Legal Opinion Letter

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SEC ENFORCEMENT ACTION REFLECTS APPROACH ON MARKET "GATEKEEPERS"

by

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In a September 2004 speech, Stephen M. Cutler, the Director of the Enforcement Division of the Securities and Exchange Commission (SEC), stressed the importance of "gatekeepers" in maintaining fair and honest capital markets. He described the role that auditors, lawyers (in-house and outside), research analysts and independent directors play in preventing corporate wrongdoing and the need for greater personal accountability and deterrence in the corporate world.

Within days of Mr. Cutler's remarks, the SEC brought an enforcement action against the general counsel of a publicly-traded company that should make both in-house and outside counsel take notice. The SEC filed a complaint against John E. Isselmann, Jr., the former general counsel of Electro Scientific Industries, Inc. (ESI), a manufacturer of equipment for electronics and other high-tech manufacturers, seeking to recover civil penalties and to enjoin Mr. Isselmann from future securities law violations.

The facts alleged in the SEC's complaint are as follows:

- In August 2002, ESI's CFO and Controller developed a scheme to fraudulently inflate ESI's financial results. In one particular instance, the CFO and Controller reduced expenses and increased net income by $1 million by eliminating vested retirement and severance benefits for ESI's Asian employees. By doing so, ESI reported a profit for the quarter ended August 31, 2002 consistent with analyst's expectations rather than a loss.

- On September 17, 2002, Mr. Isselmann participated in an Audit Committee meeting during which ESI's CFO told the committee that legal counsel had approved the elimination of the benefits. Mr. Isselmann had not reviewed or approved the decision to eliminate the benefits and had not sought advice from outside legal counsel, yet he did not question the CFO's statements.

- Around the same time, Mr. Isselmann learned that ESI executives had provided the company's auditors with a memorandum stating that ESI was under no legal obligation to pay the retirement and severance benefits.

- On October 3, 2002, Mr. Isselmann asked ESI's legal counsel in Japan to advise him on the elimination of the retirement and severance benefits. Japanese counsel informed Mr. Isselmann that ESI could not unilaterally terminate the benefits without violating the law. Despite this opinion, Mr. Isselmann did not inform either the Audit Committee or the auditors.

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- On October 7, 2002, during a Disclosure Committee meeting, Mr. Isselmann attempted to raise the issue of elimination of the retirement and severance benefits for Asian employees. However, the CFO objected to discussing the issue and Mr. Isselmann backed down.

- Prior to filing of the quarterly report, an Audit Committee member questioned Mr. Isselmann once again about the elimination of the benefits. Mr. Isselmann did not inform the Audit Committee member of the contrary advice received from Japanese legal counsel and the quarterly report was then filed.

- In March 2003, after learning that the CFO and Controller had eliminated the retirement and severance benefits upon discovering an accounting error that negatively impacted earnings, Mr. Isselmann reported what he knew about the elimination of the benefits to ESI's outside legal counsel and Audit Committee.

- Following an internal investigation, ESI restated its financial results for the quarter ended August 31, 2002 from a net profit of $158,000 to a net loss of $3.4 million. Mr. Isselmann resigned from the company the same month.

What is significant in the SEC's charge against Mr. Isselmann is that, unlike in other SEC actions against lawyers who participated in or facilitated fraudulent activity, the SEC's complaint against Mr. Isselmann acknowledges that he "was not involved, present or consulted" when the alleged fraudulent activity took place. Rather, the SEC took issue with Mr. Isselmann's failure to question the CFO about his statements to the Audit Committee that the elimination of benefits had been approved by legal counsel and his failure to bring the contrary legal advice received from Japanese counsel to the attention of the Audit Committee, the Board of Directors and the auditors even though there was ample opportunity to do so. The SEC claims that this failure to act allowed the company's executives to conceal the ongoing fraud. Although Mr. Isselmann was not charged with criminal conduct, the SEC's enforcement action did result in a settlement in which Mr. Isselmann paid a $50,000 civil penalty and consented to an order enjoining him from future securities law violations. The Oregon State Bar also began an investigation, and Mr. Isselmann faces possible sanctions and/or disbarment.

Interestingly, the activity that is the subject of the SEC's charge against Mr. Isselmann occurred prior to the enactment of SEC Rule 205 relating to "up the ladder" reporting by legal counsel. The SEC charged Mr. Isselmann with violating Rule 13b2-2 under the Securities Exchange Act of 1934 which prohibits, among other things, officers and directors from omitting to state a material fact to accountants in connection with an audit or filing with the SEC. Rule 205 was adopted in accordance with the Sarbanes-Oxley Act of 2002 and requires a lawyer to report evidence of a material violation of law or a material breach of fiduciary duty by a company or an officer, director, employee or agent to the company's chief legal officer or the chief legal officer and chief executive officer. Unless the lawyer reasonably believes that such officer has responded appropriately within a reasonable time, the lawyer must report the evidence "up the ladder" to the audit committee, another committee of independent directors or the full board of directors.

The SEC's enforcement action against Mr. Isselmmann should be seen as a clear indication that the SEC is serious about holding auditors, attorneys, research analysts and independent directors personally responsible for failing to fulfill their gatekeeper responsibilities. The SEC has acknowledged the competing interests that lawyers often must balance and the extreme pressures that they face. Rule 205 makes clear that lawyers owe their professional and ethical duties to the company and not to the company's officers, directors or employees. Lawyers must take their role as gatekeepers seriously, and a company's board of directors should promote and encourage a corporate culture that ensures that the company's lawyers have overt, sufficient and consistent support in fulfilling this role.

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