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SEC's New Enforcement Authority Freezes HealthSouth Payments to Senior Management

Last week, in an extraordinary legal maneuver, the Securities and Exchange Commission ("SEC") obtained a federal court order freezing payments by HealthSouth Corporation to its senior management. This is believed to be the SEC's first use of a "temporary freeze" provision in the recently enacted Sarbanes-Oxley Act of 2002 ("Act"). The court's order relied on the Act as the basis to bar HealthSouth from making any "extraordinary payments (whether compensation, bonuses, incentives or otherwise) to its directors, officers, partners, controlling persons, agents or employees...."

The freeze order was obtained in connection with a civil action that the SEC filed last week against HealthSouth and its Chief Executive Officer, Richard M. Scrushy. The SEC alleges that HealthSouth systematically overstated its earnings by at least $1.4 billion in order to meet or exceed Wall Street expectations. In a related criminal proceeding, HealthSouth's former CFO, Weston Smith, pled guilty to securities fraud charges. Smith was allegedly involved in filing a false certification statement accompanying HealthSouth's Form 10-Q for the second quarter of 2002. HealthSouth's current CFO, William Owens, also pled guilty to similar charges. These are the first publicized criminal charges based on the certification of financial records as required by the Sarbanes-Oxley Act.

Under a provision of the Act, the SEC is now empowered, during the course of an 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," to seek a temporary court order barring an issuer of publicly-traded securities from making "extraordinary payments (whether compensation or otherwise)" to such persons. See Section 1103 of the Act [15 U.S.C. § 78u-3(c)]. The Congressional debate leading up to the enactment of this provision in the Act indicates that the availability of freeze orders was seen as an important device to prevent companies from continuing to pay "rewards" and "enrich" corporate executives while the companies are under an SEC investigation.

The Act does not define the phrase "extraordinary payments," although the statute itself indicates that the phrase is not limited to "compensation." Under another provision of the Act, the CEO and CFO of a publicly-traded company may be compelled to return "any bonus or other incentive-based or equity-based compensation" when a company is required to prepare an accounting restatement in connection with a financial reporting requirement under the securities laws. See Section 304 of the Act [15 U.S.C. § 7243]. The freeze order provision in the Act is designed as a preemptive measure to prevent these types of remuneration from getting into the pockets of executives connected to companies under an SEC investigation. Consistent with this purpose, the court's freeze order in the case of HealthSouth precludes the company's payment of "compensation, bonuses [and] incentives."

Furthermore, the Act does not impose any concrete standards on the SEC's right to obtain a freeze order. The Act does not require the SEC to demonstrate a probable securities law violation, nor does the Act require the SEC to establish that a freeze order is necessary to protect the dissipation of assets. Instead, the Act permits the SEC to request a freeze order incidental to an investigation "involving possible violations of the federal securities laws...." Seemingly, this provision grants the SEC far ranging authority to control payments by publicly-traded companies to officers, directors and other senior management whenever the SEC suspects possible violations of federal securities laws. In the case of HealthSouth, the SEC's request for a freeze order was based, in part, on the guilty plea from the former CFO of HealthSouth and evidence that

HealthSouth's current CEO was allegedly engaged in a securities fraud scheme.

Under the Act, a court may issue a freeze order only after notice to the affected parties and an opportunity for a hearing, unless the court determines that such procedures would be "impracticable or contrary to the public interest." This non-specific standard gives courts broad discretion to issue freeze orders before affected parties even have an opportunity to contest the orders. In the case of HealthSouth, however, the company was notified before the freeze order was issued and HealthSouth consented to the order. In addition to the freeze order, HealthSouth also consented to an injunction barring the destruction of records and an order permitting the SEC to conduct expedited discovery of HealthSouth and its CEO.

A freeze order issued by the court may require a publicly-traded company to deposit "extraordinary payments" in an interest-bearing escrow account, under the court's supervision, for up to forty-five days. This time period may be extended for an additional forty-five day period. However, if a publicly-traded company or its directors, officers, partners, controlling persons, agents or employees are charged with a violation of federal securities laws, then the freeze order may continue indefinitely "until the conclusion of any legal proceedings related thereto." Thus, by charging a violation of securities laws, the SEC can obtain a freeze order on extraordinary payments to senior management for an extended time period, even though violations of the securities laws have yet to be proven. The threat of an extended restriction on a publicly-traded company's ability to make payments to its senior management would give the SEC substantial leverage in negotiating settlements with affected parties.

The Act also gives the SEC considerable discretion to impose or relieve financial burdens on various affected parties by seeking or forgoing freeze orders and pursuing or refraining from the recovery of payments already made to corporate executives. This, in turn, creates incentives for some interested parties to enter into a cooperation agreement with the government. However, the decision whether to cooperate requires a company to weigh carefully a variety of considerations, including the underlying facts and circumstances and the type of cooperation that a company would be required to provide in exchange for receiving more favorable treatment from the government.

The SEC has established a cooperation program with specified criteria that the SEC will utilize to assess whether a company is entitled to some degree of leniency. Under this program, the SEC evaluates factors such as the nature and duration of the misconduct, the levels of the company that were involved in the misconduct, the manner in which the misconduct was discovered, the manner in which the company investigated the misconduct, the efficacy of the company's actions to prevent a recurrence of the misconduct, and the completeness and precision of the report of the misconduct that the company submits to the government. Many of these points are similar to those enumerated in the recently published Department of Justice guidelines governing the prosecution of corporations and to the factors identified in the U.S. Sentencing Guidelines used as a basis to accord organizations favorable consideration in the sentencing process. All of these types of policies mean that in many instances, a company's interests may be best protected by entering into a cooperation agreement with the government. However, before making such a judgment, a company must have a full understanding of the facts underlying the alleged improprieties gained from a thorough internal investigation, as well as an appreciation of the legal risks.

On the other hand, there are risks associated with cooperation, including the possible loss of legal rights and privileges with no corresponding benefit to the company. For example, much has been written about demands from various federal agencies that companies waive the attorney-client privilege as a sign of their cooperation. Further, some government enforcement agencies view the payment of legal fees for officers and employees under investigation as a form of interference with the investigation, even though such a practice is mandated by the organization's bylaws or general corporate statutes. And finally, there are governmental pronouncements, in particular from the SEC, that in some cases the misconduct in question may be so egregious that the most severe form of punishment will be necessary, regardless of the cooperation provided by a company that is subject to investigation. Thus, a company must carefully conduct a legal "cost-benefit" analysis of its possible cooperation with the government.

While it remains to be seen how the SEC will use the Sarbanes-Oxley Act in future investigations and how other courts will interpret the freeze-order provision of the Act, the HealthSouth case is an early indication that the SEC intends to make full use of freeze orders and other enforcement tools provided under the Act. It is imperative that publicly-traded companies protect their interests in light of the SEC's new enforcement powers. Establishing internal procedures for identifying, investigating and solving problems when they arise is the key to protection. Having good policies in this arena is one thing; making them work, given Sarbanes-Oxley, is now a very, very large part of senior management's responsibility to itself and the shareholders. Proskauer's Corporate Governance/Corporate Defense Practice Group can assist you in evaluating how these issues apply to your particular business operations.

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