SIMPSON THACHER MEMORANDUM

In Vacating the Conviction of Network Associates' Former CFO, the Ninth Circuit Reminds Prosecutors That Accounting Fraud Prosecutions Carry A High Evidentiary Burden

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In a decision last week that will come as welcome news to corporate executives involved in a company's accounting functions, the U.S. Court of Appeals for the Ninth Circuit held that federal prosecutors who charge accounting fraud must prove willful and knowing deception on the part of the defendant – and not merely that the defendant wanted to maximize company performance or had knowledge of accounting rules. In *United States v. Goyal*, No. 08-10436, 2010 WL 5028896 (9th Cir. Dec. 10, 2010), the Ninth Circuit reversed the conviction of Prabhat Goyal, the former CFO of Network Associates, Inc., who had been charged with securities fraud, making false filings with the SEC, and making false statements to auditors. Holding that no reasonable juror could have convicted Goyal based on the evidence presented at trial, the court did not merely vacate the conviction on all fifteen counts. It also took the somewhat unusual step of terminating the prosecution by ordering the district court to enter a judgment of acquittal.

At issue was the accounting method used by Network Associates, Inc. ("NAI") to recognize revenue from certain sales. The government alleged that NAI overstated its revenue by improperly recognizing revenue sooner than GAAP permitted it to do. Goyal was charged with filing reports with the SEC that misstated NAI's revenue and with concealing information about this accounting practice from NAI's auditor PricewaterhouseCoopers ("PwC").

The Ninth Circuit first addressed the government's claim that NAI, under Goyal's supervision, filed reports with the SEC that materially misstated its revenue. In vacating the charges based on this allegation, the court held that the evidence was insufficient to prove that the alleged violations of GAAP "materially affected the revenue that NAI reported."

In what is perhaps the more significant aspect of the opinion, the court then turned to the government's claim that Goyal lied in management representation letters to NAI's auditor PwC. Although it agreed that a reasonable juror could have found that some of Goyal's statements to PwC were materially false, the court ruled that the government had failed to establish that Goyal "willfully and knowingly misled PwC." In fact, the court held that "[t]he government[] fail[ed] to offer any evidence supporting even an inference of willful and knowing deception." In the court's words, "Goyal's desire to meet NAI's revenue targets, and his knowledge of and participation in deals to help make that happen, is simply evidence of Goyal's doing his job diligently." In language that has wide applicability to corporate fraud prosecutions in general, the court further held that "[i]f simply understanding accounting rules or optimizing a company's performance were enough to establish scienter, then any action by a

company's chief financial officer that a juror could conclude in hindsight was false or misleading could subject him to fraud liability without regard to intent to deceive. That cannot be."

Finally, the court refused to sustain Goyal's conviction for lying to PwC simply because the management representation letters that he signed imposed an affirmative duty on him to disclose certain information that was omitted. The Ninth Circuit ruled that this theory of liability "makes a strict-liability crime out of one that requires willful and knowing deception."

In a biting concurrence, Judge Kozinski warned prosecutors about attempting to criminalize corporate wrongdoing by applying criminal laws where civil laws are more clearly appropriate. Judge Kozinski wrote: "When prosecutors have to stretch the law or the evidence to secure a conviction, as they did here, it can hardly be said that such moral judgment is warranted." Pointing to a number of cases – including *Arthur Andersen LLP v. United States*, 544 U.S. 696, 705-08 (2005) (holding that jury instructions issued at the government's request "simply failed to convey the requisite consciousness of wrongdoing" for an obstruction of justice charge), *United States v. Reyes*, 577 F.3d 1069, 1078 (9th Cir. 2009) (ordering a new trial because "the prosecution argued to the jury material facts that the prosecution knew were false, or at the very least had strong reason to doubt"), *United States v. Brown*, 459 F.3d 509, 523-25 (5th Cir. 2006) (holding that "the Government had failed to support its charges against [the defendant] with sufficient evidence of guilty knowledge"), *United States v. Moore*, 612 F.3d 698, 703 (D.C. Cir. 2010) (Kavanaugh, J. concurring) (noting that "[p]roper application of statutory mens rea requirements and background mens rea principles can mitigate the risk of abuse and unfair lack of notice in prosecutions under [the federal false statements statute] and other regulatory statutes") – Judge Kozinski wrote that the Goyal prosecution was "just one of a string of recent cases in which courts have found that federal prosecutors overreached by trying to stretch criminal law beyond its proper bounds." Judge Kozinski concluded by expressing hope "that the government will be more cautious in the future."

The *Goyal* decision is significant both because of its holding about the required proof of a defendant's mental state in accounting fraud prosecutions and the court's refusal to give prosecutors a second chance in a re-trial to carry their burden with additional evidence of the defendant's state of mind. The decision stands as a stark reminder of the discretion prosecutors must exercise in deciding whether to pursue criminal accounting fraud charges, and the importance of restricting such charges to cases involving sufficient evidence of willful misconduct.

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017-3954
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000