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Preventing a Personal Indictment Crisis — Part I

Law360, New York (February 27, 2009) — We are in the next phase of the worldwide financial tumult; scapegoating — the search for individuals and companies to indict. The risk of white collar criminal review by prosecutors has never been greater.

As Troubled Assets Relief Program funds are being used, left unused and misused, and companies scratch for loopholes to end-run newly minted and vague restrictions on executive pay and perks, the potential for criminal entanglements increases exponentially.

Risks include criminal charges, loss of reputation, cancellation of operating licenses, loss of personal wealth, permanent ineligibility from participation in government-funded programs and contracts, and loss of employment opportunities, even though the underlying conduct does not embrace traditional tests of criminality such as that attributed to Bernard Madoff.

Prosecutors are criminalizing investment and other practices which were, at the time they were occurring, approved by governments and markets under the aegis of vague laws and regulations.

There is a domino controlling presumption that the collapse of financial markets was caused by greed, which provoked the taking of unreasonable risks, which led to the dissemination of lulling, false and misleading investment information to regulators and clients, and prevented regulators and clients from discovering overvalued assets and the degree of the risks being taken.

Simultaneously, it kept investors in the dark about financial information which, had they known the true state, would have driven them to make contrary investment decisions. The controlling presumption never takes into account that some very smart people developed innovative financial products to create real wealth.

The controlling presumption is fueled by the belief that regulators and investors were duped, market managers and makers, at every level, were profiteering in unprecedented amounts, and public (SEC) and private sector (investment houses, personal financial managers and accounting firms) watchdogs slept.

Legislatures are increasing federal and state agency budgets, putting more agents and auditors into the field, and state and federal prosecutors — to divert attention from failed government enforcement and government policies — are putting historical differences aside by sharing data, targets, headlines and manpower.

Yet, imbedded in the framework of failed government policies lie unprecedented defenses to criminal allegations, not just to defend with but to prevent charges from ever being filed. The actual means by which regulations were enforced or unenforced gave governmental imprimatur to practices engaged in and the extent of risks taken.

By way of illustration, The Wall Street Journal recently reported that John Dugan, Comptroller of the Currency,

in response to a report issued by the U.S. Treasury Department's inspector general, wrote:

"We agree that, in the case of ANB, there were shortcomings in our execution of our supervisory process and that it is appropriate to take additional measures to reinforce these principles to our examination staff."

It is unconscionable for government, to have encouraged the creation of creative financial products and their attendant risks and later, when the bubble burst, to retroactively brand them as sham.

For a decade or more these financial products, many experimental, served the government's interests in creating jobs and fueling unparalleled, manufacturing, global trade, construction and the all-time Dow Jones Industrial Average highs.

Second, while the business community was being given policy messages via modes of enforcement, the actual regulations under which everyone was operating were vague, perhaps intentionally so. New ones continue to be vague.

For example, as recently as Feb. 4, 2009, the plan to restrict executive compensation and benefits was riddled with loopholes and ambiguities.

Obviously, the government does not want to stifle reward for merit or drive away invaluable leaders, and, therefore, feels compelled to allow wiggle room. However, having left room to wiggle, it cannot then complain when boards of directors and CEOs wiggle.

The government created a climate of risk-taking. If, in a declining economy, bank loan collateral ends up being undervalued after a drop from original values, bank regulators reviewed these loans and saw and or had access to all data, and left saying nothing or approving the high valuations on the books, it would be unconscionable to subsequently indict based on those loans that were reviewed and approved by government actors.

Such reviews should be construed as policy statements that the regulatee should be able to rely on and all the more so when this happens time and again industry wide. New rules to evaluate past practices don't count.

If you find yourself in a comparable situation, you must document every detail of the review and audit, i.e., what was reviewed, by whom and all conversations.

By the same token, the regulatee, to preserve the defense must be forthcoming and must not deceive or withhold records or information to take away the government's argument that its "approval" was premised on less than all the relevant information.

With the spate of anticipated indictments there will be a need for experts familiar with instructions given regulators and how enforcement practices and policies were actually implemented.

Success will depend on experts from prestigious business schools and former government staffers turned consultants who studied or participated in government regulation of financial markets during the relevant period.

The development and sale of financial products passes before many eyes, including originators, assemblers, packagers, bundlers, traders, marketers, sellers, resellers, advisors, consultants and verifiers. Several may be under the same roof.

Verifiers are independent accountants, resellers and money managers. All are at risk. There is scant comfort being the farthest from the starting line as there are due diligence obligations at every step. How many financial managers placed money with Madoff without any due diligence?

A reseller of an investment vehicle makes actual and implicit representations of associated risks in order

to make the sale and collect the fee or commission. What were these representations based on? What independent due diligences were performed?

In 2009, many subpoenas will be issued and law enforcement interviews conducted of persons and entities who resold financial products which were not what they purported to be or required preinvestment disclosures were not made.

How could wealth managers, brokers and dealers tout non-existent or seriously overvalued assets? How could auditors have verified or put value on assets that never existed?

Similarly, what did a feeder fund know or represent it knew when it touted the investment? What was their commission or placement fee, and was it disclosed? Wealth managers commonly get their fees and commissions from their clients or on trades, and they may not double dip.

Given the depth of public rage and government's need to distance itself from its own ineptitude and failed policies, no one has the right to assume, unless given written assurance to the contrary, that they are not and cannot become targets of the investigations. Parenthetically, the agent who may have visited you does not have the authority to provide that assurance.

The purpose of accumulating defenses is not just to win the case but to discourage indictments by demonstrating the hurdles the prosecution must overcome.

Opinion from counsel is another invaluable defense. A crucial element of a crime is criminal intent which is established indirectly by conduct.

If an individual or company actually seeks legal advice before acting and fully discloses to legal counsel all relevant information, experienced, knowledgeable counsel approves and the advice is followed, it becomes very difficult to prove criminal intent.

Why would legal counsel be sought and followed if there had been any intention to violate the law? However, once the defense of legal advice is invoked, the attorney-client privilege as to the entirety of that engagement is lost.

It also means going that extra step to obtain legal counsel and make full disclosure as counsel's opinion will be couched in terms of what was revealed and reviewed and, then, of course, the advice must be followed. In many complex transactions you may need to rely on CPA expertise instead of or in addition to that of legal counsel.

While we're on criminal intent, let's examine "loopholes." When is a loophole not a loophole? When does a loophole become a fraud? I have three prominent, currently ongoing illustrations:

- 1) Citigroup Inc. is examining ways to back out of its marketing arrangement with the New York Mets which includes naming the new Mets ballpark CitiField for payments totaling \$400 million over 20 years;
- 2) restaurateurs are trying to break leases for new space in light of the economy driven downturn in dining out and;
- 3) companies are exploring how to end-run government guidelines on officer compensation.

The analysis requires that we not confuse motive with entitlement. The motives to break contracts and leases or end-run government regulations are obvious, irrelevant and do not determine whether a crime was committed. That is determined by whether the contract, lease or regulation permitted the end-run and the means and transparency employed to accomplish it.

If a contract or lease is, for any number of contract law reasons, unenforceable, then there can be no fraud. The disagreement is obvious, and either party has the option of having a court decide the enforceability of

the contract or lease.

A breach of contract, no matter how mean-spirited, is not a crime unless there was never an intent to ever honor the contract. By contrast, companies manipulating officers' titles and compensation packages to avoid restrictions on executive compensation and benefits using artifices are flirting with indictment.

It has been urged that, to avoid the restrictions, a company change the executive's title. To what? Mopster-in-Chief? The value of the corporate titan is not in the title, but in the work done and decisions made. You can't take the same duties, responsibilities and expectations and wrap them into a new title and think you are now compliant.

Similarly, you may not restructure a historical compensation package so as to leave the package unchanged, but renamed. Renaming stock options, deferred compensation, bonuses or renaming the executive's title without substantive changes is fraud.

There is no question that before any recipient of TARP or economic stimulus money starts up this slippery slope, you need to consult counsel and, at that, one versed and experienced in what constitutes criminal behavior.

Another defense is the absence of clarity of the government's regulation. Many are vague. You really want a legal opinion on this before you go there. When and if you do restructuring and renaming, do it openly and transparently.

In the criminal review of investment and loan decisions, the focus must be at the time the decisions were made and not a reinterpretation based on subsequent market events.

There are monumental differences between, on the one hand, breaches of fiduciary duties or contracts and business judgments gone awry, and crimes on the other.

How does the securities broker, lender, financial product developer, trader, mortgagee, bundler, advisor, etc. protect herself: by maintaining a comprehensive file of the good faith, independent portfolio research performed, resources and consultants that were contacted, and the entire basis for the ultimate decision.

The final decision does not have to be correct, but it must be arrived at free of corruption and self interest, with full disclosure of risks, deceit free, i.e., the result of genuine due diligence.

In my followup article next week, I will look at the standard of criminal intent, "theft of services," bonuses and other pertinent matters attached to these issues.

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