

Case Study: SEC V. Koss

Law360, New York (February 08, 2012, 1:39 PM ET) -- While the United States District Court for the Eastern District of Wisconsin is hardly a hotbed of securities enforcement litigation, at least some eyes have been on U.S. District Judge Rudolph T. Randa lately as he considered a proposed settlement in the SEC v. Koss Corporation matter.

In a rare move, Judge Randa wrote the U.S. Securities and Exchange Commission on Dec. 20, 2011, asking questions about the proposed settlement. The Koss matter has drawn particular interest in light of the SEC's ongoing battles with New York District Court Judge Jed Rakoff in the pending SEC v. Citigroup case, which Judge Randa cited in his letter to the SEC. In the end, though, the Koss matter provided none of the sparks seen in the Citigroup case.

As background, on Oct. 24, 2011, the SEC simultaneously brought and settled charges against Koss Corp. and its CEO and former CFO, Michael J. Koss, relating to securities laws violation that allegedly allowed Sujata Sachdeva, Koss' former Principal Accounting Officer, Secretary and Vice-President of Finance, to embezzle approximately \$34 million from Koss from 2005 through 2009. In 2010, Ms. Sachdeva pled guilty to the underlying criminal charges and, in early 2011, she settled the SEC's fraud case against her.

In contrast to the claims against Sachdeva, the SEC's claims against Koss Corp. and Mr. Koss were not fraud claims. Rather, the SEC's complaint alleged that Koss Corporation and Mr. Koss failed to maintain adequate internal controls and books and records that would allow Koss Corp. prepare materially accurate financial statements. In the settlement, Koss Corp. and Mr. Koss consented to the entry of an injunctive order without admitted or denying the SEC's allegations. The proposed settlement would enjoin any future securities laws violations, and it required Mr. Koss to reimburse Koss \$242,419 in cash and an additional 160,000 options.

The parties submitted signed consents to the settlement and proposed final judgments, but Judge Randa did not "rubber stamp" the settlement. In his Dec. 20, 2011, letter, Judge Randa first focused on a perceived lack of specificity with respect to the injunctive relief relating to the defendants' compliance with the "books and records" and "internal controls" provisions of Section 13(b) of the Securities Exchange Act.

He wanted greater detail regarding the "reporting, oversight, and/or auditing" of the changes the defendants would make to allow for implementation and potential enforcement of the injunction. In addition, Judge Randa questioned the proposed judgments' "incorporation" of the defendants' consents, stating that procedural rules required that the injunctive relief agreed upon should be expressly stated in the final judgments.

The second substantive issue raised in Judge Randa's letter concerned the adequacy of Mr. Koss' proposed disgorgement. Absent any "factual predicate" for the disgorgement figures, Judge Randa said he could not assess the disgorgement's appropriateness. Accordingly, he requested more information about how the terms were determined and what additional disgorgement may have been available.

The SEC's Jan. 24, 2012, response sought to assure Judge Randa that the proposed settlement was "fair, reasonable, adequate, and in the public interest," while at the same time noting a disagreement with Judge Rakoff as to whether a reviewing court must find that such a settlement, in fact, is "in the public interest." The SEC then described that Koss Corp. and Mr. Koss already had taken substantial remedial measures, including restructuring Koss Corp.'s accounting function, segregating certain accounting duties, updating computerized accounting systems, strengthening its Board of Directors, and changing the company's auditors.

With this background, the SEC asserted that the parties had satisfied the statutory language of the "books and records" and "internal controls" provisions, which the SEC said was "well-tailored" to prescribe what a company must do to comply. With respect to the description of the injunctive relief in the proposed judgments, the SEC said it was willing to include the consent provisions in the final judgments.

With respect to the adequacy of Mr. Koss' agreement to repay money and return options, the SEC noted the settlement, in fact, did not call for "disgorgement" but rather required reimbursement pursuant to Section 304(a) of the Sarbanes-Oxley Act of 2002 because Mr. Koss was an executive officer during the period for which Koss Corp. restated its financial results due to misconduct.

This distinction was important, the SEC said, because Mr. Koss' payment was a statutory remedy that differed from the equitable remedy of disgorgement, which is meant to deprive wrongdoers of unjust enrichment and deter other violations. The SEC described its reimbursement calculation and asserted that the remedy was sufficient, particularly since Mr. Koss likely had been harmed as a result of the misconduct at issue.

On Feb. 1, 2012, Judge Randa sent the SEC a letter indicating that the SEC's response "largely satisfies the Court's concerns." The court accepted the SEC's willingness to submit revised final judgments that would include the consent provisions regarding injunctive relief. The court instructed the SEC to file those revised judgments by Feb. 16, 2012, for final approval.

Judge Randa's inquiry in the Koss case has drawn attention because he cited Judge Rakoff's widely publicized rejection of the proposed settlement in the SEC v. Citigroup case, which the SEC has since appealed to the Second Circuit Court of Appeals. Judge Randa's concerns, however, were not the same as those expressed by Judge Rakoff, and the somewhat anticlimactic result in the Koss case bears this out.

While Judge Rakoff fundamentally questioned the SEC's policy of allowing defendants to settle fraud charges "without admitting or denying" those charges, Judge Randa did not challenge similar language in the proposed Koss settlement. Rather, Judge Randa sought additional information to allow him to assess the appropriateness of the substantive provisions of the settlement. In addition, he sought revisions to the proposed judgments due to what he viewed as a procedural requirement to properly impose injunctive relief.

In fact, Judge Randa noted in his Dec. 20, 2011, letter to the SEC that he had earlier in 2011 approved the SEC's settlement and consent judgment relating to the now-incarcerated Ms. Sachdeva — a consent judgment that included the controversial “without admitting or denying” provision. That settlement would not be possible today, however, because the SEC announced on Jan. 6, 2012, that a defendant in an SEC settlement who had been convicted of a crime based on the same conduct would no longer be allowed to settle the matter “without admitting or denying” the SEC's charges.

This change would not affect the Koss settlement, of course, because neither defendant has been charged with (much less convicted of) a crime. The change likely will be of little practical effect because most defendants already convicted of criminal violations likely would see little downside in admitting the SEC's alleged violations in a civil case.

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