

ALERT

SEC Continues its Assault on Lawyers – This Time in Government Contracting for Failure to Disclose False Claims Act Liability

September 20, 2016

WHAT: The U.S. Securities and Exchange Commission (SEC) charged chemical company RPM International, Inc. (RPM), and RPM's General Counsel and Chief Compliance Officer Edward Moore with securities fraud for failing to disclose False Claims Act (FCA) liability in its public filings.

WHEN: The SEC filed charges on September 9, 2016.

WHAT DOES IT MEAN FOR INDUSTRY: The SEC's allegations provide three important takeaways for public companies doing business with the government, as well as their lawyers and boards. First and foremost, government investigations of any kind, but especially FCA investigations, need to be approached with a holistic view. This means addressing not only the underlying allegations but also having an appreciation of the corresponding disclosure obligations under the federal securities laws. Second, public company boards of directors need to make sure they are staying informed when the government investigates to assure any past company mistakes are not compounded by future missteps. Finally, where the SEC believes in-house counsel are impeding the compliance function, it will not hesitate to publicly accuse them of securities fraud, even without proof of intent to defraud.

OUR ANALYSIS:

On September 9, 2016, the SEC charged chemical company RPM, and Moore, with failing to disclose a material loss contingency in connection with a government investigation into violations of the

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federal FCA. Notably for lawyers working at publicly traded government contractors, these allegations are a frightening reminder that the SEC can and will charge in-house counsel with non-scienter based fraud under Section 17(a) of the Securities Act. In other words, the SEC will publicly accuse in-house counsel of fraud, and can prevail without proving that counsel intended to mislead investors.

The RPM case arises from an investigation by the U.S. Department of Justice (DOJ) centered on potential overcharging by one of RPM's subsidiaries, Tremco, Inc., on government contracts related to roofing materials. According to the complaint filed by the SEC, RPM and its general counsel knew it "faced a material loss that was probable and reasonably estimable, but RPM failed to disclose the loss contingency or record an accrual on its books when required to do so." These disclosure failures occurred in both required filings with the SEC and in securities offerings that incorporated those filings.

The DOJ investigation first started when a *qui tam* whistleblower filed a suit under the FCA in 2010. During the resulting DOJ inquiry, RPM sent estimates to DOJ stating that the overcharging was at least \$11.9 million – essentially setting a floor on the potential liability at around a third of RPM's quarterly net income. These estimates were raised to \$27-28 million over the course of the investigation and the related settlement negotiations. The FCA claims were ultimately settled by RPM in 2013 for \$61 million. The SEC has charged RPM with failing to disclose this potential liability on its annual and quarterly filings with the SEC even though it recognized a substantial payment to the government was likely. The SEC also charged RPM with failing to maintain adequate books and records and failing to devise and maintain an adequate system of internal accounting controls.

The SEC charged Moore with both securities fraud and causing RPM's books and records violations. As noted above, the SEC has chosen to bring the fraud allegations based on a much easier to prove negligence standard under Section 17(a) of the Securities Act, rather than the more common scienter based fraud under Section 10(b) of the Exchange Act. The SEC supports its fraud allegations by claiming that Moore knew of, but failed to keep the CEO, CFO, and Audit Committee reasonably informed about, the status of the investigation and the estimates regarding overcharging. The SEC also alleges that Moore made misrepresentations to RPM's outside auditors about the investigation. RPM has publicly disputed the charges, saying they "have no merit and are the product of prosecutorial overreach."

Regardless of the outcome, the SEC's complaint provides three important takeaways for public companies doing business with the government, as well as their lawyers and boards. First and foremost, government investigations of any kind, but especially FCA investigations with the potential of treble damages and a newly-inflation-adjusted civil penalty of \$11,000 to \$21,563 for each "false claim," need to be handled by experienced counsel who understand the collateral consequences of government investigations and settlements. Second, boards need to make sure they are staying informed and asking the right questions when the government is investigating. By the time RPM's Audit Committee engaged outside counsel for an independent investigation, the damage under the securities laws had already been done. Finally, lawyers for publicly traded government contractors need to know what they don't know, because even negligence can lead to securities fraud charges.