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## SEC Enforcement: Spotlighting Outside Directors

In an action filed this week, the Securities and Exchange Commission (SEC) charged three outside directors of a public company with securities fraud based on their alleged failures to fulfill their roles and responsibilities as Board members. The SEC contends that by their actions and inaction, the outside directors – Jerome Krantz, Cary Chasin, and Gary Nadelman – facilitated and assisted in a massive accounting fraud at DHB Industries, Inc., a body armor supply company. The SEC identified the directors' failures as: failing to maintain independence and skepticism; neglecting to ensure adequate financial controls and addressing weaknesses; ignoring concerns and complaints brought to their attention; and allowing management to control investigations of potential problems. This action comes less than a year after the SEC charged an outside director and audit committee chairman of infoUSA Inc., Vasant Raval, for failing to respond to red flags about that company's financials.

These cases signal the SEC's emphasis on the important role of outside directors and a new willingness to prosecute those directors who disregard or neglect their duties. Although the facts set forth in the complaint suggest a pattern of egregious inattention and recklessness not typical in the boardroom, the allegations against the DHB directors can provide lessons to all outside directors of public companies and those corporate executives working with them.

### A. Background

The SEC, in separate complaints, charged DHB and several of its officers with accounting, financial and disclosure fraud in which executives misappropriated millions of dollars of company funds, manipulated the company's financial results, and filed false public statements. The SEC's complaint against Krantz, Chasin, and Nadelman, DHB's three outside directors, portrays a complete dereliction of duty on the part of the three directors and forms the basis for a charge that they facilitated and furthered the fraud. According to the complaint, each of the three defendants had longtime personal and business relationships with DHB's CEO before joining DHB's Board. Further, the three directors allegedly received lucrative bonuses and perks for serving on the Board. Consequently, the complaint alleges, the three directors were willing to turn a blind eye to known improper use of the company's funds and to ignore other suggestions of improper accounting and financial misconduct.

In addition to their close relationship with the CEO, Krantz, Chasin, and Nadelman made little effort, according to the complaint, to discharge their responsibilities as members of DHB's audit committee. The three directors allegedly ignored numerous red flags involving DHB's lack of internal controls, fraudulent transactions, inventory overvaluation, and undisclosed payments to the CEO. Over several years, outside auditors or DHB employees identified flaws within the company, but the three directors allegedly never took any remedial action to address the problems. Even as outside auditors and legal counsel resigned over the company's accounting irregularities, Krantz, Chasin, and Nadelman remained uninterested in the company's problems. Meanwhile, under the three directors' watch, the SEC alleges that DHB's chief executive spent millions of the company's dollars on luxury cars, prostitutes, racehorses, art, and other extravagant non-business expenses.

## B. Four Lessons in Corporate Oversight

As a general matter, a diligent director who tends to his responsibilities is unlikely to find himself in the same position as the three DHB directors. However, there are four key lessons from the DHB complaint that all outside directors should remember.

### *1. Conflicts of interest can undermine a director's actual or perceived independence.*

The purpose of outside directors is to provide a counterbalance on the Board to the corporate executives, whose perspective may be biased as a result of their insider status. As such, it is crucial that outside directors be, and are perceived to be, independent. The example of the three DHB directors shows the potential dangers for directors whose objectivity is questionable.

As alleged by the SEC, before joining DHB's Board, Krantz, Chasin, and Nadelman all shared decades-long personal relationships with the CEO. Even after joining the Board, Krantz continued to serve as the insurance agent for DHB, two of its subsidiaries, and members of the CEO's family. Chasin and Nadelman each had prior business relationships with the CEO. Each of the three directors received lavish perks from the CEO, allegedly in exchange for their cooperation on the Board. Their close relationship with the CEO and their financial interest in remaining in his favor only complicates their defense.

In deciding whether to accept a position as an outside director, one should not ask whether he or she can maintain independent business judgment – that should be a given. Rather, the focus must be on how shareholders and regulators will perceive one's impartiality. If the company ever faces a fraud investigation, the SEC will scrutinize the Board's decisions. An outside director with personal or financial conflicts of interest is more susceptible to charges of enabling or facilitating the company's fraud.

### *2. Outside directors must respond, without exception, to red flags.*

Although receiving a position on a company's Board is an honor, one should always remember that it carries certain responsibilities. A failure to discharge these responsibilities properly may result in an SEC investigation and legal liability. Before choosing to serve as an outside director, one should make sure that he or she can devote the proper amount of attention to the position.

Some facts from the SEC's complaint in the DHB case illustrate this proposition. After one outside auditing firm resigned, the subsequent auditors recommended that the company hire a new controller to resolve issues with the company's accounting inventory tracking system. The three directors voted with the Board to hire a new controller – but allegedly took no further action to address the issue. When the new controller expressed concerns about DHB's inventory to the outside auditors, the CEO fired him. The SEC alleges that, even as the outside auditors expressed concerns to the audit committee about the controller's findings, the three directors neglected to do anything.

Generally, few outside directors will disregard repeated warning signs to the same extent alleged against the three DHB directors. However, outside directors should remember to be proactive in addressing red flags raised by the company's employees and auditors. It is not always enough for an outside director to hire a new controller, or any employee, and assume the job is finished. The outside director must take appropriate follow-up actions to ensure that the company is resolving any potential problems. If the company executives refuse to cooperate, the outside

director should consider whether to resign from the Board. An outside director who silently shakes his head in disapproval could face the prospect of explaining to the SEC why he or she failed to dissuade the company from engaging in fraudulent conduct.

3. *Any investigations by outside directors must be independent.*

This principle is simply the logical extension of the two previous lessons, but it is reinforced by the DHB example. Given that the outside directors are supposed to serve as a check on the rest of the Board, the outside directors cannot fulfill their responsibilities if they rely solely on corporate insiders to determine whether the company's conduct is acceptable.

As the allegations of fraud began to surround DHB, the CEO hired an outside law firm to investigate some of the company's questionable transactions. Although this step was a positive development at the time, the CEO controlled both the scope of the inquiry and the access of the law firm to the company's documents. Eventually, the law firm resigned its representation after it discovered undisclosed information that called its previous opinion into doubt. Afterwards, the CEO refused to agree to any investigations that he could not personally oversee. According to the SEC's complaint, the three directors did not object or follow up on these issues.

Again, while the facts of the case are fairly stark, the case provides guidance for outside directors who are looking into a possible violation. It is rarely acceptable for a corporate insider such as the CEO or General Counsel to conduct the investigation, even if the insider agrees to hire an outside firm. Rather, the outside directors should either conduct the investigation themselves or hire and direct an outside firm. The DHB example shows how a flawed investigation can serve as evidence that outside directors neglected their duties.

4. *Outside directors must not disregard any information, even if they do not value the source.*

When an outside auditing firm resigns due to a company's accounting irregularities, all reasonable directors would consider this event to raise a major red flag. However, if a union that is trying to organize the company's employees accuses the company of possible disclosure violations, should that information receive the same scrutiny from the Board?

The complaint against the three DHB directors describes this exact situation. Even after the union sent a letter to the SEC describing the alleged disclosure violations, the outside directors did not inquire into or investigate why various transactions were omitted from the company's filings. Unfortunately for DHB and the three directors, the union's allegations proved to be substantive.

It is human nature to dismiss or undervalue accusations from an adversarial party or a less than stellar employee. Certainly not every allegation of fraud or misrepresentation will turn out to be true. However, outside directors must remain diligent about inquiring into possible problems within the company. Not only do those inquiries fulfill the outside directors' duties, but in the event of an actual violation, the outside directors can point to their investigations as evidence that they were committed to the responsibilities of their position.

C. Conclusion

Outside directors should take solace in the fact that the SEC complaint alleges a long pattern of egregious misconduct by the three DHB directors. The defendants' behavior, as alleged, falls well outside the norms of

corporate oversight and governance. However, the four lessons noted above, as demonstrated by the example of the DHB directors, will assist outside directors in fulfilling their responsibilities towards the company and its shareholders.

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