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Securities Fraud Litigation: The Avoidance of Rubber-Stamping and Proper Disclosure

A motion to dismiss an SEC enforcement action was denied recently by the District Court of Nebraska in *SEC v. Das*. The SEC's eight-count complaint alleges fraud and other misconduct by two former chief financial officers ("CFOs") of InfoUSA Inc. (now InfoGroup Inc.; the "Company") over a four-year period. The CFOs allegedly prepared SEC filings and proxy statements with material understatements and failed to adequately disclose that the former CEO of the Company had received company funds to pay for personal transactions and related-party transactions. The former CEO allegedly received approximately \$9.5 million in unauthorized and undisclosed compensation, and two companies he controlled engaged in about \$9.3 million in undisclosed related-party transactions with the Company. The complaint alleges that the CFOs knew, or were reckless in not knowing, that the Company's filings materially understated the CEO's compensation and failed to properly disclose related party transactions.

Item 402 - Undisclosed Perquisites

The former CEO's undisclosed perquisites allegedly included reimbursements for personal use of jets, yachts, cars, credit cards, life insurance policies, homes, and country club memberships. The former CEO allegedly used corporate funds for personal jet travel and hotel accommodations, including on a South African honeymoon and on trips to France and Las Vegas. Form 10-K requires companies to disclose information on executive compensation according to Item 402 of Regulation S-K. Item 402 requires disclosure of compensation awarded to, earned by or paid to certain executives, including the CEO. Item 402 also requires disclosure of perquisites and other personal benefits paid to executives.

Whether the expense reimbursements were compensation under Item 402 of Regulation S-K was decided by the court to be a fact-specific inquiry. The court noted that almost all cases interpreting Item 402 involve money knowingly given to executives by a company; because the SEC alleged that the CFOs knowingly caused the Company to pay for the former CEO's private expenses, the complaint survived dismissal.

The SEC alleged that the CFOs essentially "rubber-stamped" the CEO's reimbursement requests. The Company's internal policies and controls required documentation sufficient to demonstrate that an expense was a valid business expense and not employee compensation. The complaint alleged that the CFOs approved the requests despite the lack of sufficient documentation or explanation and approved some reimbursement requests without any business justification. Several employees of the Company had also voiced concern over the reimbursements. The SEC alleged that the improperly approved requests were compensation under Item 402 and thus should have been disclosed properly in a Form 10-K.

Item 404 - Related-Party Transactions

The SEC complaint also made claims that several of the Company's Forms 10-K and proxy statements had materially understated, mischaracterized, or omitted significant related-party transactions involving two companies owned by the former CEO. Intended to highlight any potential conflicts of interest, Form 10-K requires public companies to furnish information regarding certain relationships and related transactions in accordance with Item 404 of Regulation S-K. The court found that the SEC's complaint sufficiently alleged that the Company entered into transactions with the companies controlled by the CEO and should have disclosed the same under Item 404.

The amounts paid to the two related companies allegedly were understated by approximately \$5.4 million. The Forms 10-K did reflect the Company's payment for the use of an aircraft owned by one of the companies, a jet-leasing company;

however, the complaint alleged such to be materially misleading because the Company's payments involved more than the use of an aircraft, including other undisclosed transactions. Both CFOs allegedly approved payments on behalf of one of the companies made directly to a jet leasing company, instead of paying the company directly, in order to reduce the amount of related-party payments that would need to be disclosed. The CFOs also allegedly structured purchases of two jet interests and four cars from the CEO's entities in a way that concealed the transactions from investors, including the use of a straw man. The Company had allegedly paid the two companies for the former CEO's homes, yacht, and cars and provided rent-free office space to the entities in buildings owned by the Company.

Conclusion

As the litigation against the CFOs continues, the former CEO has settled with the SEC in a related proceeding, consenting to the entry of a permanent injunction prohibiting future violations of antifraud, proxy, and reporting provisions. He agreed to an order directing his disgorgement of roughly \$4 million along with prejudgment interest and a civil penalty of approximately \$2.24 million. The order bars him from serving as an officer or director and places restrictions on his voting rights in Company shares.

As the fiscal year closes for many companies, it is important for CFOs to be aware and objective, avoiding "rubber-stamping" of reimbursement requests without adequate and detailed support, and bearing in mind the consequences of looking the other way.