SEC Resolves Investigation with First Use of Non-Prosecution Agreement

The SEC recently announced that for the first time in its history, it had signed a company to a non-prosecution agreement rather than bringing an enforcement action. The company, Atlanta-based children's clothing giant Carter's, Inc. ("Carter's" or the "Company") had reported inflated net income for several quarters as a result of a multi-million dollar accounting fraud and insider trading scheme executed by a sales executive. While the Commission's six-count Complaint against the sales executive makes clear that it could also have brought an enforcement action against Carter's, the Company avoided this by detecting, investigating and reporting the fraud, and by taking extensive remedial measures, including disclosing the overstatement to the investing public and restating its income for the affected periods. The Carter's story demonstrates the importance, in the current regulatory environment, of responding promptly and responsibly to red flags, and proactively cooperating with authorities when serious employee misconduct is discovered.

I. The Elles Accounting Fraud Scheme

Until 2009, Joseph Elles was the Executive Vice President of Sales at Carter's, and based on the Company's numbers, he was successful. That year, Carter's reported sales of $1.59 billion, generating net income of $116 million. Carter's largest wholesale customer was Kohl's Corporation, the nationwide department store operator, whose account Elles handled personally.

The SEC alleged that by falsifying internal paperwork and lying to his colleagues, Elles was able to grant unauthorized discounts, or "accommodations," to Kohl's, and defer the recognition of the associated expenses, inflating Carter's net income by millions of dollars from 2004 to 2009.[1] The Complaint also alleges that Elles traded on the non-public information concerning the fraudulently overstated earnings, and realized profits of nearly $5 million from the exercise of employee stock options and sales of Carter's stock.

Managers became suspicious of Elles in 2007, when they questioned certain of his accommodations to Kohl's, and he lied. This resulted in an extensive internal investigation, culminating in the fall of 2009, when Carter's reported the accounting fraud to the SEC, and announced that it was delaying the issuance of its third-quarter results to complete an audit of its accommodations practices. Carter's later announced that it would have to restate its results for every quarter going back to September 2007. On the day of the initial announcement, Carter's stock fell nearly 24%.

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[1] According to the Complaint, it is standard practice among clothing manufacturers to provide certain customers with discounts, designed to help the customers increase their profit margins. In the industry, these discounts are called "accommodations," or, as they are termed in Carter's public filings, "customer margin support." As an accounting matter, an accommodation is of course an expense to the manufacturer, which reduces the net income realized by the related sales; they must be recognized in the same period as the associated revenue is recognized, so that the company's net income for that period reflects the accommodation. The Complaint alleges that Elles exceeded the amounts of accommodations he was authorized to grant to Kohl's, concealed the excess accommodations from the accounting department, and fraudulently caused the accounting department to defer recognition of accommodation expenses, inflating Carter's income for prior periods. *Securities and Exchange Commission v. Elles* (U.S. Dist Ct. N.D. Ga. Civ Action No. 1:10-CV-4118) available at http://www.sec.gov/litigation/complaints/2010/comp21784.pdf

While two of the counts in the SEC's Complaint against Elles involved aiding and abetting securities violations by Carter's itself, the SEC did not file a complaint against the Company. Rather, citing the Company's cooperation and self-reporting of Elles' misconduct, the Division of Enforcement permitted Carter's to enter into a non-prosecution agreement ("NPA"), pursuant to which the Commission would not bring an enforcement action against the Company in exchange for its continued cooperation and compliance with the NPA's other terms.[2]

The move was unprecedented for the SEC. While the Department of Justice and U.S. Attorney's Offices have routinely used non-prosecution agreements to secure the cooperation of entities and individuals in appropriate circumstances, the SEC had never done so in its approximately 77-year history. In its press release announcing the NPA and the charges against Elles, the Commission explained that the NPA "reflects the relatively isolated nature of the unlawful conduct, Carter's prompt and complete self-reporting of the misconduct to the SEC, its exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation, and Carter's extensive and substantial remedial actions."

II. The SEC's Cooperation Initiative

While the Carter's NPA was the SEC's first, the Commission had signaled its intention to consider such agreements nearly a year earlier, when it announced a new cooperation initiative. The initiative, announced in January 2010, established "incentives for individuals and companies to fully and truthfully assist with SEC investigations and enforcement actions," and provided "new tools to help investigators develop first-hand evidence to build the strongest possible cases." In part, the initiative authorized SEC Staff to use three "cooperation tools," not previously available in SEC enforcement matters, but which "have been regularly and successfully used by the Justice Department in its criminal investigations and prosecutions."

These new "cooperation tools," spelled out in the Division of Enforcement's 2010 Enforcement Manual, include cooperation agreements, deferred prosecution agreements, and non-prosecution agreements. In the criminal context, a non-prosecution agreement is generally viewed as the least onerous of the three types of cooperation-related agreements, since it does not require a company to be charged with an offense. The Enforcement Manual does not specify whether the other types of SEC agreements require an enforcement action, but it appears that the Commission intends the use of non-prosecution agreements to be rare. For example, the Manual states that non-prosecution agreements are inappropriate for repeat offenders "in virtually all cases," and that such agreements "should not be entered into in the early stages of an investigation," when a company's role in the misconduct and the importance of its cooperation are unclear. The Enforcement Manual also requires consideration of whether there are other means of obtaining a company's cooperation, such as a plea agreement with criminal authorities.

III. Evaluating a Company's Cooperation

How will the SEC determine whether to offer a company one of its "cooperation tools," and if so which one? The Enforcement Manual states that the Commission will continue to evaluate a company's cooperation, and "whether, and to what extent, it grants leniency to investigated companies," by considering the factors in the

[2] The NPA is available at www.sec.gov/litigation/cooperation/2010/carters1210.pdf
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Commission's 2001 "Seaboard Report."[3] As the Enforcement Manual notes, the Seaboard Report set forth "four broad measures of a company's cooperation":

- Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;
- Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely and effectively disclosing the misconduct to the public, to regulatory agencies, and to self-regulatory organizations;
- Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and
- Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.

IV. The Carter's NPA

The Seaboard Report factors clearly supported the Commission's decision to offer Carter's a non-prosecution agreement. As the Commission noted in announcing the NPA, Carter's self-reported Elles' misconduct "prompt[ly] and complete[ly]," cooperated in an "exemplary and extensive" manner, and undertook a "thorough and comprehensive internal investigation," followed by "substantial remedial actions." The latter is the likely explanation for the absence of a remedial obligation in the NPA, which is a standard provision according to the Enforcement Manual. In short, as the SEC's Director of Enforcement stated in announcing the NPA, while Elles did "the wrong thing," "Carter's did the right thing by promptly self-reporting the misconduct, taking thorough remedial action, and extensively cooperating with our investigation, for which it received the benefits of a non-prosecution agreement."

It was also significant to the Commission that Elles' misconduct was "isolated," something demonstrated by the fact that Elles had to lie repeatedly to colleagues and actively conceal his fraud in order to execute it. Clearly, the misconduct did not reflect a systemic problem or an inappropriate tone set by senior management.

The key terms of the Carter's NPA are:

- Carter's must provide "full, truthful and continuing cooperation" to the SEC, including:

[3] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Securities Exchange Act of 1934 Release No. 44969 (October 23, 2001) available at http://www.sec.gov/litigation/investreport/34-44969.htm

  - providing the Commission with all non-privileged documents and information the Division of Enforcement requests, "wherever located," if they are in the "possession, custody or control" of the Company; and
  - using the Company's "best efforts" to secure the cooperation of current and former directors, officers, employees and agents of the Company, including making such persons available for testimony and interviews.

- If the Company knowingly provides false or misleading information or documents in any proceeding or investigation, it would be a violation of the NPA, and could trigger a referral to criminal authorities.

- Carter's is prohibited from "denying, directly or indirectly, the factual basis" for the NPA, "except in legal proceedings to which the Commission is not a party." This last exception is significant, since without it, Carter's would have been hamstrung in defending itself in the now-pending shareholder litigation arising from the Company's income overstatements.

- To police its "gag" provisions, the NPA gives the Division of Enforcement the right to approve the text of any press release concerning the agreement.

- If the Division of Enforcement determines that Carter's breached the NPA, it will provide Carter's with the opportunity to make a Wells submission in response to that determination. The Division of Enforcement may then recommend an enforcement action "for any securities laws violations, including, but not limited to, the substantive offenses" that gave rise to the NPA. By the terms of the NPA, the making of such a determination is in the Division of Enforcement's "sole discretion and not subject to judicial review."

- To preserve its ability to bring an enforcement action in the event of a breach, the NPA provides for the tolling of the statute of limitations with respect to any such action. This is a standard provision in criminal non-prosecution, deferred prosecution and cooperation agreements used by the Department of Justice and U.S. Attorney's Offices.

- In any such enforcement action, any documents or statements provided by Carter's during its cooperation may be used against the Company. This provision is also standard in such agreements in the criminal context.

While Carter's is limited in its ability to deny wrongdoing, it is significant that the NPA does not require Carter's to make an admission of wrongdoing, or admit to a statement of facts detailing the misconduct, as is common in agreements of this type in the criminal context. Such admissions can be used against a company by criminal authorities or by private plaintiffs, neither of whom are bound by the NPA.

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Self-reporting and cooperation have long been high-percentage moves for a company in the criminal context. The United States Attorney's Manual's Principles of Federal Prosecution of Business Organizations, better known as the "Filip Memo," requires Federal prosecutors to consider "the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents" in deciding whether to bring criminal charges. The Filip Memo also requires consideration of a company's pre-existing compliance program, and its remedial actions.

The SEC's cooperation initiative emphasizes these same considerations, and the Carter's case highlights how effective such measures can be in minimizing the damage caused by employee misconduct in the regulatory and civil contexts. This is not to say that effective compliance programs and cooperation with authorities will avoid an enforcement action in every case. The SEC's Enforcement Manual makes clear that non-prosecution agreements will be offered only in exceptional circumstances, and Carter's certainly benefited -- in a manner of speaking -- from the fact that Elles was essentially a rogue employee, who actively concealed his misconduct and lied when confronted about it. But if there is a moral to the Carter's story, it is about the importance of vigilance both before and after the discovery of misconduct. Companies that police themselves effectively, and react swiftly and responsibly to indications of misconduct, will put themselves in the best possible position with respect to both criminal and regulatory authorities.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email David N. Kelley at 212.701.3050 or dkelley@cahill.com; Anirudh Bansal at 212.701.3207 or abansal@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

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