

TOP DEFENSE VERDICTS

Securities and Exchange Commission v. Malmstedt

When the smoke cleared from software company Legato System Inc.'s 1999 securities fraud disaster, the fingers of disgruntled company executives, stockholders and Securities and Exchange Commission lawyers pointed directly at the company's former head of worldwide sales, David Malmstedt.

The case from the SEC's perspective looked cut and dry, but Malmstedt's lawyer, Phillip Eskenazi of Akin Gump Strauss Hauer & Feld's Century City office, set out to prove his client did not know about or authorize the sales and accounting trickery that eventually caused the company's stock to plummet.

Eskenazi was successful, with a San Jose jury unanimously finding Malmstedt not liable on six claims of violating the Exchange Act and aiding and abetting fraud. *Securities and Exchange Commission v. Malmstedt*, C 02-2427 JW (N.D. Cal. June 13, 2004).

It was the first time a civil financial fraud case was brought against a sales executive in the state of California without a parallel criminal proceeding and the only case the SEC lost in the state in 2004, according to Eskenazi.

"I think this ruling shows that the SEC — especially in the wake of Enron and the Martha Stewart scandal - can be overzealous," he says. "They made calculations in this case that Malmstedt did something wrong, and they were going to make an example of him. Most people settle with the SEC because the consequences of losing are just too great, but they can be beaten. They're not infallible."

SEC senior counsel Kevin Gross says he has no comment on the outcome, except that the agency remains undeterred by the result. The SEC, which did not obtain outside counsel on the matter, did not appeal the verdict.

"We are disappointed," he says. "But we respect the jury's verdict and the staff will continue to investigate and pursue cases where financial fraud has occurred at a company."

Gross alleged that Malmstedt, 48, and Mark Huetteman, former Legato vice president for North American sales, made side arrangements allowing resellers of Legato software to return any goods they couldn't find buyers for, and hid the tentative nature of those sales from the



Photo by Hugh Williams

"Most people settle with the SEC because the consequences of losing are just too great, but they can be beaten. They're not infallible," says Phillip Eskenazi of Akin Gump Strauss Hauer & Feld, who won the only defense verdict against the Securities and Exchange Commission in the state last year.

company's finance department. That led Mountain View-based Legato to improperly record the transactions as revenue, which in turn led to an artificially inflated stock price.

Legato disclosed the side arrangements publicly in April 2000 — shortly after firing Malmstedt for failing to raise overall sales. The company one month later restated its financial results for 1999, admitting it had overstated its income by \$12.3 million. The SEC found that the fraud inflated Legato's stock price by just under \$30 a share to a little more than \$80 a share in the second-half of 1999.

In the largest of the alleged frauds, Malmstedt was accused of orchestrating a side arrangement between Legato and Logicon Advanced Technology, a reseller specializing in large software sales to the U.S. Air Force.

To secure the \$7 million deal, the SEC alleged that Malmstedt told Huetteman to provide Logicon with a side letter offering the company the right to cancel the transaction if needed.

The side letters were not by themselves illegal.

But SEC lawyers alleged that Huetteman and Malmstedt kept Legato's finance department in the dark about the side letter, causing it to treat the contract as a normal purchase order and record the transaction as revenue.

As proof, SEC lawyers submitted a side letter, e-mailed from Huetteman to Vince Steckler at Logicon and copied to Malmstedt, as showing an intent to deceive, which was required to find Malmstedt guilty of fraud.

But Eskenazi showed that Malmstedt received hundreds of e-mails on a daily basis and most likely wouldn't have read the Logicon e-mail, which was written to someone else and dealt with a subject he was not directly responsible for. He also showed the jury e-mails written by Malmstedt telling his subordinates that the sales force should not be offering similar side arrangements.

"It didn't add up," Eskenazi says.

— Geneva Whitmarsh