re:The Auditors

A China Fraud Dissected: Part 1 Milton Webster, AgFeed Audit Committee Member and Whistleblower

By Francine • Feb 26th, 2014 • Category: Latest, Pure Content, The Big 4 And Globalization

Lawrence Blitz v. AgFeed Industries, Inc., Goldman Kurland & Mohidin LLP, McGladrey & Pullen LLP, et al is a securities fraud class action where investors claim the company's expansion was "fueled in large part by fraud." AgFeed began in the 1990's as a Chinese manufacturer of animal nutrition products. It grew rapidly by expanding sales for its animal nutrition operations through hundreds of independent dealers, and by acquiring dozens of independent Chinese hog farms in 2007 and 2008 to enter the hog breeding and production business.

Until 2010, all of AgFeed's operations were in China. In September 2010 it acquired M2P2, LLC a large United States hog producer in Tennessee. AgFeed was listed on NASDAQ in 2007 as the result of a reverse merger transaction. The lawsuit covers the period from March 16, 2009 through and including September 29, 2011.

The company's fraudulent strategy, referred to by company executives in emails as "enlarging by faking", involved overstating asset values in the Chinese hog farms it purchased, overstating accounts receivable in its animal feed division, reducing its allowance for doubtful accounts to a minimum even when business conditions indicated customers were less likely to pay, and misrepresenting the value of equipment, inventory and cost of goods sold in its legacy hog business in its financial statements which were filed with the SEC.

An excellent, long read by Dune Lawrence at Bloomberg last December describes how the fraud was discovered and why the company eventually delisted its own common stock from NASDAQ to avoid a mandatory delisting by the exchange. In July of 2013, the company filed for Chapter 11 bankruptcy. Lawrence's story provides the background you'll need to appreciate what I'm going to talk about next.

There are four aspects of the AgFeed story that have not been written about in much detail. I will talk more about them in a series of posts.

Milton Webster, an AgFeed whistleblower, was a member of the company's board of directors, an Audit Committee member, who says he saw problems with the company's accounting almost immediately after joining the board on February 24, 2011. He subsequently resigned on February 14, 2012. It is highly unusual for a board member, especially an Audit Committee member, to be a fraud whistleblower in a public company.

Goldman Parks Kurland Mohidin LLP (Goldman) is the CPA firm that provided accounting services to AgFeed from at least 2007 to November 2010. McGladrey & Pullen LLP (McGladrey) replaced Goldman as AgFeed's independent auditor in November 2010 and continued in that capacity through the end of the period that is subject to the litigation. Both firms are registered with the PCAOB, have been inspected and continue to produce audit opinions for public issuers. Two China-based audit firms that supported Goldman and derive the majority of their revenue from Goldman are also registered with the PCAOB and have never been inspected given China's prohibitions on physical inspections of Chinese audit firms by US regulators. Both firms continue to support Goldman.

Protiviti, a division of Robert Half Int'l, provided support to AgFeed's management in assessing its internal controls over financial reporting as required by Sarbanes-Oxley. Protiviti is a creditor of AgFeed in bankruptcy and is being evaluated as a potential additional defendant in the bankruptcy proceedings by the the debtor and equity committee for Protiviti's apparent failure to catch the fraud.

Once trouble started, law firm Latham and Watkins pitched itself to represent the company, directors, and executives in the securities and derivative litigation. L&W continues to serve in that capacity (except the derivative which was wiped out by the bankruptcy) and also serves as special counsel to the company in bankruptcy. The firm was eventually hired as counsel to the special investigative committee to address the various fraud allegations such as a second set of financial records, inflated asset valuations and undisclosed related-party transactions. Too many roles and, perhaps, too many conflicts of interest…

I'm going to start with the story of Milton Webster.

Milton Webster: Whistleblower

Why don't directors blow the whistle on fraud more often? Tom Gorman, a former SEC official and now a partner at law firm Dorsey told me, "I suspect that is because they typically have the authority and the position to do something about the issue. In contrast the typical whistleblower does not and not infrequently gets fired when trying to raise the issue."

AgFeed Audit Committee member Milton Webster will never see his day in court. He passed away unexpectedly last December. But before he died he gave documents and testimony to the SEC to aid its investigation of AgFeed and its executives and also gave a deposition in the class action lawsuit. Since the lawyers for McGladrey, Keker & Van Nest, didn't show up for Webster's deposition, they will never get a chance to question him.

> Question from plaintiffs' attorney Joshua Silverman: While you served on the Board of Directors of AgFeed, did you also serve on any committees?
>
> > Answer from Webster: Well, I was the Chairman of a Special Committee that was formed to investigate certain allegations of impropriety within the organization. And I was also, for the record, supposedly a member of the Audit Committee and perhaps the Nominating or Compensation

> Committee, but, in fact, there was never an Audit Committee meeting. And when I tried to assert my rights as a member of the Audit Committee, I was rebuffed and treated as if I was not a member of the Audit Committee.

Question from Michael Bowen from Foley & Lardner, attorney for one of the AgFeed executives, Gerald Daignault: Were you satisfied with the effort the committee made to complete that investigation?

> Answer from Webster: I was satisfied with the work that was done pursuant to the scope of the engagement as defined. I was not comfortable at the end with the limitations and scope that had been imposed upon the committee by management and their law firm, Stevens & Lee.

Question from Bowen: What limitations in scope were imposed upon the committee?

> Answer from Webster: I don't have the document in front of me, but in preparing the scope document, which I prepared, you know, with the cooperation of Mayer Brown, it was a bit broader at the end of the day as it was authorized.

Question from Bowen: Okay. So if I understand your answer correctly, you had proposed a scope of work document to management and the charter that the committee was eventually given was somewhat narrower than the scope of work document you had proposed; is that correct?

> Answer from Webster: That's correct.

Question from Bowen: Were you dissatisfied with that narrowing at the beginning of the committee's work?

> Answer from Webster: I was dissatisfied with it, but it was something that I could live with, given the urgency of the, you know, the immediacy of the issues that needed to be investigated.

Question from Bowen: Okay. Are you telling me, Mr. Webster, that this report was not reduced to writing at any point?

> Answer from Webster: Well, there were many thousands of pages of documentation, but the final report, no, it was not reduced. The Board's report was not reduced to writing. It was a verbal report presented by Latham & Watkins, and I believe FTI was present, a representative was present, via teleconference and then in person both in Chicago and in New York.

According to the complaint, on January 2, 2012 special committee chairman Webster sent an email to Latham & Watkins urging the publication of the committee's report. The AgFeed directors and executives rejected his suggestion apparently, according to the complaint, "because of the advice of Latham & Watkins that telling the truth would hurt the defendants in this litigation."

Webster testified at deposition:

> At that point in time, I think Latham was somewhat conflicted in that they represented both the company and the company and — they represented the Special Committee, who's conducting the investigation, and also the company and officers and directors as defendants in actions that could, in theory, have been brought by the company against those officers and directors. So, you know, [Latham & Watkins' Michelle Rose] concerns were that the Special Committee knew the truth that perhaps was not in the interest of the defendant to have out there if they were trying to protect themselves.

Webster resigned on February 14, 2012. (Gothner was Webster's personal friend who had recruited him as a director.) From Webster's deposition:

Question from Bowen: Can you describe the circumstances leading to that departure?

> Answer from Webster: Gothner had been elected as Chairman and Chief Executive Officer I believe it was in December in a vote of 3 to 1. I was the one vote against him. I had no confidence in the management as led by Van Gothner to manage the company in the best interest of the shareholders. It was very clear that it was going to be a very adversarial situation. It was clear that the Board of Directors, as Gothner was attempting to reconstitute it would not release the report of the Special Committee to the public. And the problems the company was facing at that time with dissident shareholders and the SEC in my estimation was only going to grow. And, as they say, it was time to get out of Dodge.

Joshua Silverman, an attorney for the plaintiffs at Pomerantz LLP here in Chicago describes the challenge Webster faced:

> When Mr. Webster saw what the company's executives were doing, he refused to play ball. Instead, he fought relentlessly for the company to come clean with its shareholders. Webster's courage and independence should be held out as a model for other outside directors of public companies.

A former SEC official who is now an attorney in private practice told me that, unfortunately, there's little guidance for directors about what to do when faced with fraud or illegal acts. The guidance that does exist won't help much, either.

For example, in 1997 the SEC criticized the directors of W.R. Grace & Co in a "21(a) report" for "failing to take steps …to ensure full and proper disclosure." The SEC said W.R. Grace & Co. violated securities laws, according to a whitepaper prepared by law firm Jones Day, "because proxy statements and periodic reports did not fully disclose the substantial retirement benefits of the company's CEO. Although W.R. Grace's directors were informed of the CEO's retirement benefits, they took no action to correct the misleading disclosures. The SEC found that the directors' reliance on the company's disclosure process, although not bad faith, was insufficient to adequately discharge their duties. Again, the SEC did not sue the directors but repeated that directors who know or should know that a company's public statement is inadequate or incomplete must take steps to correct the failure."

The SEC's admonishment to W.R. Grace, while somewhat general, does bear repeating:

> Serving as an officer or director of a public company is a privilege which carries with it substantial obligations. If an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure. An officer or director may rely upon the company's procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues.

On the one hand, directors are famously worried about legal liability. In practice, directors are rarely sued successfully and, when they are, their out-of-pocket cost is slim or none. According to Stanford University's David Larcker and Brian Tayan in their book *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*, that's because directors are either indemnified by the company or covered by directors' and officers' insurance (D&O insurance) purchased by the company on their behalf.

On the other hand, ethical directors want to protect shareholders and the markets but risk being ostracized by the same network that got them the gig if they blow the whistle on those buddies. Michael Woodford, the CEO who blew the whistle on the Olympus fraud, may have been right but he's on the speaker's circuit not in another CEO job. Jonathan Weil of Bloomberg wrote back in November about G. Allen Andreas III, a 43-year-old investment manager in New York who noisily resigned last September from the board of tanker-fleet operator Overseas Shipholding Group Inc.

> The extraordinary part is how he went out, along with the events that followed. With one simple act, after eight years on the company's board and audit committee, Andreas blew the whistle on an accounting debacle that might sink the company.

Andreas has a distinct advantage as a whistleblower. He's super rich. His father, G. Allen Andreas Jr., is the former chairman and CEO of agribusiness giant Archer-Daniels-Midland Co. He's a lawyer by training, and president of Galaco Capital, a private investment firm that manages his family's money.

(I often tell accounting students that the only people who can afford to be ethical are the super rich and the very poor. The super rich are beholden to no one and the poor have nothing to lose.)

The new Chief Justice of the Delaware Supreme Court, the handsome and forthright Leo Strine, recently gave a stern warning to those who would serve as directors outside their cultural or language comfort zone. Those remarks were made during a hearing related to another Chinese fraud case, Puda Coal:

> If you're going to have a company domiciled for purposes of its relations with investors in Delaware and the assets and operations of the company are situated in China that, in order for you to meet your obligation of good faith, you better have your physical body in China an awful lot. You better have in place a system of controls to make sure that you know that you actually own the assets. You better have the language skills to navigate the environment in which the company is operating. You better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company…

Kevin LaCroix at D&O Diary further quotes Strine on whether "getting out of Dodge" is a good plan of action when a director suspects fraud:

> As if that were not enough, Chancellor Strine also had words about the independent directors' decisions to resign. As he said, "there are some circumstances in which running away does not immunize you. In fact it involves a breach of fiduciary duty." He added that "if these directors are going to eventually testify that that the time that they quit they believed that the chief executive officer of the company had stolen assets out from under the company, and they did not cause the company to sue or do anything, but they simply quit, I'm not sure that that's a decision that itself is not a breach of fiduciary duty."

A veteran China companies director brought another case of director gumption to my attention. In June of 2011 the independent audit committee members of Jiangbo Pharmaceuticals, Michael Marks and John Wang, resigned and memorialized a list of concerns in a long letter to the rest of the board. They claimed they were being blocked from conducting a thorough independent investigation in response to a subpoena from the SEC.

The SEC rarely brings an enforcement action against independent directors. But that may change given these recent cases, the agency's renewed emphasis on accounting fraud and the SEC's "Operation Broken Gate" initiative targeting lapses by gatekeepers. Directors who fail to investigate "red flags" in good faith and who fail to act ethically when faced with fraud and illegal acts risk finding themselves behind the eight ball or, worse, behind bars.

Part 2 will discuss the role of the two AgFeed auditors, Goldman Parks Kurland Mohidin LLP and McGladrey & Pullen LLP. Stay tuned.

Francine is
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3 Responses »

1. *Tyler* on February 28th, 2014 at 12:14 pm:

   In our Capstone class in the Auburn MAcc program, we have extensively discussed whistleblowing, and continue to. I guess this might be standard to curricula these days. This case is so interesting. I've never considered a director to be the one blowing the whistle.

   And, "the only people who can afford to be ethical are the super rich and the very poor" is a good way to condense what I think the consensus of our class has been.

2. *Francis Pileggi* on March 4th, 2014 at 1:13 am:

   Thanks for your insightful analysis

3. *Francine* on March 4th, 2014 at 8:30 am:

   @Francis Pileggi

   Thanks so much!

   Francine

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- **About the author**


Francine McKenna (@retheauditors) is the Transparency Reporter at MarketWatch.com, a Dow Jones publication, where her work is also featured frequently in the Wall Street Journal. McKenna had more than twenty-five years of experience in consulting and professional services including tenure at two Big 4 firms, both in the US and abroad before becoming a journalist. Look for her prior columns, "Accounting Watchdog" at Forbes.com and "Accountable" at American Banker. For more information, click "About" at the bottom of this page. For more information contact Francine McKenna, fmckenna@mckennapartners.com

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