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OUTSIDE DIRECTORS FAIL TO HEED RED FLAGS AND WIND UP IN SEC HURRICANE

The SEC recently sued three former outside directors of DHB Industries, alleging that the three were "willfully blind" to the company's fraudulent accounting practices.[1] The SEC alleges the defendants were faced with numerous hurricane warnings—not just a red flag or two—and proceeded nonetheless to allow management to continue a fraud. It follows closely on the heels of another SEC action against an outside director of InfoGroup, filed in April 2010.[2] The SEC also sued two former outside directors of Chancellor Corporation in 2003.[3] Taken together, these cases illustrate the SEC's increasing willingness to target outside directors who do not adequately discharge their duties as directors.

Since the mid-1990s, the SEC has consistently communicated its view that corporate directors have an "affirmative responsibility to exercise their authority through the disclosure process."[4] The SEC's then-director of the Division of Enforcement warned directors of public companies in 2008 that they "are potentially liable whenever a company makes a materially misleading public statement or omission."[5] Despite these statements, the SEC has rarely sued outside directors.

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1 The complaint was filed February 28, 2011 in the S.D. Fla. and is *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-52-directors.pdf.

2 Complaint, *SEC v. Raval*, 8:10-cv-00101 (D. Neb. Mar. 15, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21451-raval.pdf. The case was quickly settled and resulted in Raval agreeing to pay a $50,000 civil penalty.

3 Complaint, *SEC v. Chancellor Corporation*, 03-cv-10762, (D. Mass. Apr. 24, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm.

4 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Release No. 39157 (Sept. 30, 1997).

5 SEC Director, Division of Enforcement, *Keeping up with the Smartest Guys in the Room: Raising the Bar for Corporate Boards* (May 12, 2008), *available at* http://sec.gov/news/speech/2008/spch051208lct.htm.

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Consequently, many took notice in 2003 when the SEC brought an enforcement action against two former outside directors of Chancellor Corporation. More recently, in April 2010, the SEC brought charges against Vasant Raval, a former director of InfoGroup.[6] The SEC's recent action against DHB's outside directors should serve as another reminder that outside directors must diligently discharge their disclosure oversight obligations.

The SEC's latest action stems from DHB's accounting restatement in 2006 that erased three years of reported profits. According to the Complaint, outside directors Jerome Crantz, Cary Chasin, and Gary Nadelman, who comprised the company's Audit and Compensation Committees, "wholly failed to carry out their duties as 'independent' directors and Audit and Compensation Committee members and instead were willfully blind to numerous red flags signaling accounting fraud, reporting violations, and misappropriation at DHB."[7] Previously, the SEC sued DHB's CEO David Brooks, its CFO Dawn Schlegel, and its COO Sandra Hatfield, and all three were the subject of federal criminal charges.[8]

Accounting misstatements at the company allegedly started in 2003 and were caused by weaknesses in the company's inventory processes. The deficient financials used unsubstantiated bills to price the company's "work in process" and "finished goods," causing an overvaluation of the company's inventory. The company also erroneously failed to account for excess and obsolete inventory and improperly expensed amounts from cost of goods sold as R&D. In the Fourth Quarter of 2004, this resulted in an inventory valuation of $9 million, or $7 million over the actual $2 million value. Eventually, the company's inventory was overvalued by $33 million. In March 2006, the company announced for the first time that its financial statements for the first three quarters of 2005 could not be relied on, and in late 2007, the company also announced a restatement of its financials for 2003 and 2004.

According to the SEC's Complaint, the three directors ignored numerous red flags regarding inventory control deficiencies. The company's auditor resigned in protest in 2003 and issued a material weakness letter to the Audit Committee. In 2004, the company's new auditor informed the Audit Committee of multiple internal control weaknesses. Later, the company's Controller identified many of the same concerns and indicated an intent to resign but was instead hastily fired by Brooks.

When DHB's new auditor refused to consent to filing of the company's 2004 Annual Report, the company forged the auditor's signature and filed the report. Shortly thereafter, the new auditor provided the company with a signed audit report but quickly issued a material weakness letter stating that the company's inventory valuation system was materially inadequate. In a highly unusual hurricane warning, the letter also mentioned the company's forgery and stated that the Audit Committee itself constituted a material weakness, saying that the "conduct of the Audit Committee did not demonstrate its understanding of its oversight role of the company's external financial reporting and internal control over its financial reporting processes."

In addition to inventory problems, the Complaint details Brooks' looting of the company. From 2003 to 2006, Brooks allegedly diverted $10 million from DHB through a fraudulent business arrangement with TAP, a business controlled by Brooks and his wife. The Complaint says that the outside directors "facilitated the fraud" by "ignoring red flags pointing to a fraudulent scheme." The directors allegedly were notified of the fraud when a union attempting to organize DHB's employees warned the company of its failure to disclose. The company proceeded to hire outside counsel to investigate the TAP transactions, but Brooks improperly controlled the flow of information to outside counsel, according to the SEC. After issuing an initial report, outside counsel

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6 For more information about the history of SEC enforcement actions against outside directors and the SEC's case against Raval, see our *Commentary* "SEC Targets Independent Director for Failing to Investigate CEO," April 2010, *available at* http://www.jonesday.com/sec_targets_independent/.

7 Specifically, the SEC alleges the three were primary violators of 10(b) and 14(a) of the Exchange Act and Exchange Act Rules 10b-5 and 14(a)(9) and aiders and abettors to DHB's violations of 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-11, and 13a-13. The complaint also alleges that one of the directors, Nadelman, violated Section 13(b)(5) of the Exchange Act and Exchange Act Rules 13b2-1 and 13b2-2.

8 The cases were docketed as *U.S. v. David H. Brooks & Sandra Hatfield*, No. 06-CR-550/Seybert (E.D.N.Y. 2006). Brooks and Hatfield were convicted in September 2010. Schlegel pled guilty to the charges pursuant to a plea agreement.

ultimately resigned from the engagement and called into question its earlier report in a letter to the Audit Committee.

The SEC devotes seven paragraphs in the Complaint to outlining the close personal and business relationships between Brooks and the outside directors. Among other things, the directors were Brooks' former neighbors, visited him often socially, and benefited from business directed to them by both DHB and Brooks. The three apparently used seats in the company's Madison Square Gardens skybox for the benefit of their outside businesses. The SEC also alleges that the directors intentionally hid the fact that the company improperly paid for prostitutes.

Old-time sailors will recall the coastal storm warning system of red flags that gave rise to the current use of the terminology. One red pennant indicated moderate breezes and a small craft warning. The coming of gale winds and rough seas was represented by two red pennants, and a storm warning by a single red flag. The hoisting of a red flag with a black square in the middle signaled the approach of a hurricane, the flag the SEC seemingly alleges the DHB directors ignored.

Accordingly, it is difficult to conclude that the SEC is actively targeting outside directors. However, the actions should give all independent directors reason to reevaluate how they identify and respond to red flags. When any flags are hoisted, directors should discharge their oversight obligations by carefully documenting their consideration of warning signs and consult with outside counsel when there is a need for a special committee or an internal investigation. Companies should carefully evaluate relationships between management and independent directors and ensure that the internal investigations and conflicts of interest policies are ready to handle modern corporate governance storms.

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