

DETERMINED TO BE AN
ADMINISTRATIVE MARKING
E.O. 12065, Section 6-102
By Jihv NARS, Date 5/2/2013

Circ. 4/9 for 4/10

~~Recommendation~~
Approved by
Commission

Sherry Stephen
Supervisory Program Information Specialist

PR 10 2002

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~~HG~~
A-reused

PRIVILEGED AND CONFIDENTIAL

ACTION MEMORANDUM

April 9, 2002
STATS No. NY-7026-A

TO: The Commission

FROM: Northeast Regional Office ("NERO")

SUBJECT: In the Matter of Adelphia Communications Corporation

RECOMMENDATION: That the Commission issue a formal order of private investigation to determine whether there have been violations of Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2) and 13(b)(5) of the Securities Exchange Act of 1934, and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder.

ACTION REQUESTED BY: Regular Calendar: Although the issuer has begun to produce documents and has stated its intention to cooperate, it has delayed meeting with the staff to explain its accounting treatment of the transactions in question. Subpoena power now would aid the staff should the issuer's cooperation deteriorate.

SOURCE OF CASE: News articles

DATE OF REFFERAL: March 28, 2002

OTHER OFFICES OR DIVISIONS CONSULTED: Office of the General Counsel/
Richard Levine (x0886)
Office of the Chief Accountant/
Michael Kigin (x4421)
Division of Corporation Finance/
Mary Kosterlitz (x2843)

TENTATIVE SUNSHINE ACT STATUS: Closed pursuant to 17 C.F.R. Section 200.402(a)(3), (5), (7), and (10).

PRIOR COMMISSION ACTION: None

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**Office of Chief Counsel
Division of Enforcement**

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I.

SUMMARY

This is an investigation into possible financial reporting violations by Adelphia Communications Corporation ("Adelphia"), a Pennsylvania-based cable television company quoted on NASDAQ. On March 27, 2002, Adelphia disclosed that, as of December 31, 2001, the company was potentially liable for approximately \$2.3 billion of bank borrowings that were not included on its consolidated balance sheet. These borrowings consisted of draw-downs by separate entities owned by the family of John J. Rigas ("Rigas"), Adelphia's Chairman and Chief Executive Officer (the "Rigas Entities"), pursuant to credit facilities under which Adelphia is a "co-borrower" and jointly liable for the total outstanding balance. Adelphia representatives acknowledge that the Rigas Entities have used as much as \$1 billion of the \$2.3 billion to buy Adelphia securities. In a March 28, 2002 Form 8-K, Adelphia further disclosed that it had guaranteed, and would likely be liable for, an additional \$500 million unsecured bank debt of its former subsidiary, Adelphia Business Solutions, Inc. ("Adelphia Business"), which filed for Chapter 11 bankruptcy protection on March 27, 2002. On April 1, Adelphia announced that it obtained an extension to file its 2001 Form 10-K and that its auditors, Deloitte & Touche, LLP ("Deloitte"), were evaluating the accounting treatment of these obligations for the company's 2001 financials.

The staff is investigating three principal issues: (1) whether Adelphia's prior financial statements were false or misleading for failing to report the company's joint obligations with the Rigas Entities and Adelphia Business; (2) whether Adelphia should have consolidated its financials with those of the Rigas Entities; and (3) whether the Rigas family and Adelphia manipulated the price of Adelphia stock by disclosing extensive purchases of Adelphia stock by the Rigas family while concealing that Adelphia was backing the loans that helped fund those purchases. The staff has issued voluntary requests for documents and witnesses from Adelphia and Deloitte. The staff seeks a formal order to assist in its investigation to determine whether Adelphia or others violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b), 13(a), 13(b)(2) and 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder.

II.

RELEVANT ENTITIES AND INDIVIDUAL

A. Adelphia is a Pennsylvania corporation headquartered in Coudersport, Pennsylvania. Adelphia, which is the sixth largest cable company in the United States, owns, operates, and manages cable TV systems and other related telecommunications businesses. Adelphia common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and listed on NASDAQ's National Market.

B. Adelphia Business is a former subsidiary of Adelphia that was spun off by Adelphia on January 14, 2002. On March 27, 2002, Adelphia Business filed for Chapter 11 bankruptcy protection.

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C. Deloitte has been Adelphia's independent auditor since at least January 1994.

D. Rigas is the founder, Chairman, and CEO of Adelphia. His sons, Michael J. Rigas, Timothy J. Rigas, and James P. Rigas, are officers and directors of Adelphia. Rigas' son-in-law, Peter Venetis, is also a director of Adelphia. Together, Rigas, his sons, and son-in-law hold five of Adelphia's nine Board of Director positions. Based on news reports and the staff's own review of Adelphia's filings, the staff believes that Rigas or members of his family, acting through the Rigas Entities, have purchased at least \$1.8 billion of Adelphia's securities since 1998, at an average price of approximately \$40 per share.

III.

FACTS

A. Adelphia's Recent Disclosures

On March 27 – 28, 2002, Adelphia disclosed that it had excluded from its consolidated balance sheets a total of almost \$3 billion in possible liabilities associated with credit facilities under which Adelphia is a co-borrower or guarantor. First, on March 27, 2002, Adelphia issued an earnings report which stated, in a footnote, that Adelphia's consolidated balance sheet did not include among liabilities nearly \$2.3 billion of bank borrowings by the Rigas Entities for which Adelphia, through certain of its subsidiaries, was jointly liable. Specifically, the company stated that:

Certain subsidiaries of the Company are co-borrowers with certain companies owned by the Rigas Family and managed by the Company ("Managed Entities") for borrowing amounts of up to \$5,630,000[,000]. Each of the co-borrowers is liable for all borrowings under the credit facilities and may borrow up to the full amount of the facilities. . . . Amounts borrowed by Managed Entities under the facilities [as opposed to separate amounts borrowed directly by Adelphia's subsidiaries] are not included on the Company's consolidated balance sheet. The Company expects the Managed Entities to repay their borrowings in the ordinary course. The Company does not expect that it will need to repay the amounts borrowed by the Managed Entities. As of December 31, 2001, co-borrowing credit facilities balances, net of amounts otherwise reflected as debt on the Company's consolidated balance sheet, totaled approximately \$2,284,000[,000].

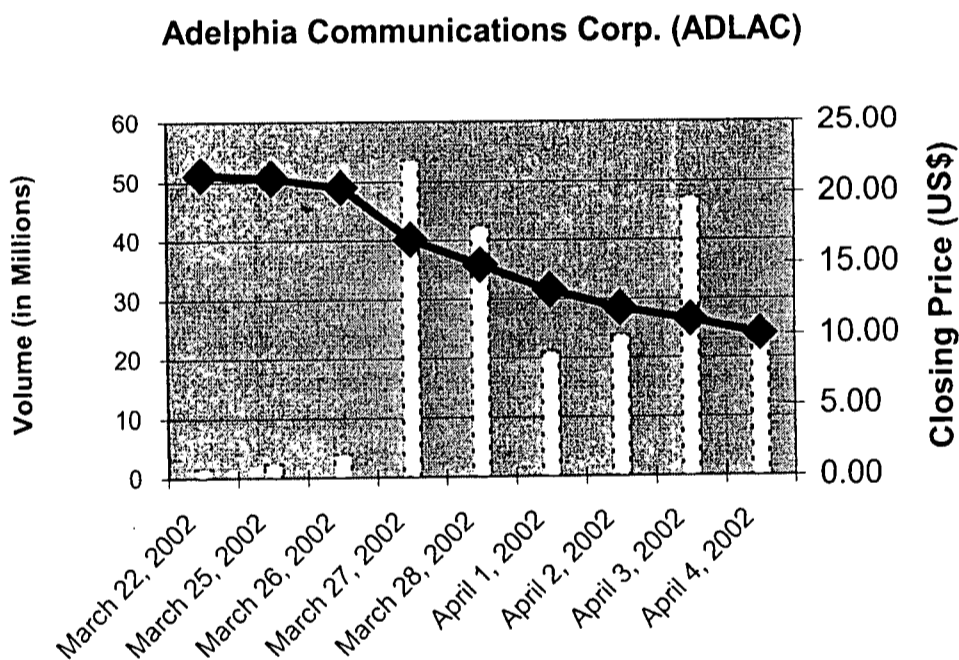
Second, on March 28, 2002, Adelphia disclosed probable liabilities to repay loans taken by Adelphia Business, which filed for protection under Chapter 11 of the U.S. Bankruptcy Code the day before. In a March 28, 2002 Form 8-K, Adelphia stated that Adelphia would likely be liable for all or part of a \$500 million bank debt of Adelphia Business that Adelphia had guaranteed, and perhaps for other financial transactions involving the company that could not be

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immediately clarified. The staff's review of Adelphia's filings with the Commission has also not revealed any prior disclosure by Adelphia of these Adelphia Business liabilities.

Following Adelphia's earnings announcement on March 27, 2002, Adelphia hosted a conference call with financial analysts in which its representatives acknowledged that a significant portion of the \$2.3 billion borrowed by the Rigas Entities, perhaps as much as \$1 billion, had been used to purchase Adelphia securities. The company declined to provide additional details and indicated that it would make further disclosures concerning the co-borrowing arrangements in its upcoming Form 10-K, which was to be filed on April 1, 2002. On April 1, 2002, Adelphia requested an extension in filing its annual report with the Commission, citing a need for additional time to allow Deloitte to review accounting matters relating to the co-borrowing facilities of Adelphia and the Rigas Entities.

These disclosures prompted a steep decline in price of Adelphia's common stock, from a closing price of \$20.39 per share on March 26 to a closing price of \$10.00 on April 4, on heavy trading:



B. Possible Violations

There appear to be three principal issues arising out of Adelphia's recent disclosures:

1. *Failing to report borrowings by the Rigas Entities and Adelphia Business on Adelphia's financials.* Although the facts are still developing, it appears that, since 1996, Adelphia's subsidiaries and the Rigas Entities have been co-borrowers on credit facilities pursuant to which Adelphia, through its subsidiaries, would be liable for draw downs by the Rigas Entities. During that period, the Rigas Entities apparently did draw down on those facilities, but Adelphia did not reflect liabilities for those draw downs on its consolidated balance

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sheet, or anywhere else on its consolidated financials. Since its 10-K for 1997, Adelphia has described aspects of its co-borrowing agreements with the Rigas Entities in footnotes to its publicly-filed financials. Those footnotes, however, deceptively suggest that Adelphia actually is including its liability for Rigas Entity borrowings in Adelphia's reported debts, when – in fact – those borrowings expose Adelphia to significant liability in excess of the company's reported debts. On the December 31, 2000 balance sheet, for example, Adelphia lists "Total subsidiary debt" of \$9.179 billion and states in the accompanying footnote that "[c]ertain subsidiaries of Adelphia are co-borrowers with Managed Entities [*i.e.*, the Rigas Entities] under credit facilities for borrowings of up to \$3,751,250[,000] [the apparent ceiling of the credit facilities]." The footnote, however, never mentions how much the Rigas Entities have drawn down under the credit facilities or the fact that Adelphia's liabilities for those borrowings are separate from, and in addition to, the \$9.179 billion in "Total subsidiary debt" listed on the balance sheet. Adelphia might have violated Generally Accepted Accounting Principles by not including Rigas Entity borrowings in the line item for Total subsidiary debt and, beyond that, might have misled the public by suggesting that it was including such borrowings in its reported liabilities when it was not. Adelphia made no prior public disclosure of its guarantee of \$500 million in loans to Adelphia Business.

2. *Consolidation of the Rigas Entities.* Adelphia managed the Rigas Entities, which were controlled by the Rigas family. Under FASB Statement No. 94, consolidation of financial statements is appropriate, among other things, when one entity has an other-than-temporary controlling financial interest in another entity. Therefore, depending on the facts, it is possible that the financials of these entities should have been consolidated or combined with the financials of Adelphia.

3. *Failure to disclose that Adelphia was funding purchases by the Rigas family of Adelphia stock.* The Rigas family's undisclosed use of the proceeds from the credit facilities to purchase Adelphia securities raises a concern that the company and the Rigas family may have engaged in fraudulent efforts to support artificially the price of Adelphia stock. Over the past several years, analysts have viewed purchases of Adelphia stock by the Rigas family as a show of confidence in the company – unaware that Adelphia itself was helping to finance the purchases through the co-borrowing arrangements. As Oren Cohen, a Merrill Lynch analyst, explained in The Wall Street Journal on April 4, "[i]nvestors should feel blindsided . . . The people who bought stock in the November deal [*i.e.* one of Adelphia's recent stock offerings] and saw that the Rigases were also buying stock in the deal didn't realize that Adelphia was co-borrower with the family on these loans."

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IV.

LEGAL DISCUSSION

Possible Violations of Section 17(a) of the Securities Act And Sections 10(b), 13(a), 13(b)(2) And 13(b)(5) Of The Exchange Act And Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1 And 13b2-2, As A Result of Adelpia's Liability and Contingent Liability Disclosure Practices

Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraud in connection with the purchase or sale of securities. A violation of these antifraud provisions occurs when: (1) there is a false or misleading statement of material fact; (2) made in the offer or sale, or in connection with the purchase or sale of securities; and (3) the defendant acted with scienter.¹ See Basic, Inc. v. Levinson, 485 U.S. 224, 231 n.6 (1988).

Materially false or misleading statements in periodic reports filed with the Commission violate Section 10(b) of the Exchange Act and Rule 10b-5 if the statements are made with scienter. E.g., Aaron v. SEC, 446 U.S. 680, 696-97 (1980); Goldman v. Belden, 754 F.2d 1059, 1069 (2d Cir. 1985); SEC v. Benson, 657 F. Supp. 1122, 1130-31 (S.D.N.Y. 1987). The scienter requirement may be satisfied by reckless conduct, which has been defined as "conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care.'" Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000) (quoting Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978)).

Section 13(a) and Rules 13a-1 and 13a-13 require issuers to file annual and quarterly reports with the Commission. Rule 12b-20 requires disclosure of such additional information as may be necessary to make the required statements not misleading. Implicit in these provisions is the requirement that the information reported be true, correct, and complete. United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir.), cert. denied, 502 U.S. 813 (1991); SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). No showing of scienter is necessary to establish an issuer's violation of the corporate reporting provisions. SEC v. Wills, 472 F. Supp. 1250, 1268 (D.D.C. 1978). Consequently, an issuer violates the reporting provisions if it files materially false or misleading reports or omits information necessary to render the statements made not misleading. SEC v. Koenig, 469 F.2d 198, 200 (2d Cir. 1972); see also Kaufman & Broad, Inc. v. Belzberg, 522 F. Supp. 35, 42 (S.D.N.Y. 1981) (Rule 12b-20).

Adelpia may have violated the antifraud and corporate reporting provisions by filing with the Commission quarterly and annual reports that may have contained materially misstated financial statements with respect to fiscal years 1997 through 2001. Adelpia may have failed to include on its consolidated balance sheet bank borrowings, or otherwise understated liabilities, for which it is

¹ Scienter is not a requirement for a violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 697 (1980).

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jointly liable with the Rigas Entities. Adelpia may have also failed to disclose contingent liabilities arising from its guarantees of present or former subsidiaries' debts. In addition, Adelpia might have misrepresented that it was including its potential liability for Rigas Entity borrowings on its consolidated financial statements, when it was not. It is also possible that Adelpia should have combined or consolidated the financials of the Rigas Entities with its financials. The staff is not yet able to quantify the potential liabilities or contingent liabilities that Adelpia may have failed to disclose.

If the foregoing occurred, Adelpia may also have failed to maintain accurate books and records and to devise and enforce an appropriate system of internal controls.² Such failures may, in turn, have resulted from the falsification of certain Adelpia books and records and the conduct of certain Adelpia employees, including senior management, possibly in violation of Section 13(b)(5) of the Exchange Act and Rule 13b2-1.³

If an officer or director made or caused Adelpia to make a materially false or misleading statement or omission to an accountant in connection with the audit or examination of any of Adelpia's financial statements or the preparation or filing of any document or report Adelpia filed with the Commission, such individual possibly violated Rule 13b2-2 as well. Finally, if Adelpia personnel knowingly or recklessly engaged in conduct resulting in a material misstatement of Adelpia's financial performance, they too may have violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

V.

NEED FOR A FORMAL ORDER

A formal order is needed to conduct a complete and efficient investigation of these matters. A formal order will enable the staff to compel testimony and the timely production of documents from, among others, Adelpia, Deloitte, the Rigas Entities, lending institutions, and individuals associated with these entities.

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- 2 Such failures would respectively constitute violations of Section 13(b)(2)(A) of the Exchange Act (requiring issuer to "keep books, records, and accounts" that "accurately and fairly reflect" issuer's business activities) and Section 13(b)(2)(B) of the Exchange Act (requiring issuer to "devise and maintain . . . internal accounting controls sufficient" to permit, among other things, preparation of accurate financial statements).
- 3 Section 13(b)(5) of the Exchange Act prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account described in Section 13(b)(2). Rule 13b2-1 prohibits any person from directly or indirectly falsifying, or causing to be falsified, any book or record subject to Section 13(b)(2)(A).

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VI.

RECOMMENDATION

In light of the foregoing, the staff recommends that the Commission issue a Formal Order of Private Investigation in this matter.