a uniform, written I-9 compliance policy and train staff on it.
- Put in place a calendaring system to notify HR staff of upcoming re-verifications for individuals that possess temporary employment authorization.
- Establish a method for proper cataloging and retention of I-9s. Separate former and active employees' I-9s.
- Keep your Forms I-9 organized and separate from general personnel files—this helps to prevent ICE from obtaining any employee documentation that the employer is not legally bound to give to ICE. Storing the I-9s separate from employee personnel files also helps to safeguard the sensitive information entered on the Form I-9.

ICE does not grant extensions to respond to the inspection subpoena. Conducting an internal I-9 audit by trained legal staff or by in-house HR, can not only save an employer money and stress, it goes a long way toward demonstrating an employer's good faith effort to comply. The money spent on an internal audit is a fraction of the cost of fines for I-9 violations, fees for representation, and lost revenue from a full-blown ICE inspection.

The fines that ICE levies are not only for unauthorized employment. Any deficiency on a Form I-9, from failing to put the employee's name on the top of the second fillable page to using an expired form, all errors are violations, either technical or substantive, and open an employer to liability.

An employer can have a 100% legal-to-employ workforce and still have I-9 violations on every Form I-9. Though it is only a two page form, it can cost employers time, money, and headaches without rock-solid HR policies and well-trained staff handling I-9 employment verification.

The most common Form I-9 errors:

Too Late: Employees must complete, sign, and date Section 1 of the I-9 form no later than their first day of work, but cannot be asked to fill it out before they have accepted a job offer. Employers must complete Section 2 of the form within three business days of the employee's first day of work. This means that if an employee starts work on a Tuesday, the employee must complete Section 1 Tuesday, and the employer has until Friday to complete Section 2.

Incomplete: Errors like failing to provide an acceptable address (no P.O. Boxes), failing to sign, and failing to date the form are common. The employer is responsible for checking to see that Section 1 of the form is accurate and complete.

Over-documentation: While it may seem like the employer is being diligent by requesting as many documents as possible to verify that an employee is legally eligible to work in the U.S., the employer cannot ask for anything more than what the form requires. The instructions ask for either one document from “List A” or a combination of one document each from “List B” and “List C.” The documents chosen are up to the employee. The employer cannot demand specific documents. Asking for a particular document or additional documents, beyond what is required by the form, can be considered discrimination.

Accepting Scans or Copies of Documents: An employee cannot send a scan of their social security card and driver’s license to satisfy I-9 requirements. The employer (or employer’s agent, such as HR staff or the hiring manager) must review the original I-9 form and original documents in person, and NOT by photo, scan, or video.

Form corrections: Any corrections or changes an employer makes to an I-9 must be signed and dated by the employer agent. If corrections to Section 1 are needed, the *employee* must make them (signing and dating near the correction). Any errors must be crossed out with a single line. The use of White Out or correction fluid on the Form I-9 is a violation.

The Spanish Version: The Spanish-language version of the I-9 can only be used by employers and employees in Puerto Rico. The employer can

provide the Spanish-language version to Spanish-speaking employees for reference or guidance, but it cannot be the version actually completed and placed in the employee's file.

Wrong Documents: Check that the documents the employee presents are on the USCIS lists of acceptable documents (the lists are part of the Form I-9, page 9).

Thankfully, employers can remedy most violations during an internal I-9 audit. There are error that cannot be corrected. Such errors can still be addressed in an internal audit. A note added to the I-9 file, as part of the internal audit (conducted of the employer's freewill), noting the error and why it cannot be corrected, demonstrates the employer's good faith effort and diligence in complying with employment eligibility verification laws.

When employers have evidence that they review their Forms I-9 for compliance, and that they make every effort to correct any errors and maintain their obligations under the law, ICE auditors consider that evidence when reviewing subpoenaed forms and assessing fines.

Retention:

Employers must retain an employee's completed Form I-9 for as long as the individual works for the employer. Once the individual's employment has terminated, the employer must determine how long after termination the Form I-

9 must be retained, which is either three years after the date of hire, or one year after the date employment is terminated, whichever is later.

Employers can maintain Forms I-9 electronically, but there are specific requirements and procedures the employer must follow if the I-9s are only stored electronically. The m-274, *Handbook for Employers, Guidance for Completing Form I-9*, contains detailed information on these requirements (pages 28-29). The m-274 is a 70-page handbook for guidance on a two page form.

OFFICE OF SPECIAL COUNCIL ACTIONS

Although only a two-page form, the I-9 document in certain situations can stump even well-seasoned human resources personnel. A situation may arise in which a complex correction must be made while avoiding potential violations of the anti-decimation provisions. The stress placed upon not requesting certain documents from an employee and not accepting additional documents to those required comes from the employer's potential liability for discrimination claims.

The Office of Special Counsel for Immigration-Related Unfair Employment Practices (OSC) enforces the anti-discrimination provision (§274B) of the Immigration and Nationality Act (INA), 8 USC §1324b.

This federal law prohibits: 1) citizenship status discrimination in hiring, firing, or recruitment or referral for a fee, 2) national origin discrimination in hiring,

firing, or recruitment or referral for a fee, 3) document abuse (unfair documentary practices during the employment eligibility verification, Form I-9, process, and 4) retaliation or intimidation.

Again, employers cannot specify which document(s) they will accept from an employee. The refusal to hire an individual because of a future expiration may also constitute illegal discrimination. An immigration-discrimination claim against an employer generally involves back pay and civil fines if the employer is found to have violated the law.

I-9 COMPLIANCE: MERGERS AND ACQUISITIONS

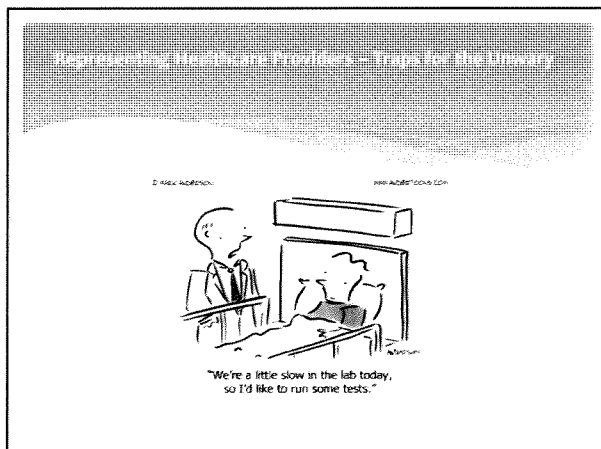
An important and easily overlooked issue that an employer should address during restructuring is Form I-9 compliance. A successor-in-interest may assume the I-9 liabilities of the predecessor employee; however, this means that the new employer is also liable for any mistakes in the I-9s completed by the predecessor. Therefore, prior to commencing a transaction, an examination of the organization's I-9s should be conducted through an audit. If the successor organization does not assume I-9s of the predecessor, new I-9s may be completed for all of the organization's employees within three days of the transaction to avoid any allegation of an unfair immigration-related employment practice such as document abuse or discrimination on the basis of citizenship or nationality. It is important for in-house counsel to be aware of I-9 compliance-related

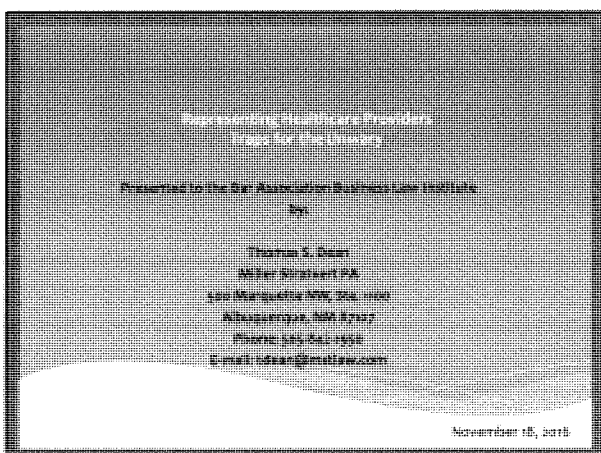
issues that may arise as a result of a restructuring between companies. Companies consider these liabilities early on in any transaction to ensure that they are in compliance with immigration regulations and to avoid run-ins with the Office of Special Counsel.

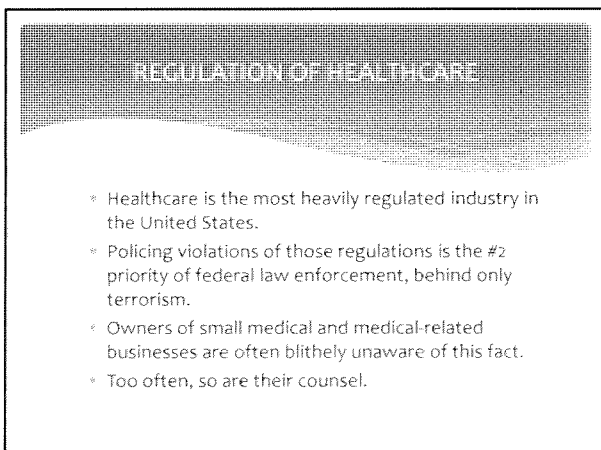
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Representing Healthcare Providers – Traps for the Unwary







Scope of Today's Presentation

- * Identify the key statutes and rules
 - * HIPAA Privacy Rule
 - * Stark Law and Anti-Kickback Statute
- * For each, consider some hypothetical situations that implicate them; and
- * Consider how to recognize when you and your client are in a situation where those rules apply.

Take the last issue first for a moment: When will healthcare regulations impact you?

- * Purchase and sale of a business that bills for goods or services to Medicare, Medicaid;
- * Use of or access to patient health records;
- * Negotiating part-time employment or independent contractor agreements for physicians or their family.

What kinds of businesses bill for goods and services to Medicare and Medicaid?

- * Ambulatory surgery centers;
- * Clinical laboratories;
- * Independent diagnostic testing facilities (radiology centers);
- * Durable medical equipment providers;
- * Prosthetics and orthotics;
- * Patient transport services;
- * Housekeeping services that contract with hospitals;
- * Food services that contract with hospitals;
- * Software vendors that contract with hospitals.

HIPAA Privacy Rule (45 CFR Part 164, Subpart E)

- * Any business that bills for medical and medical-related goods and services electronically is a "Covered Entity" for purposes of the HIPAA Privacy Rule.
- * Most businesses that have access to any patient information of a Covered Entity are "Business Associates."
- * Business Associates are required to comply with the Privacy Rule.
- * The Covered Entity should put the Business Associate on notice of that duty by means of an Agreement.

Who is a Business Associate?

- * The defense attorney representing a doctor's office in a medical malpractice case is likely a Business Associate.
- * The chaplain service that gets a list of patients and next of kin.
- * The accounting firm or almost any consultant who can access the billing records of a Covered Entity.
- * The copy service, etc., etc.

What are the risks of becoming a Business Associate?

- * Financial Sanctions:
 - * Catholic organization that had and lost a list of patients to be visited at a chain of nursing homes;
 - * Management company sanctioned for failing to safeguard patient information.
- * Bad Publicity.
 - * Some wrongful disclosures must be fixed by publication of notice to potentially affected patients

Stark Law (42 USC 1395nn, Regulations at 42 CFR Part 411, Subpart J)

The Stark Law is unusual because it is a strict-liability rule. There is no obligation for the regulators to prove an awareness of the rule, or any intent to break it.

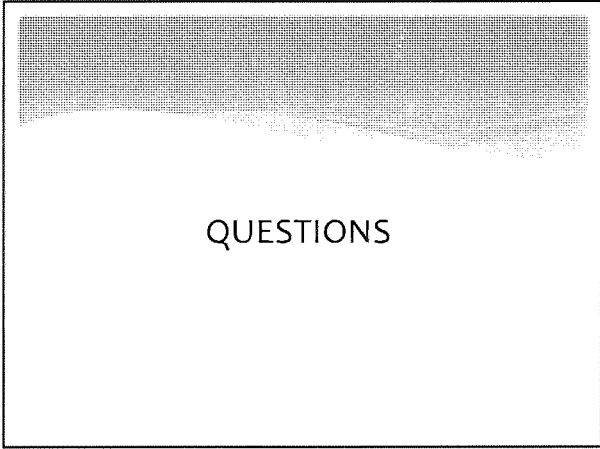
The scope of the Stark Law is limited to a discrete body of "Designated Health Services" (DHS) and to financial transactions or interests that involve a doctor or family member who is in a position to refer DHS.

Anti-Kickback Statute 42 U.S.C. § 1320a-7b

The federal Anti-Kickback Statute is a criminal statute that prohibits the exchange (or offer to exchange), of anything of value, in an effort to induce (or reward) the referral of federal health care program business.

When these rules are implicated

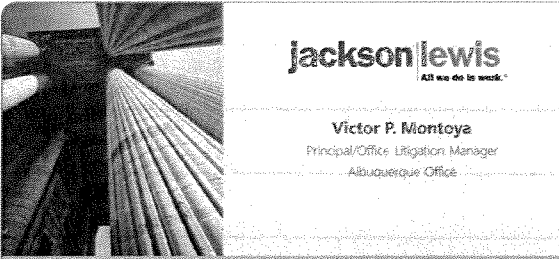
- * Non-physician buys into an Ambulatory Surgery Center;
- * Company hires a medical director for a medical-related business;
- * Any company with an owner married to a physician that negotiates with a hospital for anything; and
- * Transport services.



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This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

Joint Employer



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“All we do is work.”

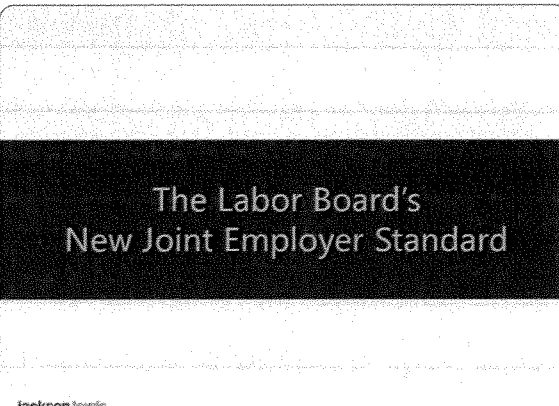
Victor P. Montoya
 Principal/Office Litigation Manager
 Albuquerque Office

**Legal Update:
 Joint Employer Issues**

Presentation Outlook

- The NLRB's New Joint Employer Standard
 - DOL Interpretation
 - Legislative Action in Wake of the Board's New Standard
 - Federal
 - State
 - Impact of the New Standard on Other Federal Agencies
 - Department of Labor (FLSA, FMLA, OSHA)
 - U.S. Equal Employment Opportunity Commission (EEOC)
 - Office of Federal Contract Compliance Programs (OFCCP)
 - Practical Considerations Regarding Joint Employer Status
 - Walling Off Subsidiary/Affiliate
 - Miller & Anderson – Joint Employer – Part Two

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**The Labor Board's
 New Joint Employer Standard**

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*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

- Browning-Ferris (BFI) operates a waste recycling facility.
- BFI subcontracts employees from Leadpoint to sort recyclable items inside the facility and to perform basic housekeeping functions.
- Teamsters (Union) filed a petition to represent approximately 240 employees, which were comprised of sorters, housekeepers, and screen cleaners.
- The Union already represented approximately 60 direct BFI employees who worked on the exterior of the facility.

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4

Former Joint Employer Standard

- Joint employment exists "where two separate entities share or codetermine those matters governing the essential terms and conditions of employment."
- The joint employer's control over employment matters must be "direct and immediate" as to things like hiring, firing, discipline, supervision, and direction.

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5

Former Joint Employer Standard

- Former joint employer standard has existed since the mid-1960's (*Greyhound Corp.*, 153 NLRB 1488 (1965)).
- The joint employer standard was refined in *TLI Inc.* 271 NLRB 798 (1984), *Laerco Transportation*, 269 NLRB 324 (1984) and *Airborne Express*, 338 NLRB 597 (2002).
- The joint employer standard has remained relatively unchanged for the past 30(+) years.

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6

*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

New "Modified" Joint Employer Standard:

- (1) whether a common law employment relationship exists;
- (2) whether the potential joint employer "possesses sufficient control over employees' essential terms and conditions of employment to permit meaningful bargaining."

Control under the new standard can be **direct, indirect**, or even a **reserved right to control**, whether or not that right is ever exercised.

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2

*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

What Does the Board Consider a Common Law Employment Relationship?

- o Restatement (Second) of Agency
- o Section 220(1) provides that a "servant is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control."

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*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

What is "sufficient control" under the new Joint Employer Standard?

**Direct, Indirect, or a
Reserved Right to Control.**

Whether or not that right is ever exercised.

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4

*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

• Possible Indicators of Joint Employer Status

- Controlling the number of employees needed for job or task.
- Safety rules and standards.
- Establishing production standards.
- Determining job duties.
- Instruction relating to the means and manner to accomplish a job.

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10

*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

• Possible Indicators of Joint Employer Status

- Training employees or establishing employee training requirements.
- Indirectly controlling employees' wages through a commercial agreement.
- Retaining potential control over employment conditions reserved in commercial agreements.
- Retaining the right to terminate the relationship.
- Requiring employees to follow rules or handbooks.

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11

*Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)*

• Possible Indicators of Joint Employer Status

- Imposing highly standardized operational requirements.
- Owning facilities/equipment where employees work.
- Requiring operational modifications.
- Monitoring and auditing operations.
- Setting maximum wage rates for employees.

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12

Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)

Current Status

- On September 4, 2015, a tally of ballots showed a 73-17 vote in favor of union representation. The Teamsters were certified.
- Teamsters filed an unfair labor practice charge against BFI, claiming that the Company was refusing to recognize or bargain with the Union.
- The Board issued a unanimous decision, finding BFI and Leadpoint, as joint employers, had violated the NLRA.
- BFI appealed the January 12, 2016 decision to the U.S. Court of Appeals for the D.C. Circuit on January 20, 2016.

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13

Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)

Current Status

- On June 7, 2016, BFI argued in its opening brief that the Board's new standard is defective and unenforceable because:
 - (1) it is contrary to the employment relationships recognized by Congress in the 1947 Taft-Hartley amendments to the NLRA;
 - (2) it relies upon the kind of assessment of "economic realities" prohibited in the Taft-Hartley amendments;
 - (3) it fails to promote stable collective bargaining relationships; and
 - (4) it is arbitrary and capricious because it overturns decades of settled law and imposes a standard so broad and unconstitutionally vague that parties cannot arrange their affairs to achieve predictable legal outcomes.

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14

Browning-Ferris Industries of California, Inc.,
362 NLRB No. 186 (August 27, 2015)

Current Status

BFI also argued:

- That it is not a joint employer of Leadpoint employees under either the old joint employer standard or the new; and
- Even if the new joint employer standard survived judicial scrutiny, it was inherently inequitable to apply the new test retroactively.

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15

Browning-Ferris Industries of California, Inc.
362 NLRB No. 186 (August 27, 2015)

Current Status

- BFI voiced indignation and frustration with the "[v]irtually boundless scope of the Board's new joint-employer test."
- It also expressed concern the new standard will adversely affect a panoply of bargaining obligations.
- Briefing will continue through July 28, 2016.
- A determination from the D.C. Circuit is not anticipated before the fall.

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16

**DOL Administrative Interpretation
re: Joint Employment**

- On January 20, 2016, DOL's Wage Hour Division issued AI No. 2016-1 to address joint employment under the FLSA and MSPA.
- Dovetails on NLRB approach
- High stakes: if two businesses found to be joint employers, then jointly liable for compliance of overtime, misclassification, a minimum wage, FMLA, and other obligations under FLSA
- Issued by WHD Administrator David Weil, who has written about the "fissured workplace" (arguably the basis for the NLRB's expanded joint employer standard)
- Goal is to hold the "lead business" liable for the "intermediary" employer FLSA violations

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17

**DOL Administrative Interpretation
re: Joint Employment**

- Previous AI on independent contractors expanded the definition of "employee". The AI further expands that definition.
- Past focus of the DOL was on horizontal relationships (2 gas stations that share employees). Now the focus is also on vertical relationships (staffing companies, parent/sub, possibly franchisor/franchisee).
- Clear guidance for DOL investigators.
- AI is not the law, but will have a significant impact because of judicial deference.

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18

Congressional Action in Response to NLRB's New Joint Employer Standard

- **The Protecting Local Business Opportunity Act** (S.2015/H.3459) was introduced on September 9, 2015 by Senator Lamar Alexander (R-Tenn) and House Representative John Kline (R-Minn). The Act seeks to amend the definition of "employer" under the NLRA.
 - "Section 2(2) of the National Labor Relations Act (29 U.S.C. 152(2)) is amended by adding at the end the following: "Notwithstanding any other provision of this Act, two or more employers may be considered joint employers for purposes of this Act only if each shares and exercises control over essential terms and conditions of employment and such control over these matters is actual, direct and immediate."

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19

Congressional Action in Response to NLRB's New Joint Employer Standard

- **Appropriations Rider**
- "Sec. 408. None of the funds made available by this Act may be used to investigate, issue, enforce or litigate any administrative directive, regulation, representation issue or unfair labor practice proceeding or any other administrative complaint, charge, claim or proceeding that would change the interpretation or application of a standard to determine whether entities are "joint employers" in effect as of January 1, 2014."

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20

Congressional Action in Response to NLRB's New Joint Employer Standard

- On September 28, 2015, Senator Mike Lee (R-UT) introduced **The Protecting American Jobs Act** (S. 2084) which would transfer prosecutorial and adjudicative authority over labor disputes from the NLRB to federal courts. The bill would effectively strip the Board of its power to prosecute and adjudicate labor dispute.

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21

State Legislative Action

- In the wake of *Browning-Ferris*, several states have introduced legislation aimed at protecting businesses from the wide-ranging effects of the NLRB's aggressive decision.
- Eight states (Texas, Louisiana, Tennessee, Wisconsin, Michigan, Indiana, Georgia and Utah) have passed legislation that prohibit a franchisor from being considered an employer or co-employer of franchisee employees.
- Similar legislative efforts have been introduced in California, Colorado, Massachusetts, Oklahoma, Pennsylvania, Vermont, and Virginia.
- Legislators in Wyoming, North Carolina, Arizona, and Colorado are evaluating similar efforts.

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22

Joint Employment Under FMLA

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23

U.S. Department of Labor Family and Medical Leave Act

- Issued in January 2016
 - Issued Fact Sheet #28N: Joint Employment and Primary and Secondary Employer Responsibilities Under FMLA
- Definition of Joint Employment:
 - Joint employment exists when an employee is employed by two (or more) employers such that the employers are responsible for compliance with the FMLA.
- Analysis:
 - Same analysis as the FLSA

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24

U.S. Department of Labor Family and Medical Leave Act

- The **primary employer** is responsible for:
 - Giving required notices to its employees;
 - Providing FMLA leave; and
 - Maintenance of health benefits.
- The **primary employer** is also mostly responsible for job restoration.

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U.S. Department of Labor Family and Medical Leave Act

- A **secondary employer** is responsible for accepting the individual upon return from FMLA
 - As long as the company continues to use an employee from the staffing agency, and the agency chooses to place this employee with the company.
- As a **secondary employer**, the company would also be prohibited from interfering with an employee's FMLA rights and also from discriminating against him/her for protected activities, even if the company is not otherwise a covered employer, as defined above, under the FMLA

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27

U.S. Department of Labor Family and Medical Leave Act

- **Determining who is a primary and secondary employer:**
 - Who has authority to hire and fire, and to place or assign work to the employee;
 - Who decides how, when, and the amount that the employee is paid; and
 - Who provides the employee's leave or other employment benefits.
- In the case of a temporary placement or staffing agency, the agency is most commonly the primary employer.

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28

U.S. Department of Labor Family and Medical Leave Act

- Employees who are jointly employed by two employers must be counted by both of them in determining the employer's coverage and employee eligibility under FMLA, regardless of whether the employee is maintained on one or both of the employers' payrolls.
- The employee's worksite is the primary employer's office from which the employee is assigned or to which the employee reports.
 - However, if the employee has physically worked for at least one year at a facility for a secondary employer, then the employee's worksite is that location.

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U.S. Department of Labor Occupational Safety and Health Act

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U.S. Department of Labor Occupational Safety and Health Act

- Draft policy prepared by DOL's Office of the Solicitor illustrates the agency's intent to hold franchising corporations responsible, at least in part, in OSHA and other labor law enforcement actions against franchisee businesses.
- The draft policy addresses whether, for purposes of OSHA, a joint employment relationship can be found between the franchisor and the franchisee, leading both entities to be liable as employers.

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30

U.S. Department of Labor Occupational Safety and Health Act

- A joint employer standard may apply where the corporate entity exercises direct or indirect control over working conditions, has the unexercised potential to control working conditions, or based on the economic realities.
 - Control includes such matters as hiring, firing, discipline, supervision and direction.
- Draft policy also contains laundry list of documents and information OSHA should obtain to reach its determination.

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10

U.S. Department of Labor Occupational Safety and Health Act

- If OSHA's (draft) joint employer policy advances, OSHA's ability to cite a host employer would be enhanced and could be used by unions as leverage against employers who have been targeted for organizing.
- An expansion of the joint employer standard could also provide an opportunity for OSHA to ratchet up fines against a parent company for repeated violations.

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11

U.S. Department of Labor Occupational Safety and Health Act

- In January 2016, two GOP house leaders accused the DOL of lying about not coordinating with the NLRB on the draft policy.
- These allegations come in light of new evidence showing that the NLRB's GC and staff at the DOL discussed the joint employer standard over a video conference call.
- Due to the significance of the NLRB's new joint employer standard, it is not surprising that discussions would have taken place in advance of its issuance; however, the DOL's failure to provide correspondence or otherwise cooperate with the investigation is, at best, curious.

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12

Joint Employer Liability Regulated by The U.S. Equal Employment Opportunity Commission

- The EEOC filed an amicus brief in *Browning-Ferris* stressing that the Board's joint employer standard **will influence** judicial interpretation of Title VII.
- Compensatory damages are capped under Title VII, and the caps generally increase as the number of employees increases. Thus, the plaintiff's bar will be encouraged to establish joint employer status because doing so could increase the number of employees, thereby increasing the amount of available damages.
- Threshold coverage may impact the small business exception.
- The EEOC has targeted retailers as part of its E-Race and Systemic Discrimination initiatives.

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36

Joint Employer Liability Regulated by The Office of Federal Contract Compliance

- Administers and enforces three federal contract-based rights laws that require most federal contractors and subcontractors, as well as federally assisted construction contractors, to provide equal employment opportunities.
- Anticipated expansion of jurisdictional reach through "single entity" test.
- Published a "question and answer" application on the single-entity test which contains 27 questions to guide potential contractors through the analysis.

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36

Practical Considerations to Minimize Finding of Joint Employer Status

- There is no specific test.
- Ensure that the agreement with the contractor supports the fact that you are not a joint employer; and ensure that the practice is consistent with the agreement.
- One end of the continuum is to give the contractor complete control, and evaluate contractor's performance.
- On the other end of the continuum is to eliminate the contractor entirely and directly employ those working at the facility.

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36

Practical Considerations to Minimize Finding of Joint Employer Status

- Review and revise agreements to support your position that Company A is not a joint employer of Company B's employees.
- Some terms to consider for the contractor agreement:
 - Company B's employees are solely employed by Company B; the parties do not intend to create a joint employer relationship.
 - Recite that Company B alone retains the sole right to...and then include a list of employment decisions...such as hire its employees, determine their wages and benefits, assign, schedule, train, discipline, and terminate its employees.
 - Include a statement that Company A shall not and does not have the right to ...and include all of the rights Company B alone has in this list.

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37

Practical Considerations to Minimize Finding of Joint Employer Status

- Ensure that Company B has its own employment policies and procedures. You can review them as part of due diligence when deciding whether to enter into or renew your contract with them.
- To the extent Company A concludes that it must exercise *some* control over the operation, minimize it to the extent possible and realize that any control, or right to control, that you retain may be used against you to support a finding that you are a joint employer.

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38

Practical Considerations to Minimize Finding of Joint Employer Status

- Review indemnification language. Consider requiring Company B to indemnify Company A for any costs incurred in opposing a joint employer claim.
 - Include language that Company B will cooperate with you in presenting your defense to the joint employer claim by making available management representatives to prepare for hearings and to testify at hearings, and to provide documents reasonably requested by Company A relating to this issue.
 - Should Company B reimburse Company A's representative for the cost of bargaining?
- Bring the contracted work in-house.

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39

Practical Tips to "Wall Off" A Subsidiary or Affiliate

• Governance Structure

- Rather than a VP or General Manager, a true officer structure with a new president
- Board members unique to that company (no overlapping board members between sub and parent)
- Processes and presentations to report up to the board of parent
- Strict adherence to corporate formalities such as minutes and reporting mechanisms
- Sub has its own policies

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40

Practical Tips to "Wall Off" A Subsidiary or Affiliate

• Employment Structure

- Focus on employment, hiring, firing, reviews, discipline, supervision, pay decisions
- All HR decisions for the sub are made locally
- Employees at the sub only work for the sub and are paid by the sub
- If parent has employees in that jurisdiction, set up a new payroll company and move the employees to a new facility afterwards
- No cross-use of employees between parent and sub. Employee works for the one or the other
- Sub has separate connection to ADP (could be in a master contract)
- Sub takes physical possession of the personnel files and maintain those (will need secure facility)
- Training to take on new roles

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41

Practical Tips to "Wall Off" A Subsidiary or Affiliate

• Other

- Check real and personal property leases so that only the sub is on the lease
- Consider your insurance policies. DIC (Difference In Coverage) insurance for your new officers and directors
- Master Servicing Contract (for bank accounts, billing, marketing) that accounting accurately tracks
- Can produce separate P&Ls
- Necessarily means ceding control by parent, but regulation must be real and not window-dressing

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42

Miller & Anderson

- The NLRB's New Approach to "Joint Employer Status" - Part Two

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23

The NLRB's "Ping-Pong" Over Consent

- Dating back to 1990, the NLRB has taken conflicting stances on whether unions can organize in one bargaining unit if the employees of two separate companies – a single employer and those it jointly employs with another (usually a staffing agency) – regardless of whether the two companies consent. Such "mixed units" are pervasive in today's workplace, where employers routinely utilize temporary workers to supplement their regular workforces.
- In *M.B. Sturgis*, 331 NLRB 1298 (2000), the Board held that employer consent should only be required when employers are entirely independent businesses, with nothing in common except the industry in which they operate. In all other cases, when they are not physically and economically separate, **consent should not be required**.
- Four years later, the Board rejected *Sturgis* in *Oakwood Care Center*, 343 NLRB 659 (2004). The Board clarified that employees from nominally different employers **should not be able to form a single bargaining unit without consent**, because employers who join a multi-employer bargaining unit must all consent to their inclusion.

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24

Miller & Anderson

- In *Miller & Anderson, Inc.*, 364 NLRB No. 39 (July 11, 2016) the Board held that employer consent **is no longer required** for bargaining units that combine jointly employed and solely employed workers of a single user employer, provided the employees share a "community of interest".
- Community of interest factors include: type of work performed by employees, the operational integration of that work, whether the employees have common supervision and come into contact with each other, the interchange between and among their positions and whether they have similar wages, benefits and other terms and conditions of employment.

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Miller & Anderson

- The Board also addressed the scope of the respective bargaining obligations for the employer and the contractor in a combined unit.
 - An employer has an obligation to bargain over all terms and conditions of the employees it solely employs, while its bargaining obligation for the jointly employed workers extends only to those terms and conditions which it possesses the authority to control.
 - A contractor's duty to bargain covers only the jointly employed workers and extends only to the terms and conditions that it possesses the authority to control.

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40

What Does This Mean for Employers?

- Temporary employees typically have less loyalty to a joint employer than its regular employees, and thus, will be more likely to vote in favor of union representation. As such, they can dilute the support you have among your regular employees and perhaps tip the scales in favor of unionization.
- A company could become unionized even if a majority of its regular employees votes against unionization.

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41

Recommendations for Employers

- Review contracts and practices to determine whether your company would be considered a **joint employer** under *Browning-Ferris*.
- Determine whether your employees and the temporary employees have a **community of interest**.
- Seek to structure operations and working terms to prevent a "community of interest" between the groups of workers.
 - Maintain clear separation between employee groups.
 - Ensure little similarity between employee assignments (i.e. jobs, locations).
 - Avoid permanent and temporary employees working side by side.
 - Make clear distinctions regarding employee functions in contracts/agreements.

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42

Recommendations for Employers

- Where not possible to restructure operations and working terms to avoid joint employment or a community of interest:
 - Ensure your supervisors treat the temps with dignity and respect and that they are fully indoctrinated into your company's culture.
 - Assert necessary control over temporary workers' terms and conditions of employment in contracts/agreements.
 - Regularly monitor / audit contractor compliance with state and federal obligations.
 - Regularly monitor contractor treatment of temporary employees.

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