

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of)

GEORGE W. PHILLIPS)

) INITIAL DECISION
)

APPEARANCES: Catherine S. Croisant and Emlee Hillard Smith for
the Securities and Exchange Commission, Division of
Enforcement, Boston District Office.

James S. Dittmar, Frank C. Huntington, and Karen M.
O'Tool for George W. Phillips

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

The Securities and Exchange Commission (Commission) initiated this proceeding on September 8, 1993, pursuant to Section 21C of the Securities Exchange Act of 1934 (Exchange Act). The Commission's Division of Enforcement (Division) recommends that the Commission issue a cease and desist order to Mr. Phillips based on allegations that he violated and that he caused violations of the Exchange Act and Exchange Act rules.

The Order Instituting Proceedings alleges that in 1988 George W. Phillips (Mr. Phillips):

(1) violated Commission Rule 13b2-1, issued pursuant to Section 13b of the Exchange Act,

(2) that he caused Shearson Lehman Brothers Holdings, Inc. (Shearson Holdings) and Shearson Lehman Brothers, Inc. (Shearson, Inc.) 1/ to violate Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 13a-13 and 12b-20, and

(3) that he caused two officers of The Boston Company (TBC), the President and the Vice President and Chief Financial Officer, to violate Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

I concluded five days of hearing in Boston on December 6, 1993. The record consists of approximately 80 exhibits and

1/ Shearson Loeb Rhodes acquired Lehman Brothers between 1983 and 1988 (Respondent's Proposed Findings, 2). In 1988, Shearson Holdings and Shearson Inc. were known as Shearson Lehman Hutton Holdings, Inc. and Shearson Lehman Hutton, Inc., respectively. My references to Shearson will include both firms.

testimony from 14 witnesses on 1,067 pages of transcript. 2/ Several exhibits received confidential treatment at the request of counsel for Shearson and TBC. The parties each filed Proposed Findings of Fact and Conclusions of Law and Supporting Briefs. The last brief was filed on March 21, 1994.

FINDINGS

My conclusions are based on the record and my observations of the witnesses' demeanor. I applied preponderance of the evidence as the applicable standard of proof.

Shearson's Filings and Books and Records in 1988

In 1988 Shearson Inc. was wholly owned by Shearson Holdings. Shearson Inc. was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act, and it had publicly traded debt registered with the Commission that was listed on the New York Stock Exchange. Shearson Holdings also had securities registered with the Commission pursuant to Section 12(b) of the Exchange Act that were publicly traded. At all relevant times, both companies were required to file reports with the Commission and to maintain accurate books and records pursuant to Sections 13(a) and 13(b) of the Exchange Act.

In 1988 Shearson's wholly owned and biggest subsidiary was TBC, a holding company headquartered in Boston which provided financial services - specifically mutual fund administration, institutional trust and custody, institutional asset management,

2/ One exhibit consists of five volumes, 703 pages, of testimony that the Division of Enforcement took from Mr. Phillips during its investigation of these matters in 1989 and 1990 (Tr. 317-18).

and private banking (Division Exhibit 34, 2).

On December 16, 1988, the TBC Board learned that company's financial statements for 1988 contained material misstatements. As a result of investigations by the accounting firm of Coopers & Lybrand and two law firms, the TBC Board on December 16, 1989, discharged James von Germeten, President of TBC, and accepted letters of resignation from Joseph Murphy, Vice President and Chief Financial Officer of TBC, and Joseph Walsh, TBC Treasurer. 3/

3/ On December 6, 1992, the United States District Court for the District of Massachusetts entered a Final Judgment of Permanent Injunction permanently enjoining Mr. von Germeten from violating Section 10(b) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1; and aiding and abetting violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13, SEC v. James N. von Germeten, Civil Action No. 92-12357WD. (Division Exhibit 32).

On February 4, 1993, the Commission accepted an offer of settlement in which TBC consented to the entry of a cease and desist order from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-13 and 13b2-1. The order finds, among other things, that TBC reported materially overstated income to Shearson for the first three quarters of 1988 which caused Shearson to incorporate erroneous figures in its books, records, and periodic reports, The Boston Company, Exchange Act Release No. 31822, 53 SEC Docket 1275 (Division Exhibit 34).

On September 20, 1993, the United States District Court for the District of Massachusetts entered a Final Judgment of Permanent Injunction permanently enjoining Mr. Murphy from violating Section 10(b) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1; and aiding and abetting violations of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13, SEC v. Joseph F. Murphy, Civil Action No. 92-12358WD. (Division Exhibit 33).

On October 5, 1993, the Commission issued an Order Instituting Proceedings and Opinion Pursuant to Rule 2(e) of the Commission's Rules of Practice (Joseph F. Murphy, CPA, Exchange Act Release No. 33014). The Commission accepted an offer of settlement denying Mr. Murphy the privilege of appearing or practicing before it with the ability to apply for admission with conditions after four years.

(continued...)

On January 17, 1989, Shearson Inc. and Shearson Holdings, Inc. each filed a Form 8-K with the Commission reporting that they had overstated their net incomes in filings for the first three quarters of 1988 by a total of \$30 million after-tax: \$5.8 million in the first quarter, \$12.4 million in the second quarter, and \$11.7 million in the third quarter. The erroneous filings occurred because TBC provided false financial information to Shearson.

Respondent

In 1988 Mr. Phillips was a Vice Chairman and a Board member of Shearson, one of ten senior executives on its Planning Committee, and Chair and Chief Executive Officer of TBC.

Mr. Phillips began as a financial analyst, and in a 28-year career with a single company became a major player in the remarkable success achieved by one of this country's major

3/(...continued)
(Division Exhibit 35).

On May 18, 1993, the United States District Court for the District of Massachusetts entered a Final Judgment of Permanent Injunction permanently enjoining Mr. Walsh from violating Rule 13b2-1; and aiding and abetting violations of Section 10(b), 13a, and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, and 13a-13, SEC v. Michael J. Walsh, Civil Action No. 93-10997WD. (Division Exhibit 15).

On August 19, 1993, the Commission issued an Order Instituting Proceedings and Opinion Pursuant to Rule 2(e) of the Commission's Rules of Practice (Michael J. Walsh, CPA, Exchange Act Release No. 32770). The Commission accepted an offer of settlement denying Mr. Walsh the privilege of appearing or practicing before it with the right to apply for admission with conditions after three years. (Division Exhibit 16).

financial institutions. 4/ Mr. Phillips's success story could easily become the basis of a best seller describing the opportunities offered by American business in the 1970s and 80s. Like most best sellers, Mr. Phillips's career was not without pain and that is the material of this decision.

Mr. Phillips joined The Boston Safe Deposit & Trust Company (Boston Safe) a non-bank bank 5/in 1962, two weeks after earning a MBA degree and two years after graduating from college with a degree in economics. Boston Safe was TBC's major operating company. 6/ In the period 1962 - 1980 he worked at positions of increasing responsibility either "downstairs" at Boston Safe or "upstairs" at TBC. During the period 1978 - 1980, when he held consecutively the titles of Executive Vice President and Chief Operating Officer of Boston Safe and Executive Vice President and Chief Operating Officer of TBC, he worked with Mr. Dwight Allison, Jr., President and Chief Executive Officer of TBC, to sort out TBC's various enterprises - bring order out of organized chaos - so as to define TBC's business purpose. In 1980 Mr. Phillips helped formulate management's recommendation to sell TBC so that it would have the capital needed to grow the businesses which resulted from the

4/ In May 1993 Mellon Bank acquired TBC for one and a half billion dollars (Tr. 802).

5/ A Massachusetts chartered trust company which does not engage in commercial lending whose deposits are insured by the Federal Deposit Insurance Corporation (Division Exhibit 34, 2).

6/ At the end of 1988, Boston Safe's assets and liabilities constituted approximately 95 percent of the assets and liabilities on TBC's balance sheet (Division Exhibit 34, 2).

sorting process. In 1981 TBC had three core businesses - an investment management organization for pension funds, Boston Safe, and the real estate counsel group - earnings of \$2 million, assets of \$200 million, and 700 employees (Tr. 869-71, 942).

Shearson, which itself had been acquired by American Express in the summer of 1981, acquired TBC effective October 30, 1981, for approximately \$45 to \$50 million (Tr. 871). As of November 1, 1981, Mr. Phillips became President of TBC and Chair and Chief Executive Officer of Boston Safe. In 1983 he became Chairman and Chief Executive Officer of TBC. He reported to a Shearson Vice Chair at the firm's New York City headquarters.

In mid-1985, Mr. Phillips became a Shearson Vice President and moved his office to New York City. He remained Chairman and Chief Executive Officer of TBC but he resigned the titles he held with the Boston Safe because federal law prohibits a duality of banking and broker-dealer responsibilities and, as noted, Shearson Inc. was a registered broker-dealer. 7/ As part of his responsibilities for Shearson, Mr. Phillips assumed executive reporting responsibility for TBC, the TBC Real Estate Counsel, and 13 other separate business entities, mainly Shearson's asset management businesses whose assets totaled \$108 billion (Mr. Phillips's Deposition, May 4, 1989, 86). These included Lehman Asset Management, Bernstein McCauley, Shearson Asset Management, Shearson Equity Management, and Shearson Management. Also Shearson's real estate activities which included Balcour, Robinson Humphrey Real Estate Properties,

7/ Glass-Steagall Act, 13 U.S.C. 378

Inc., Shearson Lehman Realty Group, Shearson's facilities management and planning, and Herbert Construction Co. Another business reporting to him, American Express Asset Management, was a joint venture of Shearson and American Express located in London, and another AYCO headquartered in Albany, N.Y., offered financial planning to corporate executives.

Mr. Phillips's responsibilities increased in 1987 when Nippon Life Insurance bought 13 percent ownership of Shearson from American Express and became Shearson's second largest shareholder. Mr. Phillips was one of two Shearson executives assigned to liaison with Nippon executives to establish a relationship aimed at a joint venture between the two firms.

As a member of Shearson's Executive Planning Group, Mr. Phillips participated in Shearson's acquisition of E.F. Hutton for over \$1 billion in January, 1981. In 1988 he was responsible for integrating into Shearson's structure the following Hutton components:

- (1) all Hutton's asset managing activities which totaled approximately \$22 billion in mutual funds and private accounts,
- (2) all Hutton's direct investment activities,
- (3) Hutton Trust Co.,
- (4) a Hutton owned bank in Zurich, Switzerland,
- (5) Hutton's employee pension plan, and
- (6) mutual fund custody, administration, and support services.

Finally, as a member of Shearson's senior management, Mr. Phillips was required to participate in corporate activities which

recognized the contributions of Shearson's employees. 8/

Mr. Phillips returned to Boston as TBC's Chair and Chief Executive Officer of TBC in January 1989. He continued as Shearson's liaison with Nippon on asset management issues, and remained a Board member of AYCO. Three people were assigned his other duties at Shearson.

Allegations

The Division urges issuance of a cease and desist order because it charges that:

1. Mr. Phillips violated Exchange Act Rule 13b2-1 because his failure to act directly and indirectly caused TBC's books and records to be falsified which caused Shearson's books and record to be falsified, and 9/
2. Mr. Phillips's failure to act caused Shearson to violate Section 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-

8/ As a member of Shearson's Policy Group, Mr. Phillips was required to attend and participate in the events and trips, in and outside the country, which recognized and rewarded Shearson's best workers (Tr. 905-07).

9/ Exchange Act Rule 13b2-1 provides that:

No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.

Section 13(b)(2)(A) of the statute mandates that every issuer with securities registered pursuant to Section 12 and every issuer required to file reports pursuant to Section 15(d) shall make and keep books, records, and accounts which accurately and fairly reflect the transactions and disposition of the issuer's assets, and maintain a system of internal accounting controls sufficient to provide that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles.

13 and caused Messrs. von Germeten and Murphy to violate Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. 10/

To decide whether the Division has carried its burden of proving these allegations, it is necessary to determine whether Mr. Phillips knew, should have known, or was negligent in not knowing before the Board found out on December 16, 1988, that Mr. von Germeten, Mr. Murphy and Mr. Walsh had falsified or caused to be falsified TBC's financial statements and books and records, and, if he did know, should have known, or was negligent in not knowing, whether his failure to act caused violations of the securities laws and regulations to occur (Section 21C of the Exchange Act).

To put the issues in context, Mr. Phillips is not charged with fraud, self-dealing, or conflict of interest, rather the issue is whether he carried out his responsibilities with the required duty of care and/or diligence. Inasmuch as corporate directors and officers occupy a fiduciary capacity, directors and other officers must exercise the utmost good faith in all transactions touching

10/ Section 13(a) requires issuers of securities registered pursuant to Section 12 to file information, documents, and annual and quarterly reports as the Commission may prescribe. Rule 12b-20 requires information in addition to what is required to make the statement or report not misleading.

Section 10(b) makes it unlawful by means of interstate commerce or the mails or any national securities exchange, to use or employ in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of any Commission rule. Rule 10b-5 makes it unlawful under the same circumstances to (1) employ any device, scheme, or artifice to defraud, (2) to make untrue statements of material fact or to omit to state a material fact necessary to make a statement not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit.

their duties to the corporation and its property. However, the fiduciary relationship does not make an officer liable as a n insurer. Generally, any alleged breach of a fiduciary duty is a question for the trier of fact after examination of all the evidence. 3 Fletcher Cyclopedia of the Law of Private Corporations 181-83 (perm. ed. rev. vol. 1994).

I find that Mr. Phillips did not violate the statute or rules as alleged because the preponderance of the evidence is that he did not know until November 9, 1988, that there were potential problems with TBC's financial books and records, that his lack of information was not due to recklessness or negligence, that his actions in the period November 9 through December 16, 1988, were reasonable, and that his inaction neither directly nor indirectly caused Shearson, Mr. von Germeten, or Mr. Murphy to violate the Exchange Act or Exchange Act rules. 11/ The following factual determinations caused me to reach these conclusions.

1. Mr. Phillips had no direct responsibility for TBC's financial reports to Shearson.

The events at issue occurred in 1988. When Mr. Phillips moved to New York in mid-1995 his new responsibilities at Shearson made it impossible for him to continue his day-to-day operating responsibilities for TBC and Boston Safe. TBC was reorganized and

11/ I am assuming that the Division has shown that Shearson, Mr. von Germeten and Mr. Murphy have violated the statute and rules as alleged. If I had not made this assumption, I would have to examine carefully the issue of whether a consent injunction and, in Mr. Murphy's case, a settlement can be used to prove a violation by a third party.

made a holding company and Mr. von Germeten, TBC President, assumed day-to-day executive responsibility for TBC in Boston. All the executives, except the President of one subsidiary, TBC's Real Estate Counsel, reported to Mr. Phillips through Mr. von Germeten (Mr. Phillips's Deposition May 4, 1989, 31-35). Mr. von Germeten also took over for Mr. Phillips as Chair and Chief Executive Officer of Boston Safe. (Tr. 953).

There are no standard duties for a chief executive officer. In 1988, Mr. Phillips's responsibilities as TBC's Chair and Chief Executive Officer were to:

- (1) chair the monthly Board of Directors meetings in Boston,
- (2) understand the Yearly Business Plan,
- (3) shepherd major capital requests from TBC through the Shearson approval process, and
- (4) allocate executive compensation at TBC.

Shearson's President and Chief Operating Officer did not expect Mr. Phillips to perform any different functions for TBC than he did for the other 13 subsidiaries for which he had reporting responsibility (Tr. 798-99).

Mr. Phillips was not an accountant. He did not perform any functions or activities with respect to TBC's record keeping or accounting policies (Tr. 774-79, 820, 958). Under Shearson's management reporting structure he was not responsible for the accuracy of TBC's financials. Each subsidiary reported to a Shearson executive at Mr. Phillips's level but the financial staff of the subsidiaries, including TBC, reported directly to Shearson's

financial people (Tr. 794-99, 811-13). Mr. Phillips and Mr. Allison, the Chair of TBC's Audit Committee, considered Mr. Murphy, TBC's Chief Financial Officer, the person responsible for communicating financial information between (1) TBC and its audit committee, (2) the financial staffs of Shearson and TBC/Boston Safe, and (3) TBC and the auditors, Coopers & Lybrand. (Mr. Phillips's Deposition, January 24, 1990, 86; Tr. 635-36). Mr. Phillips was not in the loop on accounting/financial matters - he did not assist in preparing materials and he did not sign them or submit them to people inside Shearson or to outside agencies that Shearson reported to such as this Commission and the Federal Deposit Insurance Corporation (Tr. 90-92, 423-24, 443, 524-26, 795, 820, 929-30). Shearson's Chief Financial Officer and Controller, located in New York where Mr. Phillips was located, did not consult with Mr. Phillips. Shearson's financial people and TBC's auditors talked to and met regularly with TBC's senior financial people led by Mr. Murphy and Mr. Walsh. Mr. Phillips did not attend meetings when TBC's financial people came to New York (Tr. 443-44).

After many years in which he developed TBC's core businesses and hired many of its senior people, Mr. Phillips thought TBC was a well-oiled machine, and he did not spend a lot of time on TBC matters but allocated equal time among TBC and three other major Shearson business units (Mr. Phillips's Deposition, May 4, 1989, 84; Tr. 1036-37)

For the reasons stated, I find that Mr. Phillips did not have direct oversight responsibility for the accuracy of TBC's

financials.

2. Even if you assume that Mr. Phillips was responsible for TBC's financials, there is no showing that he knew, should have known, or acted recklessly or negligently in not knowing that TBC's books and records contained materially false financial information and that TBC was transmitting this information to Shearson for inclusion in its reports.

The standard applicable to Mr. Phillips discharge of his duties as a Director and officer is whether he acted in good faith and with the diligence which an ordinary prudent person would exercise under similar circumstances in a like position. 12/ I find that in these circumstances it was reasonable for Mr. Phillips to rely on the representations that Messrs. von Germeten, Murphy, and Walsh made to him, to TBC's Audit Committee, to the financial officials at Shearson, and to Coopers & Lybrand which served as TBC's auditors, that TBC's financials were accurate. Mr. von Germeten and Mr. Murphy were members of TBC's senior management and Mr. von Germeten was on TBC's Board with Mr. Phillips. Mr. Phillips

12/ The following cases involve financial advice from a source outside the corporation, however, the logic would apply also to financial information received from an in-house professional. "In fulfilling their duty to inform themselves, officers and directors are entitled to rely on the advice of financial and legal advisors, ... provided they do not do so 'blindly'". Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 150 (S.D.N.Y. 1989). Also, Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 287 (2d Cir. 1986), citing a New York statute "[I]n performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other data ... presented by ... public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence." See also, H. Harman v. D.A. Willbern, 374 F.Supp. 1149, (D. Kan. 1974).

had no reason to believe that Messrs von Germeten, Murphy, and Walsh were not carrying out their professional duties honestly. He trusted them and expected TBC's figures to be accurate. (Mr. Phillips's Deposition, May 4, 1989, 100). Mr. Robert Druskin, at the time Shearson's Chief Financial Officer, and Mr. Robert Matza, at the time Shearson's Executive Vice President and Controller, worked closely with Mr. Murphy and Mr. Walsh and they were unaware that the financials contained materially false information until it was revealed in late November. Both of these men who had careers in corporate finance agree that a company's top management is entitled to rely on the financial staff's representations that it has accurately reported financial results, and that senior management's responsibility for financials assumes that the staff has not overridden controls and procedures which is what appears to have happened in this situation (Tr. 787-89, 820-24). 13/ Their views are unchallenged in this record.

Even though Mr. Phillips knowledge of TBC was unique in the company, TBC had changed so much in the two and a half years since he left Boston and relinquished day-to-day supervision that it was entirely reasonable for him not to know in 1988 that TBC's financials contained false information. 14/ In the period 1982 through 1987, TBC's annual earnings compounded at a very, very high

13/ Mr. Allison testified that the Coopers & Lybrand investigation concluded that "it was much more a case of internal controls which were overridden by rule of management, if you will, as opposed to controls that were inadequate." (Tr. 640)

14/ An added fact is that by all accounts Mr. Phillips was very busy on a variety of Shearson matters in addition to TBC.

rate. In just seven years, 1981 to 1988, TBC went from 700 employees and annual earnings of \$2 million to 3,000 employees and annual earnings of over \$130 million. During 1988, TBC "grew" its balance sheet from roughly \$12 billion to \$20 billion, and it also brought in-house servicing of Hutton's mutual funds - administration, custody, accounting, transfer, etc. 15/ These substantial increases in quantity as well as new business activities prevented Mr. Phillips and even people close to the situation at TBC in Boston, including the auditors, from discerning that TBC's financials contained materially false information.

Mr. Phillips did not attend meetings in Boston where he might possibly have learned information which would have alerted him to the illegal activities, i.e., the weekly meetings of TBC's Policy Group of senior executives, TBC's Audit Committee, and the Asset and Liability Committee of Boston Safe which basically managed the balance sheet (Tr. 440-41). 16/ For all these reasons, it is reasonable that Mr. Phillips, busy in New York, did not know that

15/ This action was in response to the Competitive Equality Banking Act of 1987 which capped the annual growth of non-bank banks to 7 percent of their balance sheet as of September 30, 1988. (Mr. Phillips's Deposition, May 4, 1989, 89-90)

16/ Mr. Vaill was TBC's Chief Financial Officer until Mr. Murphy assumed the position in the summer of 1987. In 1988 Mr. Vaill was TBC Executive Vice President and Chief Administrative Officer and member of TBC's Board. He was also President and Chief Administrative Officer of Boston Safe and a Board member. Mr. Vaill was on the monthly estimate and close phone calls, and he participated in the weekly meetings of TBC's Policy Group and Boston Safe's Asset and Liability Committee. Mr. Vaill denies Mr. Walsh's statement that he received the lists of the questionable prepaid expenses compiled by certain members of TBC's financial staff (Tr. 348, 688-89). Mr. Vaill appears to have had a high level of knowledge as to what was going on (Tr. 308-09).

TBC's financials were false based on the materials provided to him.

Mr. Phillips received three types of financial reports from TBC: "estimate" and "close" packages monthly, a "Black Book" which contained a month-end financial statement for each of TBC's business segments, and a daily balance sheet for Boston Safe. On their face these materials do not reflect the use of improper accounting; a reader who did not know what was going on could not learn of the improper adjustments that TBC was recording from reviewing these reports (Tr. 184-86, 306-08). People in various TBC business units knew that the figures for their unit were incorrect, but only a few people knew the big picture (Tr. 308-09).

Shearson used the "estimate" and "close" submissions prepared by TBC in Boston as management tools. The estimate package was finalized about ten or eleven days before the close of the month, and compared estimated earnings and expenses to the budgeted amounts. The close package was finalized about the sixth of the month and compared actual results with estimates. Both packages were sent to Shearson's financial staff in New York after a phone call among Mr. Phillips, Mr. von Germeten, Mr. Murphy, Mr. Walsh, Mr. Vaill, and Mr. Bambauer from TBC's Financial Analysis Department. 17/ Mr. Phillips did not attend the series of meetings in Boston among members of the financial staff, Mr. Walsh, Mr. Murphy, and Mr. von Germeten which resulted in preparation of the

17/ The final version of the close package was sent to members of TBC's Policy Group which consisted of senior management. The close package was not incorporated in Shearson's financial statements (Tr. 136).

"estimate" and "close" packages and other financial reports.

The Division relies almost exclusively on Mr. Walsh's testimony to show that Mr. Phillips knew that TBC's figures were false before November 9, 1988. Mr. Walsh assumes that in the second quarter of 1988, Mr. Phillips was told that Mr. von Germeten ordered TBC's financial staff to treat prepaid expenses improperly. 18/ Mr. Phillips denies that anyone gave him this information. In May 1988, Mr. Phillips stopped by Mr. Murphy's office in Boston, and Mr. Murphy said in an off-hand way that he wanted Mr. Phillips to be aware that there was a total of \$6.5 million in expenses on TBC's books that had been deferred (expenses were reclassified as prepaid assets) - \$3 million in 1987 and \$3.5 million in 1988. Mr. Murphy said he thought the amounts were immaterial. Mr. Phillips told Mr. Murphy not to get trapped in materiality rules but to "clean it up" (Mr. Phillips's Deposition, May 4, 1989, 131-32). 19/

Mr. Walsh's conclusion that Mr. Phillips was aware that TBC's financial information was false is based largely on Mr. Phillips participation in the "estimate" and "close" phone calls. I find Mr. Walsh's testimony unpersuasive because he seems to assume that Mr. Phillips knew that improper accounting was taking place because subjects came up on the phone calls, but, except for Mr. Walsh, the

18/ Mr. von Germeten ordered arbitrary adjustments so that earnings or estimates would be what he wanted. Current expenses were taken off the income statement and put on the balance sheet as assets. TBC's financial staff designated improper assets as "prepaid/REV" on lists so that they knew what should be reversed or taken back into expense later (Tr. 52-56).

19/ Mr. Murphy considered Mr. Phillips "a straight arrow" who would not like this sort of thing (Tr. 606).

evidence is unanimous the directives or decisions to use improper accounting were made at meetings in Boston which Mr. Phillips did not attend, and that it was at these meetings that Mr. von Germeten ordered, contrary to the staff's advice, accounting treatment that violated generally accepted accounting standards (Tr. 334, 342). The persuasive evidence is that the discussions that occurred during the phone calls were general and not the full blown, frank conversations about generally accepted accounting standards that took place before the calls. 20/ According to Mr. Bambauer, a member of TBC's financial staff who prepared the "estimate" and "close" reports and who attended the meetings in Boston with Messrs von Germeten, Vaill, Murphy, and Walsh, Mr. Phillips saw the reports after discussions occurred and he got final permutations that resulted from meetings where Mr. von Germeten pushed for higher estimates or higher results (Tr. 629-34). This is in accord with Ms. Irene Cyl Aronin's (Ms. Aronin) testimony that Mr. von Germeten was the big cause of the improper adjustments (Tr. 102). Ms. Aronin was TBC's Controller from April 1987 until October 4, 1988. 21/ Mr. Walsh, her superior, and Mr. Bambauer told her that Mr. von Germeten ordered improper accounting (Tr. 173). Ms. Aronin was never told that Mr. Phillips directed or pressured for improper

20/ There is no evidence to support Mr. Walsh's statement that Mr. Phillips was present or he believes he was present at meetings where accounting decisions were made.

21/ At one meeting where she disagreed with Mr. von Germeten on an accounting issue, he turned to Mr. Murphy who had agreed with her and said "You know what I want. Do it." (Tr. 114-15) Mr. von Germeten dictated what went on at Boston Safe's Asset and Liability Committee and did not consider differing views (Tr. 240).

adjustments and she was unaware of any improper adjustments made because of the close phone calls with Mr. Phillips (Tr. 173-74).

Mr. Phillips's formal, no-nonsense manner caused people to believe he was "extraordinarily" well prepared for the phone discussion, however, the fact that the call took place minutes after he received approximately 20 pages of figures supports his position that he had not studied the material and his purpose in asking questions was to make sure he knew what information Shearson was going to receive about TBC's profitability or estimated profitability. I accept Mr. Phillips's position that he conducted an exceptions type review which questioned apparent differences between estimates and budgeted amounts in the "estimate" report or between estimates and actuals in the "close" report. This conclusion is supported by Mr. Bambauer and by the circumstances - it is impossible to review 20 pages of figures in detail in a few minutes and then immediately conduct a thorough review on a conference call which is concluded in less than an hour (Tr. 634, 679).

The weight of the evidence is that Mr Phillips did not receive the list of questionable prepaid expenses which TBC's financial staff began keeping in 1987. Mr. Phillips denies that he saw these reports. Mr. Walsh believes that at least once Mr. Phillips asked for and received a copy of the list (Tr. 456). I discount Mr. Walsh's testimony where it conflicts with Mr. Phillips's testimony because Mr. Phillips is more credible and his version is supported by other evidence. For example, I accept Mr. Phillips's position

that Messrs von Germeten, Murphy, and Walsh told him during the estimate and close calls in June - August 1988 that the amount of prepaid expenses was going down (Tr. 981-82). Mr. Walsh remembers Mr. Phillips being told the amount was going up (Tr. 359-60). Mr. Walsh is less credible because of evidence that he has lied in several situations. For example, he attended Audit Committee meetings and was a key liaison with Shearson and Coopers & Lybrand in 1988 but he did not disclose that he believed TBC's financials to be false in material respects; he lied about Ms. Aronin's resignation to the financial people at Shearson and Coopers and Lybrand, and he certified to the Federal Deposit Insurance Corporation on October 21, 1988, that a Call Report for Boston Safe was accurate when he knew it was false in material respects. Also, Mr. Druskin and Mr. Matza deny Mr. Walsh's assertion that they told him to deal with Mr. Phillips on everything including accounting issues. Moreover, Mr. Walsh never spoke to Mr. Phillips directly or privately about these issues even though Mr. Phillips was in Boston monthly and their offices were within 30 feet of each other.

Mr. Vaill, who participated in the "estimate" and "close" phone calls, testified that two or three times between May and the fall of 1988 Mr. Phillips questioned whether the level of prepaid expenses was acceptable with respect to generally accepted accounting standards. Mr. Murphy or Mr. Walsh said that the level of prepaids would be acceptable by the time an accounting was

required (Tr. 686). 22/ According to Mr. Vaill, no accounting decisions were made on these calls, rather, they were either a review of TBC's financial performance (close) or the likelihood of achieving estimates (estimate).

For all the reason stated, I find that Mr. Phillips did not learn from his monthly review of the "estimate" and "close" financial packages in 1988 that TBC's financials contained materially false information.

3. Mr. Phillips acted reasonably on the information he had in October and November 1988 as to the resignation of TBC's controller.

Sometime in October 1988, Mr. von Germeten told Mr. Phillips that Ms. Aronin had submitted her resignation as TBC Controller, that she had refused to sign the third quarter financials, that Mr. Murphy had signed them, that Ms. Aronin was transferring to another position at TBC, and that he had commended her for her actions. Mr. von Germeten also told Mr. Phillips that Mr. Murphy and Ms. Aronin had a personality conflict (Tr. 990-91). 23/ TBC's Controller is

22/ Mr. Murphy and Mr. Walsh appear to be talking in terms of Coopers & Lybrand's year end audit for 1988. People at TBC seemed to assume that because TBC's audited figures for 1987 contained \$3 million in prepaid expenses, the auditors would not question a similar amount in 1988. According to Ms. Aronin, Mr. Walsh believed the problem was one of timing, i.e., the problem would be resolved if the arbitrary adjustments - where a current expense was taken off the income statement and put on the balance sheet as an asset - were reversed by the end of the year (Tr. 95-97, 606-09)

23/ When Mr. Lucey, at the time an Executive Vice President and Manager of Institutional Sales, raised Ms. Aronin's resignation at TBC's Policy Group on October 8, Mr. Murphy said she had threatened to resign but had not resigned and added the sexist comments that
(continued...)

a Board appointed position rather than a Board elected position. The former are filled by management and ratified quarterly by the Board, while the latter are higher level positions requiring an individual Board vote. Mr. Phillips did not know until December 16 that Ms. Aronin had actually resigned on October 4, 1988, because she believed the third quarter financials were materially inaccurate, that she had contacted an attorney, that Messrs. Murphy and Walsh coaxed her to return to TBC after a few weeks, and that she returned on October 31 after negotiating an employment contract. There is nothing in the record to indicate that in October 1988, Mr. Phillips had any reason to doubt Mr. von Germeten's integrity or truthfulness, or that he was aware of the truth concerning Ms. Aronin's resignation until December 16, 1988. 24/

As TBC's Treasurer, Mr. Walsh worked closely with Shearson's Vice President and Controller, Mr. Robert Matza. Mr. Walsh told Mr. Matza "kind of in passing at the very end of a conversation, by the way ... very matter of factly, Irene Aronin won't be controller anymore. ... She didn't like being controller anymore and she was going to do some kind of international liaison job." (Tr. 780-81) Mr. Matza did not ask Ms. Aronin why she was leaving the controller

23/ (...continued)

Ms. Aronin "was a very emotional person ... that she had a tough time putting things in perspective." (Tr. 740).

24/ The Division emphasizes that people were disturbed by Mr. von Germeten's abrasive management style and it alleges that Mr. Phillips knew of these concerns. This is irrelevant to the issues. The important fact is that there is no credible evidence that anyone at TBC informed Mr. Phillips before November 9 that they had concerns about Mr. von Germeten's integrity in business matters.

* Involuntary conversions of MMPS	3,500
* Prepaid expenses	9,325
* Gain on sale of servicing	115
* Real Estate Counsel deal revenue recognition	1,185
* Accrual of Mutual Fund fees	850
* Capitalization of contract programmers (maintenance)	2,000
* Accrual of personal T&A fees	170
* Accrual of institutional T&A fees	517
Total pre-tax exposure	<u>18,562</u>
Tax benefit @ 43%	(7,980)
Total projected after-tax exposure	\$10,582 <u>26/</u>

The meeting between Mr. Murphy and Mr. Phillips lasted about an hour and most of the time was spent on Mr. Murphys's concerns about the TBC management reorganization. Mr. Murphy could not explain the first two items to Mr. Phillips's satisfaction. Mr. Phillips directed Mr. Murphy to prepare a written explanation of the items specified in the memorandum and arranged to meet with Messrs. von Germeten, Murphy, Walsh, Nutt, and Vaill the following Friday, November 18, 1988, when he would be in Boston for the Board meeting. Mr. Murphy needed nine days (Veterans Day was celebrated on Friday, November 11) to provide the explanation Mr. Phillips believed necessary (Mr. Phillips's Depositions May 4, 1989, 145-46 and January 24, 1990, 87-88).

I disagree with the Division that Mr. Phillips is culpable because he did not (1) alert Shearson that there were problems with TBC's third quarter financials based on receipt of this information on November 9, and (2) act to prevent Shearson's filing of its third quarter reports containing false information two business

26/ In 1988, TBC's after-tax income was \$130 million. (Tr. 942).

days later.

There is nothing to disprove Mr. Phillips's claim that (1) he did not have a general understanding of the first two items on the memorandum or a detailed understanding of the other items, (2) that on November 9, Mr. Murphy was unable to explain the first two items and (3) Mr. Murphy offered no written explanations or supporting documentation on November 9. It is reasonable to expect that anyone in Mr. Phillips position would make sure they understood the issue before they presented it to their superior, the President of Shearson. Mr. Phillips's actions were in keeping with his management style which is to get the facts before reacting, and his reputation for thoroughness and prudence. According to Mr. Phillips:

I don't recall speaking with anybody else about it. I guess my management style has always been based on the principle that you get the facts and you avoid jumping to conclusions without the facts, and it was the responsibility of Murphy to provide the facts. (Mr. Phillips Deposition, January 24, 1990, 88)

Mr. Phillips was aware that Shearson made filings with the Securities and Exchange Commission but he had nothing to do with the process. There is no evidence that Mr. Phillips knew the filing was imminent, and/or that Mr. Murphy told Mr. Phillips on November 9 that Shearson would file its third quarter financials with the Commission on November 14. If he had engaged in a similar conversation, Mr. Druskin (then Shearson's Chief Financial Officer)

would have made sure that Shearson's chief executive officer understood that the numbers impacted on the company's third quarter financials (Tr. 834-35).

Finally, the evidence is that the memorandum is not clear on its face from an accounting perspective. Mr. Druskin found the memorandum "very ambiguous" in that it calls into question various time periods (Tr. 830-34).

At that November 18 meeting, Mr. Phillips directed Messrs. Nutt 27/ and Walsh to assemble materials as soon as possible and to inform the Audit Committee, the financial staff at Shearson, and Coopers & Lybrand of the problem (Mr. Phillips's Depositions May 4, 1989, 145-46, 151-53 and January 24, 1990, 82-83). Mr. Phillips informed Mr. Lane, Shearson's President, around this time that there were problems with TBC financials.

At the TBC Board meeting on November 18, Mr. Allison, Chair of the Audit Committee, stated he heard Ms. Aronin resigned because she believed there were material problems with the third quarter financials. Mr. Phillips repeated what Mr. von Germeten had told him in October, and he directed Mr. Murphy to speak with Mr. Allison. Mr. Phillips did not connect Ms. Aronin's resignation with the potential audit adjustments which were the subject of his earlier meeting that day with Messrs. von Germeten, Murphy, Walsh, Nutt, and Vail, and he did not inform the Board of that meeting.

27/ In an unrelated event, Mr. Phillips presented and the Board approved a reorganization of TBC's management structure at the Board meeting on November 18. Messrs Phillips, Von Germeten, and Nutt would share the Office of Chair and no one would be the Chief Operating Officer.

The Audit Committee received a report on TBC's financials on Friday, December 16, its next regularly scheduled meeting. The committee requested that the Board address the issue at the meeting which followed later the same day. The Board decided that Shearson should be informed immediately and Mr. Phillips met with Shearson and Coopers & Lybrand on Monday, December 19.

I find that the Division has not shown that Mr. Phillips lied to the Audit Committee in at least three instances. 28/ There is no persuasive evidence that Mr. Phillips thought that the information he got from Mr. von Germeten about Ms. Aronin's resignation which he repeated to the committee was false, or that he understood the details of the financial misrepresentations. In addition, it was logical for Mr. Phillips to say he did not know anything about accelerated revenues even though it was an item listed in the memorandum "Financial Statement Exposure as of 10/31/88" because his position is that the memorandum did not provide sufficient information to explain the item.

It is significant that Mr. Allison, Chair of the Audit Committee and a former President of TBC, is not critical of Mr. Phillips's dealings with the committee and characterized him as a person of prudence, care, and integrity (Tr. 642). Similarly, Mr. Vappi, a long time member of TBC's audit committee, continues to

28/ When he told the committee (1) on November 18 that he did not know much more than there were some inaccuracies in the third quarter financials and that Mr. Murphy would report to them, and (2) that he did not know the details on Ms. Aronin's resignation, and (3) when he said on December 16 that he did not know about the acceleration of revenues (Division's Initial Brief, 82-84).

hold Mr. Phillips in high regard (Tr. 580-81)

5. Investigations of these matters have absolved Mr. Phillips of responsibility.

The final persuasive fact is that there has been no showing that Mr. Phillips was found at fault in any of the many reviews, investigations, and studies of what occurred - TBC's Board retained the law firm of Goodwin, Proctor and Hoar, TBC's Audit Committee retained the law firm of Ropes and Gray, and Shearson/American Express retained Coopers & Lybrand and also did a study in-house. There is nothing in the record which raises questions about the integrity of these reviews. Based on these after-the-fact analyses, Shearson's senior management concluded that Mr. Phillips played no role in what occurred, that he was not aware of the problems until late November when he informed Shearson's President, and that he was the only person in senior management capable of putting TBC back together again (Tr. 802). The Shearson Board elected Mr. Phillips Chair and Chief Executive Officer of TBC on January 20, 1989.

In conclusion, I find that the Division has not shown that Mr. Phillips is violating, has violated, or is about to violate the securities statutes and regulations specified in the Order Instituting Proceedings or that he is, was, or would be a cause of any violation due to an act or omission he knew or should have known would contribute to such violation. 29/

29/ I have considered all proposed findings and conclusions. They are accepted to the extent they are consistent with this decision.

ORDER

Based on the findings and conclusions set forth above, I order that the Division's request that a cease and desist order be issued to Mr. George W. Phillips pursuant to Section 21C of the Exchange Act is denied.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice. Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him or her, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to a party. If a party timely files a petition for review or the Commission acts to review as to a party, the initial decision shall not become final as to that party.


Brenda P. Murray
Administrative Law Judge

Washington, DC
August 26, 1994