DELAY IN UP-THE-LADDER REPORTING LEADS SEC TO CHARGE GENERAL COUNSEL OF ESI WITH COMPLICITY IN COMPANY'S FILING OF MATERIALLY FALSE AND MISLEADING QUARTERLY REPORT

General counsel to pay $50,000 civil penalty under settlement agreement;

The SEC, on September 23, 2004, entered a cease-and-desist order against John E. Isselmann, Jr., the former general counsel of Electro Scientific Industries, Inc., (ESI), a company listed on NASDAQ, settling an administrative action in which the SEC charged that Isselmann was complicit in ESI's filing of a materially false and misleading financial quarterly report.

First "Up The Ladder Reporting" case brought against an attorney

One of the aspects of the Sarbanes-Oxley Act that generated great controversy was the "up-the-ladder reporting" requirements of Rule 205. Now, the SEC has brought its first up-the-ladder enforcement action, and, paradoxically it was not brought under Rule 205, because the conduct took place before the rule's implementation.

Isselmann's story is that of a general counsel who learned of an illegal act, failed to speak up at a time that would have prevented his company from violating Section 13(a) of the Exchange Act of 1934 and Rules 13a-13 and 12b-20, and six months later - too late - took action by reporting his concerns first to ESI's outside counsel, and then to the company's Audit Committee.

In August 2002, after learning of an accounting error that negatively impacted earnings, and under market pressure to report a profit for the quarter ended August 31, 2002, ESI's CFO and Controller decided to eliminate vested retirement and severance benefits in ESI's Asian offices. The purpose, the SEC alleged in the cease-and-desist order it entered against Isselmann (SEC Admin. Proc. File No. 3-11678), was to reduce expenses and increase ESI's bottom line by $1 million, resulting in ESI's profits being increased by 28%. In a September meeting with ESI's Audit Committee and auditors, the CFO told the committee that the applicable Japanese laws did not require that ESI provide the benefits that had been eliminated and that the decision to eliminate the benefits had been approved by legal counsel.

According to the SEC's complaint filed against Isselmann in federal district court in Oregon, Isselmann, who was not involved, present nor consulted when the accounting decision was made, was told shortly after the Audit Committee meeting that the CFO had informed ESI's auditors that the elimination had been approved by legal counsel. Additionally, he was copied on a report ESI provided the auditors which stated that ESI had "no legal obligation" to pay the benefits. Isselmann, however, took no action to correct the auditors' and committee's mistaken impression that he or Japanese counsel had reviewed and approved of the decision.

Shortly thereafter, Isselmann learned from ESI's counsel in Japan that ESI could not legally eliminate the benefits without first obtaining the consent of ESI's Japanese employees in Japan. Isselmann, however, did not speak directly with the auditors nor disclose this information to the Audit Committee. Rather, at a meeting of ESI's Disclosure Committee, he attempted to raise the issue but was silenced by the CFO and made no further efforts. Moreover, before ESI filed the Form 10-Q, a member of the Audit Committee asked Isselmann about the elimination of the benefits and the $1 million accounting entry, but Isselmann concealed the information he had learned from ESI's Japanese legal counsel. Isselmann,

however, did provide the CFO with the written legal advice he had received. The CFO nonetheless signed the Form 10-Q with the inaccurate information, and ESI filed the report on October 15, 2002.

In December, the CFO was promoted to CEO of ESI. In March of 2003, according to the SEC's Complaint filed with the federal district court of Oregon, Isselmann learned that an accounting error had led the (now former) CFO and Controller to eliminate the Asian employee benefits. He finally took action and alerted ESI's outside counsel, and then the Audit Committee, of his suspicions of the former CFO and Controller's misconduct. The Audit Committee commenced an internal investigation, which led it to reverse the previously recorded accounting transaction, restore the $1 million liability for the payment of Asian retirement and severance benefits and restate ESI's financial results.

In a press release issued on September 24, 2004 (Litigation Release No. 18896), the SEC announced that "it would not bring any enforcement action against ESI because of its swift, extensive, and extraordinary cooperation in the Commission's investigation. This cooperation included reporting its discovery of possible misconduct to the Commission immediately upon the Audit Committee's learning of it, conducting a thorough and independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating responsible wrongdoers, facilitating the Commission staff's investigation overseas, and implementing remedial actions designed to prevent the recurrence of fraudulent conduct."

That same day, the SEC filed separate complaints in a federal district court in Portland, Oregon, against Isselmann and the former CFO and Controller. The complaint against Isselmann charged that he violated Rule 13b2-2 (relating to representations and conduct in connection with the preparation of required reports and documents) by omitting to disclose material facts to ESI's independent auditors.

The complaint against the former CFO and Controller alleged that they violated or aided and abetted violations of the antifraud, internal controls and books-and-records provisions of the federal securities laws. The complaint sought an injunction, civil monetary penalties, disgorgement and an order barring the two from serving as an officer or director of a public company. In a separate action, the Portland, Oregon U.S. Attorney's office filed criminal charges against the two former officers.

Although the SEC's charge against Isselmann did not include violations of the new Sarbanes-Oxley rules, his case demonstrates that the SEC will likely engage in a critical review of the actions of general counsels and other "gatekeepers". New Rule 205.3(b)(2) imposes a duty on a company's chief legal officer to conduct an internal inquiry and investigate evidence of a material violation. Unless the chief legal officer reasonably believes that no material violation has occurred, is ongoing or is about to occur, he must take all reasonable measures to cause the company to adopt an appropriate response. A failure to promptly follow the up-the-ladder reporting and investigative requirements could subject a general counsel to the civil penalties and remedies for a violation of the federal securities laws.

Should you have any questions about the matters addressed in this issue of the Corporate Governance Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis partner you normally contact.

Stephen Fraidin
sfraidin@kirkland.com
(212) 446-4840

Laura B. Mutterperl
lmutterperl@kirkland.com
(212) 446-4974

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