SEC May Pursue More Negligence Cases

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The Securities and Exchange Commission enforcement division may be lowering the bar in some cases on the legal standard it uses to pursue companies and individuals involved in corporate misconduct.

The *Wall Street Journal* reported last month that the SEC could file more civil cases against defendants on the basis of negligence only, rather than the more difficult-to-prove standards of intentional wrongdoing or recklessness. The report said it was a major shift in the SEC's enforcement strategy.

“Simply avoiding Ponzi scheme-style outright fraud is not enough to avoid enforcement action,” Kenneth Lench, the SEC's structured and new products enforcement unit chief told the *Journal*. “Firms and executives have a duty of care. Failure to check properly that investors are being provided with fair and accurate information could, under some circumstances, be a breach of that duty, even if there's no intent to defraud them,” he said.

While an SEC spokesperson says that there has not been a shift in the agency's policy, he did say the SEC would not shy away from pursuing negligence cases. “The Commission will use all tools available to hold wrongdoers responsible,” he says.

More aggressive pursuit on the basis of negligence may give the SEC a better chance at investigating companies and individuals involved in the financial crisis and the meltdown of mortgage-backed securities, where charges of fraud have been hard to pin down and where the Commission has faced criticism for not doing enough to pursue wrongdoing.


Gorman

Allegations of negligence in SEC enforcement actions are not new; they date back to the 1970s when the Second Circuit Court of Appeals incorporated the negligence approach when interpreting cases brought by the Commission. But there may be an increase in the willingness to pursue cases against executives who shirked their oversight duties, say corporate lawyers. “I see that as the SEC trying to expand their duty of monitor,” says Thomas Gorman, former SEC enforcement division staff member and current partner at law firm Dorsey & Whitney.

For example, in a recent case involving executives of San Francisco-based United Commercial Bank, the SEC charged three of its former executives with fraud, for misleading investors about mounting loan losses during the financial crisis in 2008, and a fourth for negligence. The SEC alleged that the bank's former CEO, Thomas Wu, and two others concealed losses on loans and other assets from the bank's auditors. The bank's collapse was one of the 10 largest bank failures

of the financial crisis, and it resulted in a loss of $2.5 billion to the Federal Deposit Insurance Corp's insurance fund. However, the Commission only alleged the bank's former chief financial officer, Craig On, acted negligently in the case by misleading the external auditors and aiding the filing of false financial statements.

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McGrath

According to William McGrath, a partner at law firm Porter Wright, the United Commercial Bank case is a good example of the SEC's willingness to differentiate on different standards to make it easier to win cases. “There are a lot of people involved in the preparation of the bank's financial statement. Wu directed the underlings to conceal the losses, showing intent which resulted in fraud charges, while all the former chief financial officer did was sign the 10-K filing without checking the items. That constitutes negligence,” he says.

Limited Resources


Robertson

“The SEC's focus in using the negligence clause shows more of an attitude shift to tell the public that ‘yes, we cannot pursue all cases using costly methods, but we have to start somewhere,’” says Christopher Robertson, a partner at law firm Seyfarth Shaw. The SEC has limited resources that prohibit it from pursuing all cases on charges of fraud, he adds, since the cases are harder to prove and typically go on longer. Pursuing a case through negligence eliminates the need to prove intent.

DETAILS ON UCB CASE

Below is an excerpt from the SEC's release concerning the charges filed against UCB executives for hiding millions of dollars in losses during the 2008 financial crisis.

The Securities and Exchange Commission today charged former bank executives with misleading investors about mounting loan losses at San Francisco-based United Commercial Bank during the height of the financial crisis in 2008 and 2009.

The SEC alleges that the bank's former chief executive officer Thomas Wu, chief operating officer Ebrahim Shabudin, and senior officer Thomas Yu concealed losses on loans and other assets from the bank's auditors, causing the bank's public holding company UCBH Holdings Inc. to understate 2008 operating losses by at least $65 million (approximately 50 percent). A few months later, continued declines in the value of the bank's loans led the bank to fail, and the California Department of Financial Institutions closed the bank and appointed the Federal Deposit Insurance Corporation as receiver. United Commercial Bank was one of the 10 largest bank failures of the recent financial crisis, causing a loss of $2.5 billion to the FDIC's insurance fund.

“Today's charges reflect an all too familiar pattern—corporate executives once seen as rising stars embrace deception to avoid losses and conceal negative news, with investors and the FDIC insurance fund left to pick up the pieces,” said Robert Khuzami, director of the SEC's Division of Enforcement. “But accountability for these executives begins today.”

Marc Fagel, director of the SEC's San Francisco Regional Office, added, “This investigation shows how federal regulators can work together to ferret out fraud by the guardians of financial institutions entrusted to deal honestly with public investors.”

According to the SEC's complaint filed in federal court in San Francisco, UCBH and its subsidiary United Commercial Bank grew rapidly, doubling in size after an initial public offering in 1998. It was the first U.S. bank to acquire a bank in the People's Republic of China, and Wu was considered a rising star in the banking industry. By 2009, however, Wu found himself at the helm of a bank on the brink of failure.

The SEC alleges that Wu, Shabudin, and Yu deliberately delayed the proper recording of loan losses, and each committed securities fraud by making false and misleading statements to investors and UCBH's independent auditors. During December 2008 and the first three months of 2009 as the company prepared its 2008 financial statements, Wu, Shabudin, and Yu were aware of significant losses on several large loans. Among other things, these executives allegedly learned about dramatically reduced property appraisals and worthless collateral securing the loans, yet they repeatedly hid this information from UCBH's auditors and investors.

The SEC's complaint also alleges that the bank's former Chief Financial Officer Craig On acted negligently by misleading the company's outside auditors and aiding the filing of false financial statements. On agreed to settle the SEC charges without admitting or denying the allegations. He will be permanently enjoined from violating certain antifraud, reporting, record-keeping, and internal controls provisions of the federal securities laws and will pay a $150,000 penalty. On also consented to an administrative order suspending him from appearing or practicing before the SEC as an accountant, with a right to apply for reinstatement after five years.

The litigation against the other defendants is ongoing.

Source: SEC Enforcement Case Release: United Commercial Bank.

In fraud cases, the SEC has to ensure that it has enough facts to prove intent to commit wrongdoing, resulting in harm or loss to other individuals. It can seek disgorgement plus a penalty of 2 times that amount from offenders. Defendants in negligence cases are held liable for failing to live up to their duty of care. The SEC may be more willing to settle for a smaller financial penalty in negligence cases. Meanwhile, recklessness involves deliberate disregard of facts or consequences, a higher legal standard than negligence. The SEC only has the authority to pursue civil cases; criminal cases involving fraud are referred to the Department of Justice or the U.S. Attorney's Office.


Schmeltz

By adopting the negligence approach, the SEC would be raising the bar for all corporate gatekeepers including board members, chief executives, accountants, and others in charge of financial reporting to perform their fiduciary duties with a higher degree of care, says Vincent Schmeltz, a partner at law firm Barnes & Thornburg. “What the SEC is saying to companies is that we are looking for accuracy in your financial statement reporting and we can hold you accountable for negligence,” he says.

Enforcement in Action

Proving intentional wrongdoing in a fraud case can be difficult, particularly when the allegation involves complex financial structured products, says Gorman. He said there are multiple people involved in a single transaction, making it difficult to pinpoint exactly who deliberately committed the fraud. In some cases, the Commission may be forced to lower the charges to negligence to win a settlement. For example, in *SEC v. Citigroup*, former Chief Financial Officer Gary Crittenden had agreed to pay $100,000, and, Arthur Tildesley Jr., former head of investor relations, agreed to pay $80,000 to settle the case. U.S. District Judge Ellen Segal Huvelle, however, refused to accept the settlement. The SEC's lawsuit had alleged that the duo's misconduct resulted in misleading statements about Citigroup's exposure to sub-prime mortgage losses. The SEC reduced the charge to negligence in order to win the court's approval of the settlement. “The complaint written by the SEC in the case reads like intentional conduct to defraud, but charges brought to them are on negligence,” says Gorman.

According to Robertson, the only reason the SEC settled the Citigroup case on negligence is because it did not have enough evidence to make a fraud claim stick. “It takes a lot of details to prove fraud. The SEC must be able to provide e-mails and text messages and other detailed evidence to make it into a fraud case,” he says. “They really do not like to lose.” In cases where detailed evidence is unavailable to prove fraud, the Commission may be increasingly willing to settle for the lesser charge of negligence, he says.

Schmeltz says such recent cases should give corporations one more reason to pay closer attention to details when reporting to the SEC. “Gather the correct information, check on any possible discrepancies, and get a second opinion if needed,” he says. And companies should carefully document the processes for accurate financial reporting. “That is what the SEC expects,” he says.