

Chapter 6
Keeping Energy Companies Out of Trouble—Dealing with the SEC
Ethical Dilemmas, and Avoiding Criminal Liability

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§ 6.01 Introduction.*

In today's enforcement climate, companies and their counsel must be prepared to address any investigation instigated by a governmental agency. These investigations range from "wildcatting"¹ to parallel proceedings initiated by different governmental

*The authors would like to thank Shelia Haddock and Sarah Tubbs for their valuable contributions to this paper.

¹ The SEC enforcement staff refers to its industry and market-wide investigation approaches as wildcatting. Wildcatting involves examinations of a cross-section of companies to learn whether a particular practice is widespread and of companies that are affiliated by industry with a company that has come under the SEC's scrutiny. Inside

agencies. The way in which a company responds to these investigations is a significant factor in determining how a governmental agency concludes its investigation. For example, Lucent Technologies Inc. recently agreed to pay the United States Securities and Exchange Commission (“SEC”) \$25 million to settle an enforcement proceeding. The instructive aspect of Lucent’s settlement is that the entire \$25 million payment was a penalty against Lucent for non-cooperation during the investigation. In responding to the government’s ever-broadening reach, companies must understand their legal obligations and governmental expectations.

§ 6.02 SEC Civil Enforcement Proceedings Frequently Evolve Into Criminal Prosecutions

Along with the SEC, the Department of Justice and the State Attorneys General are increasingly focusing their attention and resources on investigating and prosecuting business entities and executives whose practices run afoul of today’s stringent legal requirements. This increased interest by the various enforcement agencies has resulted in a regulatory climate rife with “parallel proceedings” that present new challenges to the companies struggling to manage inquiries from multiple sources.

Parallel proceedings occur when a single common set of facts give rise to simultaneous or successive investigation or litigation of separate criminal, civil, administrative or private actions by different agencies, branches of government, or private litigants. That is, a criminal grand jury investigation or prosecution may occur

Track with Broc: Bill Baker on the SEC staff “Wildcatting” for Fraud (6/3/04),

TheCorporateCounsel.net @

http://www.thecorporatecounsel.net/member/InsideTrack/06_03_04_Baker.htm.

along side a civil or administrative action by the SEC, an administrative proceeding brought by NASD Regulation, Inc., the New York Stock Exchange or other self-regulatory organization or private litigation, *i.e.*, a civil class action or bankruptcy proceeding. Such parallel proceedings present unique challenges to the target corporation along with both potential difficulties and potential benefits for both sides.

The benefits realized by the government and regulatory agencies from parallel proceedings are obvious. An enforcement action by securities regulators brings an additional range of sanctions including injunctions, cease and desist orders, officer and director bars, trading halts, asset freezes, and the appointment of a receiver or trustee who can assist the criminal investigation by replacing current management, stopping the fraud from continuing, seeking out and marshaling the assets of the defendant and the estate, investigating and quantifying the fraud, and making documents and employee witnesses available to the criminal authorities. In parallel proceedings, civil and criminal authorities share information, enhancing the efficient use of enforcement resources. Moreover, criminal prosecutors benefit from the technical and market expertise of the securities regulators while the regulators stand to benefit from utilizing a criminal conviction to dispose of the civil case. By coordinating criminal indictments and civil enforcement actions, the SEC is able to use administrative investigation orders to gather documents and take depositions in aid of the DOJ's investigation. The SEC may demand that materials produced pursuant to a grand jury subpoena be duplicated to avoid Federal Rule of Criminal Procedure 6(e) claims.

The target corporation may reap some benefit from parallel proceedings as well, albeit undeniably not as great as those enjoyed by the government. For example, a

potential criminal defendant may use a favorable result in the civil case to convince prosecutors not to file charges, or as support for a motion to dismiss those charges after they are brought. In addition, because the Federal Rules of Civil Procedure permit substantially more pretrial discovery than their criminal counterparts, a potential defendant may obtain information in the civil case that it would not be entitled to seek in the criminal proceeding simply by serving requests for admissions, broad document requests and interrogatories requesting the identity of all persons with knowledge of the allegations in the complaint and deposition transcripts of all witnesses, including those cooperating with the investigation who may have been ill-prepared before testifying under oath.

Despite these potential benefits, it is more likely that parallel proceedings project problems for target corporations. An individual defendant subjected to both civil and criminal prosecution is confronted with a difficult dilemma: Respond to civil discovery requests by giving a deposition and/or answering interrogatories versus invoke his Fifth Amendment right to remain silent. Both options present pitfalls.

If the defendant decides to respond to discovery requests in lieu of asserting his Fifth Amendment right against self-incrimination, any admissions may be used against him in a subsequent criminal trial.² If, however, he avoids civil discovery by invoking his Fifth Amendment right, he retains his ability to assert the privilege in the criminal proceeding and no adverse inference may be drawn against him—in the criminal proceeding. He will suffer the adverse inference in the civil proceeding that the

² See FED. R. EVID. 801(d)(2).

information withheld would have been unfavorable to him.³ This adverse inference places defense counsel in an untenable position when attempting to persuade the SEC to forego enforcement action and ultimately when defending his client before the fact finder in a civil or administrative proceeding.

The other side of this Janus-faced coin is no more appealing. If the defendant chooses to testify or otherwise respond to discovery in the civil case, he risks bolstering the criminal case against him by revealing his defenses before trial, disclosing unknown evidence that will lead prosecutors to further harmful information or prematurely “locking himself in” under oath to an underdeveloped version of events. The latter possibility presents even greater danger: he may inadvertently set himself up for a charge of perjury or obstruction of justice or at the least provide the prosecutor with an argument that his false statement was evidence of consciousness of guilt. More practical concerns include the costs of defending actions in the civil and criminal arenas as well as the danger that statements made in the course of settlement negotiations in the civil case may find their way into the criminal case. In short, the defendant facing both criminal prosecution and civil proceedings is confronted with a classic Hobson’s Choice: assert the Fifth Amendment privilege and lose the civil case or waive the privilege and lose the criminal case.

Recognizing the benefits, the SEC and the DOJ are more often coordinating investigative efforts. The agencies conduct joint witness interviews and make joint document production demands. Investigations are performed more quickly and companies and individuals are given less time to respond to more massive subpoenas for

³ See *Baxter v. Palmigiano*, 425 U.S. 308 (1976).

documents. The SEC is issuing Wells notices (wherein it informs a company or individual that the staff of the SEC intends to recommend an enforcement action against it) earlier in the proceedings than it has in the past. Stephen Cutler, director of the SEC enforcement division, acknowledges that the commission is “taking more risks in what it is we are investigating,” and is committed to “more creative approaches to uncover key problem areas” in an effort to be more proactive.⁴ And, taking a cue from its DOJ counterparts and classic criminal prosecution tactics, the SEC is pursuing “pre-Wells” agreements and granting “cooperator” status to subjects of its investigations with the terms of cease and desist orders negotiable depending on the value of the cooperation.

State attorneys general are likewise increasingly vigilant and assertive in launching their own investigations. While historically the SEC has led securities enforcement, recent actions spearheaded by state attorneys general reflect a new era in corporate monitoring. The states sometimes seem to be working in conjunction with federal regulations and sometimes seem to be engaged in competition with them. In either event, companies must be prepared to present a unified response and to artfully manage these related but different actions.

§ 6.03 Sarbanes Oxley Criminalizes New Areas and Provides Enhanced Penalties

While the SEC already has a plethora of tools at its disposal, Sarbanes Oxley provides the SEC significant new enforcement tools, including new causes of action and new remedies. As a result, the SEC is undertaking more investigations, conducting them

⁴*SEC Seeks to Uncover Fraud Problems Early*, WALL ST. J., March 8, 2004, at C3.

more thoroughly and efficiently, and making increasingly more aggressive settlement demands.

[1] *False Certification*

The Act established new causes of action against senior executives of a public company. The CEO and CFO must certify under oath both the accuracy and the completeness of the issuer's financial results.⁵ These certifications include specific representations regarding both the internal controls and the disclosure controls of the company.⁶ Internal controls are those processes and procedures designed to ensure that a company's accounting and financial reporting is accurate and compliant with GAAP.⁷ Disclosure controls are those processes and procedures for reporting certain "material" transactions publicly when the failure to do so might later be deemed misleading even if accounted for correctly.⁸

Section 906 of Sarbanes Oxley requires CEOs and CFOs to certify that each periodic report "fairly represents, in all material respects, the financial condition and results of operations of the issuer."⁹ The section provides for criminal penalties ranging from up to \$1million in fines and up to 10 years in prison for filing a 906 Certificate "knowing" that the subject report does not comport with all the requirements of section 906, to up to \$5 million and up to 20 years if the officer "willfully certifies" a report

⁵ See 15 U.S.C. § 7241 (Supp. 2004); 18 U.S.C. § 1350 (Supp. 2004).

⁶ See 15 U.S.C. § 7241 (Supp. 2004)

⁷ See 15 U.S.C. § 78m (1997 & Supp. 2004).

⁸ See 17 C.F.R. § 240.13a-14 (2003); 17 C.F.R. § 240.15d-14 (2003).

⁹ 18 U.S.C. § 1350 (Supp. 2004).

“knowing” that the subject report does not comport with all the requirements of the section.¹⁰

Sarbanes Oxley section 302 now requires the CEO and CFO of U.S. and foreign reporting companies to certify, in connection with each quarterly or annual filing, that (1) the signing officer has reviewed the report; (2) based on the officer’s knowledge, the report does not contain any untrue statements of material fact or omit to state a material fact necessary in order to make the statements made not misleading; (3) based on the officer’s knowledge, the financial statements and other financial information included in the report fairly represent in all material respects the financial condition and the results of the operations of the issuer; (4) the signing officers are responsible for establishing and maintaining internal controls and designed them to ensure discovery of material information; (5) the signing officers have evaluated the internal controls within the 90 days prior to the report and have presented their conclusions about the effectiveness of the internal controls in the report; (6) the signing officers have disclosed to the company’s auditors and audit committee all significant deficiencies in the internal control system and any fraud (whether material) by management or other employees with a significant role in the internal controls; and (7) the signing officers have indicated in the

¹⁰ 18 U.S.C. § 1350 (c) (Supp. 2004). In March 2003, financial officers of HealthSouth were charged with, and plead guilty to, criminal charges for filing false certifications of financial information. *See* Department of Justice Press Release, *available at* http://www.usdoj.gov/opa/pr/2003/March/03_crm_180.htm.

report whether there were significant changes in the internal controls or other factors that could significantly affect the controls since the date of their evaluation.¹¹

[2] *Securities Fraud*

Sarbanes Oxley invoked several changes strengthening the laws designed to prevent and punish fraud in the sale of securities. Section 807 of Sarbanes Oxley amends Title 18 of the United States Code by adding a new crime for securities fraud, which now provides:

§ 1348 Securities fraud

Whoever knowingly executes, or attempts to execute, a scheme or artifice---

(1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934(15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780(d)); or

(2) to obtain, by means of false or fraudulent pretenses, representations or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934(15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780(d)); shall be fined under this title, or imprisoned not more than 25 years or both.¹²

An attempt or conspiracy to commit an act illegal under this section is subject to the same penalties.

In addition to imposing stiff penalties for the acts described in 807, Sarbanes Oxley declares in section 803 that debts incurred in violations of securities fraud laws or

¹¹ 15 U.S.C. § 7241 (Supp. 2004).

¹² 18 U.S.C. § 1348.

related to common law fraud in connection with the purchase or sale of any security are not dischargeable in bankruptcy and in section 804 extends the statute of limitations for securities fraud to the later of five years or two years from the time the fraud is discovered.¹³

The SEC is empowered to seek disgorgement of bonuses and other incentive based compensation, as well as equity-based compensation such as profits from stock sales made by the CFO or CEO if there has been a restatement due to an issuer's material non-compliance with any financial reporting requirement that resulted from misconduct under section 305.¹⁴ Further, under section 1103, the SEC now has the right to seek a temporary freeze of a company's intended "extraordinary" payment to an officer or director who is under investigation by the SEC.¹⁵

[3] *Maintaining Records*

Section 802 of Sarbanes Oxley creates a new statutory provision, 18 U.S.C. §1520 requiring any accountant who conducts an audit of an issuer of securities subject to Section 10A of the Securities Exchange Act of 1934 to maintain all audit or review work papers for at least five years from the end of the fiscal period in which the audit or review was conducted. The statute imposes a harsh penalty of 10 years imprisonment for "knowing" and "willful" violations of the retention requirement.

In addition, as required by section 802, the SEC on January 24, 2003 adopted Rule 2-06 detailing the requirement that accountants retain certain records relevant to an

¹³ 11 U.S.C. § 523(a) (1993 & Supp. 2004) (bankruptcy); 28 U.S.C. § 1658 (Supp. 2004)(limitations).

¹⁴ 15 U.S.C. § 78u(d) (1997 & Supp. 2004).

¹⁵ 15 U.S.C. § 780u-3(c) (1997 & Supp. 2004).

audit or review of an issuer's financial statements.¹⁶ The rule requires accountants to retain records for seven years relevant to the audit or review, including work papers and other documents that form the basis of the audit and review along with memoranda, correspondence, communications and other documents and electronic records that meet the following criteria: (1) the documents were created, sent or received in connection with the audit or review, and (2) the documents contain conclusions, opinions, analyses or financial data related to the audit or review.¹⁷ Relevant records should be retained whether they support the auditor's final conclusions or contain information or data relating to a significant matter that is inconsistent with the final conclusions.¹⁸ The records to be retained include, but are not limited to, those documenting consultations on, or resolutions of differences in, professional judgment.¹⁹

[4] *Obstruction of Justice*

The SEC also can now bring an action against an officer or director for "improper influence" on the conduct of an audit.²⁰ Likewise, Title VIII of Sarbanes Oxley significantly expands the reach of federal laws criminalizing the destruction of certain types of corporate communications and documents.²¹ A knowing violation renders the

¹⁶ See Final Rule: Retention of Records Relevant to Audits and Reviews, SEC Rel. Nos. 22-8180;34047421;IC-25911(January 24, 2003), <http://www.sec.gov/rules/final/33-8180.htm>., codified at 17 C.F.R. pt. 210 (2003).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See 15 U.S.C. § 7242 (Supp. 2004).

²¹ See 18 U.S.C. § 1519-1520 (Supp. 2004).

officer or director guilty of a crime, punishable by fines and jail time.²² Specifically, section 802 directs the SEC to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that issuers file with the SEC.²³ Sarbanes Oxley creates two new criminal statutes regarding document destruction – sections 1519 and 1520 of Chapter 73 of Title 18 of the United States Criminal Code – and expands the scope of 18 U.S.C. §1512.

Section 1519 provides in pertinent part:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years or both.

While at first blush the language of section 1519 seems to reach only obviously culpable conduct, a more careful analysis reveals that the section arguably significantly lowers the threshold for establishing criminal intent in document destruction cases. Prior criminal statutes required proof that a defendant who destroyed a document or record acted with “corrupt intent.” Now, a government prosecutor must establish only that an individual “knowingly” committed any act prohibited by section 1519 and the focus is on the potential defendant’s state of mind at the time the documents are destroyed. Accordingly, an individual’s decision to affirmatively ignore the potential relevance of documents to future governmental investigations and to continue with across the board document destruction will not be viewed favorably. Documents destroyed without some

²² *See id.*

²³ 18 U.S.C. § 1520 (Supp. 2004).

mechanism for evaluating their potential value to possible or foreseeable government investigations or proceedings may furnish prosecutors with a prima facie case against the defendant. Thus, companies must stand ready to demonstrate that their policy includes reasonable inquiry into the potential relevance of documents to future governmental investigations.

Sarbanes Oxley strengthens section 1512 with new language:

(c) whoever corruptly (1) alters, destroys, mutilates, or conceals a record, document or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding or (2) otherwise obstructs, influences, or impedes any official proceeding or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.

On a related note, former corporate executives have recently been charged with and plead guilty to obstruction charges based on lies the executives told to a law firm conducting an internal investigation.²⁴ This not only expands traditional obstruction charges, but also exposes corporations to criminal liability for lying to their own lawyers.²⁵

[5] Whistleblower Retaliation

Sarbanes Oxley prohibits U.S. and foreign reporting companies – and their officers, employees, contractors, subcontractors, and agents – from taking retaliatory action of any kind against an employee for commencing or participating in a legal proceeding based on conduct the employee reasonably believes violates U.S. securities

²⁴ See Alex Berenson, *Case Expands Type of Lies Prosecutors Will Pursue*, NEW YORK TIMES, May 17, 2004, at C1.

²⁵ See *id.*

and antifraud laws.²⁶ The Act provides whistleblowers with civil remedies, including reinstatement with the same seniority status that the employee would have had; back pay; and compensation for special damages, such as litigation costs, expert witness fees, and attorney fees.²⁷ Additionally, the Act creates criminal penalties, including fines and up to ten years in prison for employers who take harmful retaliatory actions against whistleblowers.²⁸

Sarbanes Oxley section 301 and Exchange Act Rule 10A-3 require national securities exchanges and national securities associations to make as a condition of listing that the audit committee of each issuer set up procedures for the “receipt, retention, and treatment of complaints” regarding accounting, internal accounting controls, and auditing matters, as well as for the confidential and anonymous submission by employees of concerns regarding accounting and auditing matters.²⁹ Under these rules, a company’s audit committee must establish these procedures by the earlier of the first annual meeting after January 15, 2004 or October 31, 2004.³⁰

[6] *New Sentencing Guidelines*

Section 805 of Sarbanes Oxley directed the United States Sentencing Commission to review and amend the Federal Sentencing Guidelines to ensure that the offense levels, existing enhancements or offense characteristics are sufficient to deter and punish violations involving obstruction of justice, record destruction, fraud when victims number significantly more than 50 or when it endangers the financial security of a substantial

²⁶ 18 U.S.C. § 1514A(a) (Supp. 2004).

²⁷ 18 U.S.C. § 1514A(c) (Supp. 2004).

²⁸ 18 U.S.C. § 1513 (Supp. 2004).

²⁹ See 18 U.S.C. § 78f (Supp. 2004).

³⁰ Securities Exchange Act of 1934 Rule 10A-3.

number of victims and organizational criminal misconduct. Likewise, section 905 of the Act required the Sentencing Commission to review the guidelines to ensure that they reflect the serious nature of the offenses and the penalties set forth, the growing incidence of serious fraud offenses and the need to deter and punish such offenses. In section 1104, Congress also directed the Sentencing Commission to review and consider amending the guidelines with particular attention as to whether the offense levels and enhancements for an obstruction of justice offense are adequate in cases where documents or other physical evidence are actually destroyed or fabricated.

§ 6.04 Both the SEC and the DOJ Demand Full Cooperation

In January 2003, the DOJ published a revised set of Sentencing Guidelines that are aimed at assisting federal prosecutors in deciding whether to charge a business organization for criminal acts committed by its employees (the “Thompson Memorandum”).³¹ Replacing a 1999 memorandum that DOJ Deputy Attorney General Eric Holder drafted (the “Holder Memorandum”), the Thompson Memorandum contains revisions that significantly impact the design and implementation of corporate legal compliance programs.

Generally, a corporation may be held criminally liable for the actions of its directors, officers, employees and agents if the actions of those persons are within the scope of his or her duties and were intended, at least in part, to benefit the corporation.³²

³¹ See Principles of Federal Prosecution of Business Organizations *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

³² See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118 (5th Cir. 1980).

It is not required that the corporation actually benefit from the criminal act nor is it determinative that employee was motivated by personal gain.

Under this general standard, federal prosecutors have broad discretion in determining whether to file criminal charges against a corporation. The Thompson Memorandum, like the Holder Memorandum, provides that, when determining whether to charge a corporation with criminal activity, federal prosecutors should consider the corporation's voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation. The Thompson Memorandum goes further, presenting companies with a stark choice: cooperate candidly and completely or face the full might of the DOJ.³³ The Thompson Memorandum declares an important factor to be considered in charging a corporation with criminal wrongdoing is the "willingness [of the corporation] to cooperate in the investigation of its [officers, employees and] agents, including, if necessary, the waiver of corporate attorney-client privilege and work product protection."³⁴ The Thompson Memorandum further explains that the extent of a

³³ See Principles of Federal Prosecution of Business Organizations, *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

³⁴ See *id.* Stephen Cutler, Director, Division of Enforcement, SEC, emphasized the importance of a company's cooperation in a speech discussing the SEC's decision-making process in determining penalties to be enforced for violations. Stephen M. Cutler, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (April 20, 2004), *available at* <http://www.sec.gov/news/speech/spch042904smc.htm>. In the speech, Mr. Cutler noted that one of the three core factors in determining penalties is the extent of the violator's cooperation.

corporation's cooperation may be measured by, among other criteria, "the corporation's willingness to identify the culprits within the corporation, including senior executives"³⁵

The 2003 Guidelines encourage a new, more extensive, inquiry: whether the corporation, while perhaps purporting to cooperate, actually engaged in conduct that impedes the investigation.³⁶ The Guidelines provide examples: (1) overly broad assertions of corporate representation of employees or former employees; (2) inappropriate directives to employees or their counsel, such as directing them to decline investigative interviews; (3) making presentations or submissions containing misleading assertions or omissions; (4) incomplete or delayed production of records; and (5) failure to promptly disclose illegal activity known to the cooperation.³⁷ Any of these actions may signal a lack of voluntary cooperation.

Further, prosecutors have been instructed to scrutinize more closely the design and enforcement of the company's legal compliance program. In evaluating whether a legal compliance program is merely a "paper program" as opposed to a legitimate attempt to comply with the Act investigators consider (1) whether corporate directors have the authority, resources, and information to review the conduct of officers and employees and to ensure compliance with applicable laws and regulations; (2) whether the legal compliance program is designed to effectively uncover types of corporate misconduct

³⁵ See Principles of Federal Prosecution of Business Organizations Principles of Federal Prosecution of Business Organizations, *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

³⁶ See *id.*

³⁷ See *id.*

most likely to occur in a corporation's business; and (3) whether the corporation has invested sufficient resources in the enforcement and compliance efforts.³⁸

[1] *El Paso Merchant Energy Cooperation*

The March 2003 U.S. Commodity Futures Trading Commission (CFTC) administrative order settling charges of attempted manipulation and false reporting against Houston, Texas energy company El Paso Merchant Energy, L.P. (EPME), a division of El Paso Corporation, illustrates the potential results of "full cooperation." Although sanctioning EPME for intentionally reporting false, misleading or knowingly inaccurate market information in an attempt to manipulate the price of natural gas, CFTC credited EPME for its cooperation and noted: "We will be fair, though firm, with companies like EPME that come forward and promptly divulge all of their wrongdoing."³⁹ CFTC cautioned that, like EPME, "companies should take prudent steps such as executing internal investigations of their trading operations and swiftly turning over documents, emails, and interviews prior to our discovery of prohibited activity."⁴⁰

Rebuking other less forthright companies, CFTC noted that

[t]here remain a few companies on notice that certain unlawful practices ran rampant throughout the industry that, unlike EPME, have failed to take any meaningful steps to determine whether misconduct occurred in their corporations. Others are taking four months or more to respond to our document and email requests. Some are even playing a cat and mouse game.⁴¹

³⁸ *See id.*

³⁹ *See* CFTC Press Release 4765-03, *available at*

www.cftc.gov/opa/enf03/opa4765-03.htm.

⁴⁰ *Id.*

⁴¹ *Id.*

Issuing a stark warning, CTFC admonished, “[t]hat is not cooperation.”⁴²

[2] *Lucent Technologies, Inc. Non-Cooperation*

A prime example of non-cooperation is the recent \$25 million penalty levied against Lucent Technologies Inc. (Lucent). The SEC complaint alleged that Lucent fraudulently and improperly recognized approximately \$1.148 billion of revenue and \$470 million in pre-tax income. Lucent’s non-cooperative actions were (1) incomplete and untimely document production; (2) comments from outside counsel that undermined the settlement; and (3) expanding the scope of employees that could be indemnified.⁴³ According to Paul Berger, Associate Director of Enforcement, “Companies whose actions delay, hinder or undermine SEC investigations, will not succeed. Stiff sanctions

⁴²*Id.*

⁴³ Lucent settles SEC enforcement action charging the company with \$1.1 billion accounting fraud, *available at* <http://www.sec.gov/news/press/2004-67.htm>. Likewise, during 2004 both Symbol Technologies and Banc of America Securities LLC were faulted by the SEC for non-cooperation. In assessing a \$37 million penalty against Symbol Technologies, the SEC considered “Symbol’s initial efforts to cover up the misconduct and impede two internal investigations and commission’s investigation.” Symbol Technologies agrees to settle SEC Enforcement Action Charging the Company with Accounting Fraud, <http://www.sec.gov/news/press/2004-74.htm>. Bank of America Securities LLC was also ordered to pay a penalty related to its failure to timely and completely provide documents. <http://www.sec.gov/litigation/admin/34-49386.htm>.

and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interests of investors.”⁴⁴

[3] Counsel as “Watchdog”

In August 2003, as part of the SEC’s Final Rule implementing section 307 of Sarbanes Oxley, the “up-the-ladder” reporting requirements for attorneys went into effect. The rule applies to all attorneys who “appear and practice before the Commission” in the representation of an issuer of publicly traded securities, including corporate in-house attorneys. The rule requires attorneys to report evidence of a “material violation” by the company up the ladder to the company’s chief executive officer, chief legal officer, and the board of directors. This is but one in a series of enactments and policy statements designed in the wake of the Enron debacle to compel corporate counsel to ensure greater accountability on the part of publicly traded companies. Sarbanes Oxley further demands that CFOs and CEOs certify the accuracy and completeness of quarterly and annual reports, including financial statements, and verify that any fraud involving key officers and employees has been disclosed to the company’s auditors. Coupled with the reporting requirements placed on counsel, these provisions seek to ensure that corporate wrongdoing will be revealed and remedied.

Today’s in-house counsel face a challenging balancing act: Counsel must on one hand respond to the expectations of government agencies that have in effect “deputized” them in the crusade against corporate corruption while on the other hand avoiding

⁴⁴ Lucent settles SEC enforcement action charging the company with \$1.1 billion accounting fraud, *available at* <http://www.sec.gov/news/press/2004-67.htm> .

internal discord in their traditional relationship with a management team accustomed to deference from counsel regarding executive decision making.

These new rules and guidelines beg the question: To who is the in-house lawyer now responsible? Or put more simply, who does the lawyer represent? While the ABA Model Rules and the various states' codes of professional conduct make clear that "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents,"⁴⁵ the actual application of this concept is not so simple. In-house counsel must cultivate and maintain the confidence of management if he or she is to be an effective member of the team. Likewise, general counsel must also be responsive to the board of directors and ultimately the shareholders who expect to enjoy the benefits of a profitable business. This juggling of loyalties is no more difficult than when the potential of a corporate scandal arises.⁴⁶

Tension mounts when in-house counsel is required to undertake an investigation into employee wrongdoing. Since under the new Guidelines corporations must promptly

⁴⁵ MODEL RULES OF PROF'L CONDUCT R. 1.13

⁴⁶The toll of this tug of war on in-house counsel can be great. Coca Cola's top lawyer made headlines in April 2004 when he resigned in the wake of two government probes into alleged accounting fraud and a shareholder lawsuit. Coke general counsel Deval L. Patrick had no role in the alleged misconduct but the Wall Street Journal reported that insiders claimed board members had grown dissatisfied with Mr. Patrick's handling of the matters and others surmised that he felt "isolated," an outsider in a highly politicized corporate culture. Chad Tehune and Betsy McKay, *Coke's Top Lawyer Quits Amid Flap, Feeding Turmoil*, WALL ST. J., April 12, 2004, at A3.

disclose wrongdoing and reveal the results of internal investigations, in-house counsel must understand that their work product likely will be revealed to regulators and prosecutors. Counsel should convey this inevitability to the employees questioned during the investigation as well and should alert the employee whose interests are or may become adverse to those of the company, advising him or her that independent representation may be wise.⁴⁷

Another dilemma arises for counsel when he or she has reported evidence of a material violation “up the ladder” but has not received an appropriate response. The SEC has proposed two alternatives – neither of which applies when the report was made to the issuers “qualified legal compliance committee.”

Alternative 1: Withdrawal and Report to the Commission

A reporting attorney who has not received an appropriate response from the issuer and who believes that the material violation is “likely to result in substantial injury to the financial interest or property of the issuer or of investors” is required to withdraw from representing the issuer and notify the Commission in writing within one day.⁴⁸ The attorney must notify the commission that he or she intends to disaffirm some opinion,

⁴⁷ The Thompson Memorandum recognizes that some states require corporations to pay the legal fees for officers under investigation prior to a formal determination of their guilt. *See Principles of Federal Prosecution of Business Organizations, available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.*

⁴⁸ 17 C.F.R. §§ 205, 240, 249; *see also* SEC Release Nos. 33-8186; 34-47282; IC 25920.

document, affirmation or representation to be filed with the Commission and then must actually disaffirm in writing the information causing the material violation.

Alternative 2: Issuer Self-Reporting and Withdrawal

Upon receipt of written notice of withdrawal from the reporting attorney, the issuer is required to report the withdrawal and the circumstances surrounding it to the Commission on Form 8-K within two business days. If the issuer fails to file the required notice, the reporting attorney may report the failure and disclose his or her withdrawal to the Commission.⁴⁹

[4] Indemnification

Virtually every state authorizes corporations to indemnify their officers and directors after the fact for expenses incurred in connection with defending themselves in legal proceedings arising out of service to the corporation. Pursuant to this authorization, most corporations enact bylaws specifying that officers and directors are entitled to be indemnified for expenses (including attorneys' fees) incurred in connection with defending themselves in legal proceedings, as well as for any judgments, fines and amounts paid in settlement. The underlying public policy for this type of indemnification is that, absent fraud or breach of fiduciary duty, people who serve as corporate directors and officers should be able to perform their jobs free of fear that they will be saddled with personal liability for corporate acts.

Generally, even if an officer or director is found liable in litigation, he or she is entitled to receive indemnification if the officer or director acted in good faith and in a manner the person reasonably believed to be in, or not opposed to, the best interests of

⁴⁹*Id.*

the corporation. Indemnification is permitted even if the officer or director was negligent, provided the alleged act was committed in good faith. Moreover, regardless of good faith, an officer or director also may be entitled to indemnification to the extent the officer or director is successful in his or her defense.

However, this “authorization” to indemnify has little practical significance until the litigation is concluded. Whether an officer or director is entitled to reimbursement for legal expenses incurred during the course of the legal proceedings is generally not determined until the proceedings are over. Accordingly, most states provide corporations with the option to advance litigation expenses, with the caveat that the officer or director must promise to repay any advanced expenses if it ultimately determined that he or she is not entitled to be indemnified. Many corporations have enacted bylaws that provide that they *must* advance litigation expenses to its officers and directors. Recognizing the strong policy arguments in favor of advancement, courts have strictly enforced mandatory advancement provisions, even requiring continued advancement after a defendant has pleaded guilty because there has been no “final disposition” of the criminal proceeding until the defendant is sentenced. Sarbanes Oxley may jeopardize this scheme.

Section 1103 of the Act provides SEC a new provisional remedy:

Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest bearing account for 45 days.

Notably, a section 1103 order may be obtained prior to the filing of any formal lawsuit, it may be extended for an additional 45 days, and upon the filing of a lawsuit, the freeze may remain in effect until the conclusion of the legal proceedings.

The SEC has sought and obtained section 1103 orders in at least four cases: *SEC v. WorldCom*; *SEC v. HealthSouth*; *SEC v. Henry C. Yuen and Elsie Ma Leung*, and *SEC v. Vivendi Universal*. In its complaint against WorldCom, the SEC sought an order prohibiting the company from making any “extraordinary payments” to employees and defined those payments as including bonus, severance, and *indemnification* payments. This may signal the SEC’s intentions to use section 1103 as vehicle to halt funding of an employee’s defense – a move that likely will have a chilling effect on an officer’s or director’s ability to retain experienced counsel.

§ 6.05 Foreign Corrupt Practices Act (“FCPA”)

The FCPA prohibits payments to a foreign official that are intended to “assist the [payor] in obtaining or retaining business.”⁵⁰ However, the FCPA does not prohibit all payments intended to induce a foreign official to use his or her position favorably for the payor. For example, the FCPA exempts “grease” payments to foreign officials that are intended to expedite “routine governmental action.”⁵¹ Likewise, the FCPA’s reach is limited by its requirement that the payment be made to obtain or retain business—the business nexus.⁵²

Certainly, payments made to foreign officials to win a bid would assist in

⁵⁰ 15 U.S.C. §§ 78dd-1(a), 78dd-2(a) (Supp. 2004).

⁵¹ 15 U.S.C. §§ 78 dd-1(b) & (f)(3)(A) (B) (1997 & Supp. 2004).

⁵² 15 U.S.C. §§ 78 dd-1(a)(1) (Supp. 2004).

obtaining business.⁵³ But what about payments that are not directly related to an existing or proposed contract that give a company a competitive advantage? The Fifth Circuit recently addressed the breadth of the FCPA's business nexus requirement and held that payments that provide a competitive advantage, even if not directly linked to proposed or existing business, could violate the FCPA. The Fifth Circuit's opinion expands the government's reach under the FCPA and signifies a need for companies to re-examine their FCPA compliance procedures.

[1] ***United States v. Kay*, 359 F.3d 738 (5th Cir. 2004).**

In *United States v. Kay*, the government charged David Kay and Douglas Murphy with violating the FCPA by bribing Haitian officials to understate customs duties and sales taxes on raw rice shipped to their plant in Haiti for processing and sale there and elsewhere. Even though the payments were not directly linked to any "business," the government argued that the payments violated the FCPA because reduced customs duties and sales taxes will always provide the payor with an unfair advantage in obtaining or retaining business. The defendants argued that the FCPA was not implicated because the payments were not directly linked to an attempt to obtain or retain business. The district court agreed with the defendants and dismissed the indictment. According to the district court, as a matter of law, an indictment alleging illicit payments to foreign officials for the purpose of avoiding customs duties and sales taxes were not the sort of bribes that were criminalized by the FCPA.

On appeal, the Fifth Circuit considered the required nexus between the bribe and

⁵³ *E.g.*, *United States v. Castle*, 925 F.2d 831, 832 (5th Cir. 1991) (payment to win bid to provide buses to Canadian provincial government is illegal under FCPA).

the payor's goal of obtaining or retaining business. The Fifth Circuit first determined that the FCPA was ambiguous as to what type of payments it criminalized. Accordingly, the Fifth Circuit reviewed the FCPA's legislative history to determine Congress' intent in implementing the FCPA.

[a] FCPA not limited to obtaining or retaining governmental contracts.

After reviewing the FCPA's legislative history, the Fifth Circuit first determined that the FCPA's reach is not limited solely to obtaining or retaining government contracts. According to the Fifth Circuit, Congress could have expressly limited the FCPA's reach to "government contracts," but it did not. Thus, payments made to foreign officials to obtain or retain non-governmental business are prohibited by the FCPA.

[b] Payments made to foreign officials need not directly relate to a specific business opportunity to violate the FCPA.

The Fifth Circuit went on to hold that Congress intended for the FCPA to apply to the type of conduct alleged in *Kay* if those payments were intended to "engender assistance in improving the business opportunities of the payor or his beneficiary, irrespective of whether that assistance be direct or indirect, and irrespective of whether it be related to administering the law, awarding, extending, or renewing a contract, or executing or preserving an agreement."⁵⁴ The Fifth Circuit reasoned that Congress' concern in implementing the FCPA is not diminished "simply because the tainted payments are intended to secure a favorable decision less significant than winning a contract bid."⁵⁵

The remaining question in the case, as emphasized by the Fifth Circuit, is whether the bribery was intended to produce an effect that would "assist in obtaining or retaining

⁵⁴ *United States v. Kay*, 359 F.3d 738, 750 (5th Cir. 2004).

⁵⁵ *Id.* at 759.

business.” Thus, the Fifth Circuit rejected the government’s argument that bribes to secure lower taxes always violate the FCPA. At trial, the government would have to prove “how the tax benefit was intended to assist in obtaining or retaining business, and what was the business or business opportunities sought to be obtained or retained?”⁵⁶

[2] Kay Requires Review of FCPA Compliance Procedures

For lawyers representing businesses operating in foreign countries, *Kay* is significant in several respects. First, the 5th Circuit rejected the argument that the FCPA’s reach is limited solely to obtaining or retaining government contracts. Thus, any payments to a foreign official that provide a company with a competitive advantage for any business could violate the FCPA. Companies must review and possibly revamp their FCPA compliance procedures to ensure that a company’s employees understand that the FCPA does not relate solely to business solicited from a foreign government. Second, *Kay* makes it clear that a payment made to a foreign official need not directly relate to specific business to violate the FCPA. In the future, an FCPA compliance program must emphasize that only payments that fit squarely into one of the FCPA’s exceptions will be considered legal. Third, *Kay* is significant because the required nexus between the payment and the quid pro quo is not clear. Companies will not want to be in the unenviable position of trying to prove that any payment made was not made with the goal of “obtaining or retaining” business. As the 5th Circuit wrote, “[e]ven a modest imagination can hypothesize myriad ways that an unwarranted reduction in duties and taxes . . . could assist in obtaining or retaining business.”⁵⁷ While the conduct at issue in *Kay* was a reduction in taxes, an active or modest imagination also could come up with a

⁵⁶ *Id.*

⁵⁷ *Id.*

theory as to how any advantage a company receives from a payment to a foreign official could provide a competitive advantage and, thus, help the company to obtain or retain business. Finally, *Kay* is significant because the government likely will view the decision as vindication of its broad view of the FCPA's reach. Thus, it is possible that the government will expand the amount and types of cases it prosecutes under the FCPA.

Energy companies who do business overseas should follow *Kay* closely because of its potential impact regarding international payment practices. Unless and until the appeals courts make any changes, *Kay* is the law in the 5th Circuit and will be persuasive authority for other courts considering the same issue.

§ 6.06 Criminalization of Energy Trading

On August 14, 2002, Todd Geiger, a natural gas trader and Vice President with El Paso's Merchant Energy Division, sent a text message to a competitor whom he thought was misrepresenting the market to index publications: "Cash market manipulation + lying to index publications = JAIL TIME. Any questions?"⁵⁸ Ironically, a little over a year later in December 2003, Todd Geiger plead guilty to that very sort of conduct and now faces up to five years in Federal prison.⁵⁹

⁵⁸Government's Statement of Facts at 5, *United States v. Todd Geiger*, United States District Court, Southern District of Texas, Houston Division CR H-02-712 (December 10, 2003).

⁵⁹ Plea Agreement, *United States v. Geiger*, United States District Court, Southern District of Texas, Houston Division, CR H-02-712 (December 11, 2003); *see also* US Department of Justice Press Release, *Geiger Guilty of Falsely Reporting Gas Trades*

[1] Corporate Fraud Task Force

In 2002, the President established the Corporate Fraud Task Force which sought to further unite the activities of the Commodities Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC), and SEC in their efforts to oversee and police the energy marketing industry. According to the President's Executive Order, the Corporate Fraud Task Force's primary function is to provide recommendations for "action to enhance cooperation among Federal, State, and local authorities responsible for the investigation and prosecution of significant financial crimes."⁶⁰

The fall of Enron led to more aggressive enforcement against energy companies by government regulatory agencies, including the CFTC and the FERC. Individually, the FERC was the first to announce findings that Enron had "gamed the system" in California. FERC and the CFTC began investigations into Enron that later expanded to include several companies. The SEC also initiated investigations that have resulted in at least one high profile settlement with Reliant Energy. All of these agencies are continuing to cooperate with each other and the DOJ in ongoing investigations.

[2] Focus on Energy Traders

On May 15, 2002, Pat Wood reported to the US Senate that FERC was cooperating with the CFTC and the SEC, and that FERC had sent out requests to many

(December 11, 2003), available at <http://www.usdoj.gov/usao/txs/releases/December2003/031211-geiger.htm>.

⁶⁰ Executive Order 13271, Establishment of the Corporate Fraud Task Force, 67 FR 46091, July 11, 2002, available at <http://www.whitehouse.gov/news/releases/2002/07/20020709-2.html>

other energy-marketing firms in March 2002 requesting information regarding their trading activities. At the same time Wood announced that Enron had turned over a memo penned by Enron's outside counsel in December 2000 detailing many of Enron's manipulative California trading strategies with such colorful names as "Death Star, Get Shorty, and Fat Boy."⁶¹ The December 6, 2000 memo indicated that these were trading strategies that Enron traders were still using, although the company later claimed that such strategies were discontinued before the end of 2000.⁶² This was the first public disclosure of evidence of potential fraudulent trading activities.⁶³ Wood also testified that FERC had sent out requests in early May 2002 to all of the energy marketers asking them if they had engaged in the same "gaming of the system" as detailed in the December 6, 2000, memo. Wood made it very clear that the investigations were going *beyond Enron*.

After gathering data from many of the marketers, FERC composed a preliminary report on the manipulation of power and gas prices in the western market. This report came out in August 2002 and detailed the deceptive trade practices that were first

⁶¹See Letter from Christian Yoder and Stephen Hall, Stoel Rives LLP, to Richard Sanders, Enron (December 6, 2000) (released by FERC May 15, 2002).

⁶²Toby Eckert and Dana Wilkie, *Lawyers, fearing violations, say practices halted in 2000*, THE SAN DIEGO TRIBUNE, May 16, 2002, *available at* <<http://www.freerepublic.com/focus/fr/68710/posts>>.

⁶³Testimony of Pat Wood Before the Senate Committee on Commerce, Science, and Transportation (May 15, 2002), *available at* <<http://www.ferc.gov/press-room/ct-archives/2002/05-14-02-wood.pdf>>.

exposed by the Enron memo.⁶⁴ The report concluded that there was preliminary evidence that El Paso and Enron had engaged in “actions that adversely affected prices.”⁶⁵ The report also detailed *for the first time* the specter of false reporting to industry publications for the purposes of calculating index prices. Index prices had come into question because the indices were to be used as a basis for refunding overcharges in the FERC’s California administrative proceeding for 2000-2001 overcharges.⁶⁶

The CFTC also began investigations in Spring of 2002. As with Congress and the FERC, the CFTC first trained its’ eyes on Enron by establishing an “Enron Information Link” in May of 2002 to receive information regarding “suspicious activities” in regard to trading in the west.⁶⁷ The CFTC’s focus moved to all of the market participants in the energy marketing industry. This new philosophy followed the announcement on July 12, 2002, that the CFTC would be participating in the President’s

⁶⁴Initial Report on Company-specific Separate Proceedings and Generic Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies Fact-finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No PA02-2-000, FERC (August 2002), *available at* <<http://www.ferc.gov/legal/staff-rep-gas.asp>>.

⁶⁵*Id.* at 26.

⁶⁶*Id.* at 34.

⁶⁷CFTC Established “Enron Information Link”, CFTC Press Release (May 22, 2002), *available at* <<http://www.cftc.gov/opa/press02/opa4646-02.htm>>.

Corporate Fraud Task Force.⁶⁸ The CFTC then set about subpoenaing documents from the marketing companies and interviewing their employees; these investigations continue to this day.

The SEC is not sitting these investigations out. In the case of Reliant, the SEC issued an Order on May 12, 2003, regarding alleged violations of the Securities Act based on submission of inflated volume numbers from false trades. Reliant did not have to admit wrongdoing or pay a fine.⁶⁹ The SEC is continuing its investigations into several other energy-marketing companies. The SEC's primary concern is whether any falsely reported trades had any financial effect on the companies that reported to the public. As with the other agencies, the SEC is cooperating and sharing information with the DOJ.

[a] Marketers Settle

Many companies have decided to simply settle with the CFTC and other agencies rather than fight them on the issues surrounding index reporting. So far, thirteen energy companies have entered into agreements settling these allegations of manipulation with the CFTC for a total of over \$180 million in civil penalties. Most of the CFTC investigations resulted in findings of knowingly reporting false price and volume information for natural gas transactions to the index publications.

[i] Dynegy

⁶⁸CFTC to Participate in Interagency Corporate Fraud Task Force, CFTC Press Release (July 12, 2002), *available at* <<http://www.cftc.gov/opa/press02/opa4670-02.htm>>.

⁶⁹*Reliant Settles with the SEC*, HOUSTON BUSINESS JOURNAL, May 12, 2003, *available at* <<http://www.bizjournals.com/houston/stories/2003/05/12/daily3.html>>.

On December 18, 2002, the CFTC made its first coup in its investigation of the energy-marketing firms. An agreed order was entered against Dynegy for knowingly reporting false information to “skew index for its financial benefit.”⁷⁰ Dynegy agreed to pay a \$5 million fine. The Order further suggested that the size of the fine was partially as a result of Dynegy’s cooperation, including conducting an independent internal investigation and providing the results of their investigation to the CFTC. It should be noted that Michelle Valencia, a former employee of Dynegy, soon faced a criminal prosecution which was an offshoot of that internal investigation.⁷¹

[ii] El Paso

On March 26, 2003, El Paso was fined \$20 million for intending to skew indices for its financial benefit. As with Dynegy, the CFTC noted El Paso’s cooperation with the investigation, including “hiring an independent law firm to conduct an internal investigation, voluntarily providing information, waiving attorney-client privileges, and stopping trading activity.”⁷² CFTC’s Director of Enforcement, Gregory Mocek, noted, “[a]s with El Paso, companies should take prudent steps, such as executing internal investigations of their trading operations and swiftly turning over documents, e-mails, and interviews prior to our discovery of prohibited activity.” Mocek went on to criticize

⁷⁰See Order Instituting Proceedings, CFTC Docket 03-03 (December 18, 2002), available at <<http://www.cftc.gov/files/enf/02orders/enfdynegy-order.pdf>>.

⁷¹ Indictment, United States v. Valencia, United States District Court, Southern District of Texas, Houston Division, CR H-03-0024 (January 22, 2003).

⁷²See Order Instituting Proceedings, CFTC Docket 03-09 (March 26, 2003), <<http://www.cftc.gov/files/enf/03orders/enfelpaso-order.pdf>>.

other companies that were “playing a cat and mouse game” or delaying subpoena compliance.⁷³ As with Dynegy, the cooperation of El Paso aided in the prosecution of former El Paso employee Todd Gieger.

[iii] Other Settlements

Other companies followed the lead of Dynegy and El Paso and decided to settle with the CFTC: W.D. Energy settled for \$20 million on July 28, 2003; Williams settled for \$20 million on July 29, 2003; Enserco settled for \$3 million on July 31, 2003; Duke settled for \$28 million on September 17, 2003; Reliant settled for \$18 million on November 25, 2003; CMS settled for \$16 million on November 25, 2003; and on January 28, 2004 the CFTC settled with Aquila for \$26.5 million, Excel for \$16 million, ONEOK for \$3 million, Entergy Koch for \$3 million, and Calpine for 1.5 million.⁷⁴

Some cases are still pending. On September 30, 2003, the CFTC filed suit against American Electric Power Company (AEP) and AEP Energy Services, Inc., alleging that AEP reported false numbers to index publications in an attempt to manipulate natural gas

⁷³El Paso Trading Unit Agrees to Pay \$20 Million to Settle CFTC Charges, CFTC Press Release (March 26, 2003), *available at* <http://www.cftc.gov/opa/enf03/opa4765-03.htm>.

⁷⁴*See* CFTC Press Releases (2003), *available at* <http://www.cftc.gov/opa/opaenf2003.htm>.

prices. The complaint charges that AEP reported over 3600 purported natural gas trades, 78% of which were false, misleading, or known to be inaccurate.⁷⁵

[b] Power Traders Indicted

The early investigations of Enron by FERC turned up the notorious December 6, 2000 memo that laid out various “strategies” that Enron power traders used in the west.⁷⁶ So far three Enron traders, and four employed by Reliant, have been indicted in connection with manipulation of the electricity market in California. Enron traders Timothy Belden, Vice-President and Managing Director of Enron’s West Power Trading Division, and Jeffrey Richter, manager of Enron’s short-term California Desk, have pled guilty to conspiracy to commit wire fraud,⁷⁷ and trader John Forney, manager Enron’s West Trading desk, was indicted in 2003 in connection with trading strategies intended to manipulate or game the electricity market in Northern California from 1998 to 2001.⁷⁸

⁷⁵ Complaint, United States Commodity Futures Trading Commission v. American Electric Power Company, Inc., United States District Court, Southern District of Ohio, Civil Action No. 02-03-891 (September 30, 2003).

⁷⁶See Letter from Christian Yoder and Stephen Hall, Stoel Rives LLP, to Richard Sanders, Enron (December 6, 2000) (released by FERC May 15, 2002).

⁷⁷Kurt Eichenwald, *Enron Trader Pleads Guilty*, NEW YORK TIMES, February 5, 2003, available at http://www.oppc.net/press/2003-02-05_enron_trader_pleads_guilty.html.

⁷⁸*Former Trader for Enron Indicted*, Los Angeles Times, June 6, 2003, available at <http://www.chron.com/cs/CDA/story.hts/special/enron/1940004>.

Reliant Energy Services, Inc. was indicted along with four of its employees, Vice-President of Power Trading Jackie Thomas, Director of the West Power Trading Division Reginald Howard, Term Trader Lisa Flowers, and Manager of Western Operations Kevin Frankeny, on April 8, 2004.⁷⁹ The United States alleges that the defendants created an elaborate plan to manipulate the spot and term electricity market at the Palo Verde Hub on the Arizona-California border.

[c] Indictments for Index Reporting Violations

Investigations into price reporting by the FERC and the CFTC have set the scene for Federal Prosecutors in two separate cases so far. The Houston Division of the United States Attorney's office has won one conviction against Todd Geiger⁸⁰ and is currently

⁷⁹Bob Egelko, Mark Martin, *Houston firm indicted for role in energy crisis Reliant Energy is accused of forcing up electricity prices*, SAN FRANCISCO CHRON., April 9, 2004, available at <http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2004/04/09/MNG2S62D4B22.DTL&type=printable>.

⁸⁰ Plea Agreement, United States v. Geiger, United States District Court, Southern District of Texas, Houston Division, CR H-02-712 (December 11, 2003); *see also* US Department of Justice Press Release, Geiger Guilty of Falsely Reporting Gas Trades (December 11, 2003), available at <http://www.usdoj.gov/usao/txs/releases/December2003/031211-geiger.htm>

pursuing an interlocutory appeal of a trial judge's pretrial ruling in Michelle Valencia's⁸¹ case based on the criminal false reporting component of the Commodities Exchange Act and Wire Fraud. It is likely that both the U.S. Attorney's office in Houston and in San Francisco will prosecute new cases uncovered by ongoing investigations into trading, specifically index reporting.

In December of 2002 and January of 2003 two physical gas traders, Michelle Valencia, of Dynegy's West Trading Desk, and Todd Geiger, an El Paso Merchant Energy Group Vice-President and gas trader, were indicted⁸² for false reporting under the Commodity Exchange Act⁸³ and Wire Fraud.⁸⁴ Each defendant was charged with one count of false reporting and one count of wire fraud for each instance they are alleged to have e-mailed false information to the industry newsletter *Inside FERC*.

Documents filed by the Government in conjunction with Todd Geiger's guilty plea show that Geiger and others at El Paso agreed to report data to *Inside FERC* "according to [his] book bias" rather than "verifiable fixed price trades only."⁸⁵ The

⁸¹ See Kristen Hayes, Fake Trade Charges Tossed in Dynegy Case, Associated Press, August 27, 2003 (detailing the Judge's order and the appeal), *available at* http://abcnews.go.com/wire/Business/ap20030827_1853.html.

⁸² See Indictment, United States v. Valencia, United States District Court, Southern District of Texas, Houston Division, CR H-03-0024 (January 22, 2003); Indictment, United States v. Geiger, United States District Court, Southern District of Texas, Houston Division, CRH-02-712 (December 2, 2002).

⁸³ 7 U.S.C. § 13(a)(2) (2003).

⁸⁴ 18 U.S.C. § 1343 (2003).

⁸⁵ Government's Statement of Facts at 5, United States v. Todd Geiger, (CR H-02-

Government contends that this inflated Geiger's trading performance, a performance that led to a bonus for Geiger in 2000 of \$600,000.⁸⁶ In December of 2003, Geiger pled guilty to false reporting under the Commodities Exchange Act, admitting that he engaged in a pattern of giving false and misleading information to *Inside FERC*.⁸⁷ He is currently cooperating with the Houston United States Attorney's Office while he awaits sentencing.⁸⁸

As detailed in the Government's Statement of Facts in the Geiger case, on October 23, 2000, the head of Natural Gas Trading at El Paso sent an e-mail survey out to El Paso's traders, including Geiger, asking them whether they favored going back to reporting book bias (as in the past) or reporting variable fixed price trades only (as requested by *Inside FERC*). Most of the traders opted for reporting biased numbers. Some made telling comments. "I'd [sic] be nice if EVERYONE reported their actual

712).

⁸⁶ *Id.* at 4.

⁸⁷ Plea Agreement, United States v. Geiger, United States District Court, Southern District of Texas, Houston Division, CR H-02-712 (December 11, 2003); *see also* US Department of Justice Press Release, Geiger Guilty of Falsely Reporting Gas Trades (December 11, 2003) *available at* <http://www.usdoj.gov/usao/txs/releases/December2003/031211-geiger.htm>.

⁸⁸ Kristen Hayes, Former El Paso Trader Pleads Guilty, Associated Press (December 11, 2003), *available at* <http://www.dfw.com/mld/observer/business/7469129.htm?template=contentModules/printstory.jsp> and http://abcnews.go.com/wire/Business/ap20031211_1922.html.

deals, but with no enforcement by IF, we're going to get run over. Go with book bias." Another El Paso Vice President stated, "I vote for Number One (book bias). In my view most all of the other shops report their books in their bias." Another trader noted, "What are the odds of I FERC⁸⁹ doing an audit if they are suspicious?" to which his boss responded, "That's the point. They can't audit."⁹⁰

The Statement of Facts also noted that, on November 30, 2001, Geiger directed another El Paso employee to make up a list of 48 "completely fictitious" trades and then forwarded them to *Inside FERC*. When questioned by *Inside FERC*'s Chief Editor, Kelly Doolan, Geiger misled Doolan, as recorded on tape.⁹¹ Though *Inside FERC* decided not to include Geiger's trades in its calculations, had they done so and lowered its Sumas index, some sellers of natural gas would have suffered losses.

Valencia and Geiger initially objected to the False Reporting counts on constitutional grounds, claiming that the statute is over broad, void for vagueness, and was being misapplied in their cases. Judge Nancy Atlas agreed the statute is over broad and ruled that the statute criminalized protected speech under the First Amendment because it did not require a finding that the defendant knew the report was false.⁹² She later vacated her own order and struck only the particular language that allowed the

⁸⁹ I FERC is trader shorthand for InsideFerc, a gas trading publication.

⁹⁰ *Id.* at 6.

⁹¹ *Id.* at 7-8.

⁹² Memorandum and Order, *United States v. Valencia*, United States District Court, Southern District of Texas, Houston Division, CR H-03-2004 (August 26, 2003).

indictment to penalize protected speech.⁹³ Valencia's case is currently pending while the Government appeals Judge Atlas' order, and Geiger's guilty plea stopped the Government from appealing the same ruling in his case.

[d] Index Publications

Each month McGraw-Hill subsidiary Platts publishes *Inside FERC* to update energy companies and traders about the previous month's trading prices, volumes and other energy specific intelligence. McGraw-Hill claims that their indices have a financial impact on billions of dollars worth of natural gas transactions.⁹⁴

In December of 2002, shortly after Geiger was indicted, his counsel subpoenaed Platts for records related to gas price and volume reports. Platts resisted the subpoena claiming that the publications *Inside FERC* and *Gas Daily* are news reporters, and

⁹³ Memorandum and Order, *United States v. Valencia*, United States District Court, Southern District of Texas, Houston Division, CR H-03-0024 (November 13, 2003) (clarifying earlier August Order); *see also* Mark Babinek, *Ruling on False Trade Reporting Clarified*, Associated Press (November 14, 2003), *available at* http://www.boston.com/business/articles/2003/11/14/ruling_on_false_trade_reporting_clarified.

⁹⁴ Applicants Memorandum in Support of Application for Order to Show Cause at 5 filed by U.S. Commodities Futures Trading Commission v. McGraw-Hill Companies, Inc. MC-03-187, filed May 19, 2003.

invoked the First Amendment. Although Geiger eventually pled guilty, he was able to obtain some summaries of information collected by Platts relevant to his case.⁹⁵

In May of 2003, the Commodity Futures Trading Commission filed an application in Federal Court to enforce two broad administrative subpoenas issued to Platts for records relating to gas trade data it collected from marketers.⁹⁶ The Court has not granted that application and the CFTC's efforts to obtain compliance with their subpoenas are ongoing.

[e] Other Traders Under the Microscope

A sharp focus on trading activity by the CFTC and the FERC has also led to indictments on related fraudulent conduct in at least one other case. Two former Duke vice presidents and a trader have recently been indicted for racketeering and are alleged to have fraudulently recorded over \$50 million in profits.⁹⁷ The alleged fraud was discovered when Duke was investigating trading issues raised by the FERC, the CFTC, and the SEC.

⁹⁵ Response to Kelly Doolin's Motion to Quash, *United States v. Geiger*, United States District Court, Southern District of Texas, Houston Division, CR H-02-712 (February 25, 2003) (Kelly Doolin was an editor at Platts during the time in question).

⁹⁶CFTC Claims McGraw Hill Companies Flouted Federal Agency Subpoenas, CFTC Press Release (May 20, 2003), *available at* <<http://www.cftc.gov/opa/enf03/opa4788-03.htm>>.

⁹⁷Former Duke Energy Executives and Trader indicted for Racketeering, USDOJ Press Release, April 21, 2004, *available at* <<http://www.usdoj.gov/usao/txs/releases/April%202004/040421-Duke.htm>>.

Investigations into trading and accounting practices led to the discovery of fraud at Dynegy as well. The Government prosecuted Jamie Olis, former director of tax planning for the company, for disguising a \$300 million loan as profit using gas trades in what was called “Project Alpha.” When he was convicted this spring, he received a staggering twenty-four years in Federal prison.⁹⁸

The continuing Government investigations, against dozens of companies, make it clear that agency lawyers and prosecutors are still very interested in pursuing traders that reported false or misleading numbers *or* engaged in other wrongful trading activity uncovered during the investigations.

[f] Government Theories Remain Untested

Even though the CFTC and DOJ have secured millions of dollars in fines and several convictions for trading conduct, it is important to note that neither the CFTC nor Government prosecutors have had to test their theories on index reporting fraud at trial. So far, most of the convictions have come from plea bargains, and although the CFTC has collected massive fines, they also have not had to prove up their theories in a courtroom.

Clearly there are questions about not only the character of the information traders provided to the index publications, but as mentioned *infra*, the index publications themselves have not been forthcoming with much data about what was reported to them

⁹⁸Laura Goldberg, *Ex-Dynegy exec gets 24 years / Prosecutor defends term in fraud case, cites investors' loss*, HOUSTON CHRONICLE, March 26, 2004, Page A1.

and how they used that information. There are also serious questions about what information the index publications asked traders for at various times.

§ 6.07 Conclusion

Flush with cash, and an impressive record of successful settlements, governmental agencies cannot be ignored or underestimated. The philosophy that drove the energy marketing industry and that often put compliance and risk management issues in the back seat has also resulted in criminal indictments, and will likely result in many more. In this changing environment, corporate clients and corporate counsel need to be aware of the seriousness and breadth of such investigations. There are ways to combat potential problems, conduct proper internal investigations, and deal with the agencies and prosecutors without having to undermine the company or its employees. These investigations are not going to go away, but a properly prepared and well-informed client can weed out problems and find solutions that will serve to avoid their company's and employees' names being added to a lawsuit or indictment.