

# Client Update

## Failure to Comply with Internal Corporate Processes and Policies May Violate Exchange Act Accounting Provisions

### NEW YORK

Matthew E. Kaplan  
mekaplan@debevoise.com

Alan H. Paley  
ahpaley@debevoise.com

### WASHINGTON, D.C.

Paul R. Berger  
prberger@debevoise.com

Colby A. Smith  
casmith@debevoise.com

Jonathan R. Tuttle  
jrtuttle@debevoise.com

Ada Fernandez Johnson  
afjohnson@debevoise.com

In a novel application of the books and records and internal controls provisions of the Securities Exchange Act of 1934, on December 2, 2016, the Securities and Exchange Commission issued a Cease and Desist Order against United Continental as a result of the approval of a new route by the then CEO outside normal internal processes and policies.<sup>1</sup> Given the historic lack of clarity surrounding these accounting provisions added by the Foreign Corrupt Practice Act, the SEC's settlement with United suggests the SEC may seek to expand the use of these provisions in circumstances where it believes there has been improper corporate behavior but does not have another clear statutory violation.

### BACKGROUND

The SEC Order asserts that, although Continental Airlines terminated a direct flight route from Newark to Columbia prior to its merger with United due to its unprofitability, the former CEO of United, Jeff Smisek, approved the reinitiation of this route under pressure from David Samson, then Chairman of the Board of Commissions of the Port Authority of New York and New Jersey, outside of normal internal processes and policies. Samson had lobbied for a more direct flight from Newark to his home in the South Carolina town since early 2011, after he was appointed Chairman of the Port Authority. According to the Order, despite a preliminary financial analysis predicting losses from the Newark-Columbia route and a managing director's advice against it, United's CEO authorized the route after the Port Authority removed voting on leasing three acres of Newark Liberty International Airport land to United from the Port Authority's November 2011 board meeting agenda and appeared prepared to remove it again from the December 2011 agenda. Securing this three-acre plot

<sup>1</sup> See *In the Matter of United Cont'l Holdings, Inc.*, Exchange Act Release No. 79454, 2016 WL 7032725 (Dec. 2, 2016).

lease was crucial for United, which stood to gain an estimated \$47.5 million per year in value from the hangar it planned to construct on the land. The lease for the hangar was approved by the Port Authority the same day United's CEO approved the Newark-Columbia route. The route, which resulted in a loss of approximately \$945,000 to United Continental, was terminated shortly after Samson's resignation in 2014. Samson subsequently pled guilty to bribery charges brought by the U.S. Attorney's office. Smisek resigned from United in 2015, along with two other senior officers at the company, pursuant to an internal investigation.

### THE SEC CEASE AND DESIST ORDER

In the Cease and Desist Order, the SEC found that the CEO's actions violated the Exchange Act accounting provisions, Sections 13(b)(2)(A) and 13(b)(2)(B). Section 13(b)(2)(A) requires that covered issuers keep books, records and accounts that accurately, fairly and in "reasonable detail" reflect the issuer's transactions and dispositions of assets. The term "records" has been interpreted to reach beyond mere financial statements, instead encompassing "virtually any tangible embodiment of information made or kept by an issuer."<sup>2</sup> Section 13(b)(2)(B) mandates that covered issuers maintain a system of internal accounting controls that gives "reasonable assurances" of the following: (i) transactions are carried out in accordance with management's authorization; (ii) the recording of transactions enables both financial statements compliant with generally accepted accounting principles (GAAP) or other applicable criteria and maintenance of asset accountability; (iii) assets can only be accessed in accordance with management authorization; and (iv) regular comparisons between recorded asset accountability and existing assets are made, with appropriate action in case differences are found. The ambiguity of the terms and breadth of the statutory requirement ultimately enable the SEC to adopt broad, hindsight-based interpretations of what levels of detail and assurance it believes would have been reasonable in any particular case.

In this case, the most significant factors in the SEC's evaluation appear to have been the process followed by the company and its management in approving the new route and the alleged improper purpose associated with it. According to the Order, United had no written policy for initiating new flight routes, perhaps bolstering the CEO's belief that his managerial approval sufficed at a time when a much higher value project was at risk. In the absence of a formalized policy, however, the SEC looked to the company's standard practices and discovered that these were not followed. United allegedly neglected to obtain Network

---

<sup>2</sup> See *SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 748-49 (N.D. GA 1983).

Planning Group and Chief Revenue Officer approval for the route, nor did the route undergo several senior United executives' review at a standard marketing meeting. The SEC also found that United's Code of Business Conduct prohibited taking this loss-inducing action to influence decision making by government officials or civil servants, and that the CEO did not apply for a waiver required to disregard the Code in United's best interest. The SEC interpreted consistency with these policies to be part of the Section 13(b)(2)(B) requirement of a system of controls allowing transactions only in accordance with management authorization. Moreover, the SEC concluded that Section 13(b)(2)(A) was violated because there was no written request for a waiver of the Code to the Ethics and Compliance Director or the Board of Directors, so that the route's authorization was not reflected accurately, fairly and in reasonable detail in company records. The SEC's Order makes no assertion that United's financial statements were materially inaccurate as a result of the alleged conduct.

#### IMPLICATIONS FOR PUBLIC ISSUERS

- To comply with the Exchange Act accounting provisions, internal accounting controls must not only ensure managerial approval of transactions but also maximize the ability to prevent management decisions that fall outside standard business practices and potentially violate internal ethical policies.
- Despite the potential commercial benefits of flexible, unwritten transaction and asset disposition approval practices, issuers should be on the lookout for risks associated with potential management actions outside of standard channels and consider greater formalization of such practices, such as written policies requiring clear internal procedures and strict compliance, absent delineated circumstances.
- Companies must be vigilant in creating written documentation of compliance with various internal policies in light of the SEC's willingness to extend Exchange Act books and records violations to records significantly removed from financial statements or associated disclosures.
- Although not implicated by this case, companies should also ensure that procedures are implemented and actions documented for transactions/events that require expedited action.

\* \* \*

Please do not hesitate to contact us with any questions.