

DM EXTRA!

November 5, 2004

“White Collar Crime” Crackdown

**Prosecutors’ push puts boards on high alert;
multiple industries targeted.**

Director Summary >

As the nation gets back to business following the November elections, many directors are turning their attention to compliance. Directors in the insurance industry are still spooked by an October surprise, when New York attorney general **Eliot Spitzer** announced a widespread investigation into alleged price-fixing by New York-based insurers and insurance brokers. The event triggered a CEO resignation at a major insurance brokerage firm (**Marsh McLennan**), as well as rumors of early retirement for the chairman of a major insurance provider (**AIG**).

In the words of one asset manager (**Scott Black**, chairman and president of **Delphi Asset Management** in Boston, “In this era of Sar-

banes-Oxley, governance is a front-burner issue. I just hope that the scandal doesn’t become more widespread.”¹ This particular scandal may not be proliferating, but prosecution fever is certainly spreading like wildfire. While directors in the insurance industry and other financial services go on high alert as they check the soundness of their companies’ compliance programs, directors in other industries—especially energy, healthcare, and retailing—would be wise to follow their example.

>This DMX describes the spreading crackdown on white-collar crime in a variety of industries, and explains its significance for corporate directors.

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country’s only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director’s Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



Two Lafayette Centre
1133 21st St. NW, Suite 700
Washington, D.C. 20036

202-775-0509 • www.nacdonline.org

Research: Alexandra R. Lajoux, NACD
Legal Review: Richard H. Koppes,
Jones Day, Sacramento, California
Design: Mary A. Graham, NACD

You can't prosecute your way to compliance.

U.S. Deputy Attorney General John Comey

Crackdown on Corporate Fraud: A Key Task Force

Spitzer's actions form only one part of a broader white-collar crime crackdown that has been going on ever since the bankruptcies of **Enron** and **WorldCom**. Attorney generals of all 50 states communicate with each other, and with the **Office of the U.S. Attorney General** (their counterpart in the federal government, who heads the **U.S. Department of Justice**), via the **President's Corporate Fraud Task Force**. <http://www.usdoj.gov/dag/cftf/>

The Corporate Fraud Task members represent the **Department of Justice** (Federal Bureau of Investigation), the **Department of Labor** (Employee Benefits Security Administration), the **Department of Treasury** (Internal Revenue Service), and the **Department of Housing and Urban Development** (Office of Federal Enterprise Housing Oversight, which oversees Fannie Mae and Freddie Mac), as well as several government agencies, including the **Commodities Futures Trading Commission** and the **Federal Energy Regulatory Commission**, which have both been active in going after fraud in the energy industry. The **Securities and Exchange Commission** has also been active. During the first year of the Task Force, the SEC had a 50 percent increase in its activities related to corporate fraud. Among other actions, the SEC has sought to bar 124 corporate directors and officers from continuing their service in publicly traded companies.

Now in its third year, the Task Force is gathering new momentum under the direction of U.S. deputy attorney general **John Comey**. As of September 2004, members of the Corporate Fraud Task Force had charged some 900 violators and secured over 500 corporate fraud convictions, including at least 25 former CEOs. Many of these convictions led to prison sentences. In addition, Task Force members have frozen tens of millions in assets.

In a keynote speech at the NACD Annual Conference in October 2004, Comey explained that the main purpose of the Task Force was to deter white-collar crime by prosecuting high-profile cases. The Task Force does encourage self-reform. In one recent case involving **Computer Associates**, Comey explained, government prosecutors gave the company an 18-month deferral to give CA time to make changes. If changes are successful, the government will not prosecute. "You can't prosecute your

way to compliance," he told attendees (as quoted in the October 28, 2004, *DMX*). In general, however, Comey probably errs on the side of being too tough, rather than too lenient. Like a growing number of prosecutors, carps one commentator, Comey is "willing...to make a federal case out of almost anything."²

Ground Rules for Prosecution

In fact, the federal prosecutors on the Task Force have ground rules for what and who they target. These principles appear in an early memo from James Comey's predecessor, former deputy attorney general **Larry Thompson**. http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm

"A corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents," wrote Thompson, who is now general counsel at **PepsiCo**. "To hold a corporation liable for these actions," says the Thompson memo, "the government must establish that the actions of the director, officer, employee, or other agent, were within the scope of the person's duties and were intended, at least in part, to benefit the corporation." Furthermore, in conducting an investigation, determining whether to bring charges, and negotiating pleas, prosecutors weigh several factors:

- The nature and seriousness of the offense.
- The pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management [what Comey referred to as a "sick culture" in his October 2004 speech at the NACD conference].
- The corporation's history of similar conduct.
- The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents.³
- The existence and adequacy of the corporation's compliance program.
- The corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies.
- Collateral consequences, including disproportionate harm to innocent stakeholders and the public.
- Whether the individuals in the corporation have already been adequately prosecuted (prosecutors usually sue both individuals in the corporation and the corporation).
- Whether the government has already exacted adequate remedies via civil or regulatory enforcement actions.

CEOs under Fire

Not surprisingly, with the dual emphasis on both organizations and individuals, government prosecutors have been busy seeking convictions of individuals at all corporate levels. Last month, Enron’s former assistant treasurer pled guilty to a charge of conspiracy to commit fraud, and earlier this month, a **Houston** jury delivered five more convictions in the Enron case (involving a mid-level financial officer and four accountants). The convictions came with the help of an Enron-specific task force within the Department of Justice.

Middle managers are not the only ones charged or convicted. Government prosecutors have also convicted several high-profile chief executives with the help of the Task Force, including the former leaders of cable television provider **Adelphia Communications Corp.**, investment bank **Credit Suisse First Boston**, retailer **Martha Stewart Omnimedia**, and drugstore chain **Rite Aid Corp.** In addition, government lawyers have indicted many others—including the former CEOs of **Enron**, **WorldCom**, and **HealthSouth Corp.** These CEOs have all pled not guilty to the charges and are awaiting trial.

NACD takes no position on the merit of these charges, but it is certainly fair to observe that even conscientious CEOs and directors can be caught up in corporate scandals. Therefore, even the best directors and officers can benefit from a crash course in both civil and criminal law—as follows.

Civil vs. Criminal Law: A Crash Course

In the United States, if corporations, directors, or officers are accused of wrongful behavior, they may face not only civil but also criminal lawsuits for the same action—and the cases may be in both state and federal courts (see box below).

Box 1. The Prosecution Grid: Four Kinds of Law, Four Kinds of Government Cases

	Civil Law	Criminal Law
Federal Law	Federal civil cases	Federal criminal cases
State Law	State civil cases	State criminal cases

- **Civil law** prohibits acts that are viewed as against a particular individual. There are two types of civil law: contracts (written or oral agreements that have been breached), and torts (wrongs). In comparison to crim-

inal law, the punishments under civil law are less severe (they involve fines only, not jail or death), but standards of proof are easier to meet. Either the government—state or federal—or a private litigant may bring a civil case. (The focus of this *DMX* is on government cases.)

- **Criminal law** prohibits specific acts that are viewed as acts against society, so the government (as the representative of the public) brings charges. Punishment may include fines, imprisonment, or even capital punishment (in the most extreme cases). Purposes are generally stated as punishment, deterrence, and/or rehabilitation. Standards of proof are stringent; the person must be tried by a jury, and the jury must not have even a “shadow of a doubt” about guilt.

Criminal laws cover anything from a record-keeping violation (deemed criminal under the Foreign Corrupt Practices Act, or FCPA) to an organization created solely for criminal purposes (deemed criminal under the Racketeer Influenced and Corrupt Organizations, or RICO). FCPA and RICO, both laws from the 1970s, are the two most famous laws criminalizing wrongful business behavior. Currently the U.S. Code (the repository for all federal laws) contains 4000 federal crimes, an increase of 33 percent since 1980, notes a study by the **Cato Institute**. Many of the “crimes” pertain to business practices that were considered legal prior to passage of the laws. Cato researchers have warned about the “ever-expanding power of federal prosecutors.”⁴ **Robert J. Giuffra Jr.**, a former chief counsel to the **Senate Banking Committee** now in private practice as a defense lawyer, asks, “Where should the line be drawn? The entire *Fortune* 500 is not a criminal enterprise.”⁵

A Blurred Line

In recent years, the line between the criminal and civil law has been blurring. Some business practices traditionally considered to be merely violations of contracts, or as wrongs against individuals, are now viewed as crimes against society.

Conversely, actions that normally fall under criminal law can also be prosecuted in civil courts when plaintiffs have failed (or fear that they may fail) to satisfy the burdens of proof under criminal laws. The crossover can do harm in both directions:

- Use of criminal law to punish business wrongdoing has become so commonplace that some inexperienced prosecutors may not understand the difference between a crime and a violation of an accounting rule, notes **Mary Jo White**, past Manhattan U.S. attorney, and now a partner with **Debevoise Plimpton LLP**.⁶

The public perception that a verdict of civil liability is equivalent to criminal guilt could ruin a person's life.

—Wendy McElroy

- Conversely, the growing use of civil proceedings to buttress criminal cases can also cause problems because it is easier for a plaintiff to prevail in civil court than it is for the state to prevail in criminal court. **Wendy McElroy** (a controversial **Fox News** commentator in the tradition of **Ayn Rand**), has noted problems with this trend. “If a defendant is found ‘guilty’—that is, liable in a civil court—then his wealth, reputation, and career might be ruined by the verdict without his ever having the chance to vindicate himself in a more stringent proceeding. In short, the public perception that a verdict of civil liability is equivalent to criminal guilt could ruin a person’s life.”⁷

Geographic Hotspots for Prosecution

For both criminal and civil cases against corporations, there are some prosecuting hotspots. The biggest one is **New York**. As in all other states, there are two main sources of prosecution: state and federal. (This dual system of prosecution exists throughout the United States, because every state has its own state attorney general to enforce state laws, as well as districts of the United States attorney general to enforce federal laws.)

- Prosecution under state laws comes under the **Office of the Attorney General of the State of New York**. Although the New York attorney general’s authority to prosecute is found throughout the laws of New York state, most of the work of the office comes after the head of a department, division, or agency of the state asks the attorney general to investigate and prosecute the commission of any “indictable offense” related to the authority of that agency.⁸ The current head of this office is New York attorney general **Eliot Spitzer**, who previously served as assistant district attorney in Manhattan, enforcing state laws within that borough.
- Prosecution under *federal* laws in that location comes under a district within the jurisdiction of the United States attorney general, under the **U.S. Department of Justice**. In New York, most of these actions occur in **United States Attorney’s Office for the Southern District of New York**, which represents the nation in both civil and criminal litigation in the court. The current head of this office is **David M. Kelly**. His precedes-

sors include **Comey** and **White** (mentioned above), and **Rudolf Giuliani** (past Mayor of New York, now heading a security consulting firm), who actively cracked down on insider trading in the late 1980s.

Significantly, both **Spitzer** and **Kelley** ranked among *Corporate Crime Reporter’s* “top 10 corporate and white collar crime prosecutors” for 2004, based on that publication’s tally of the number of attempted and successful prosecutions in 2004. <http://www.corporatecrimereporter.com/>

The identification of **Spitzer** and **Kelley** as activist prosecutors is not surprising. Many of the CEOs named above were targeted by one of the two men. **Spitzer** especially put fear in the hearts of directors earlier this year when he charged **Ken Langone**, a director of the **New York Stock Exchange**, while investigating alleged conflicts of interest in the compensation of former NYSE head **Dick Grasso**. **Langone**, who did not benefit from the compensation, has asked a federal judge to dismiss the suit. Joining **Spitzer** and **Kelley** on the top corporate prosecutor list is another New Yorker, **Robert Morgenthau**, district attorney of Manhattan (who works under **Spitzer**). **Morgenthau**, called the “father of white collar crime prosecution” because of his early work in the field, was unsuccessful in going after **Tyco**, but the case will be tried again in a few months (January 2005).

Other geographic hotspots for federal prosecutors (all linked to the Task Force) include:

- **Birmingham, Alabama**. U.S. attorney **Alice Martin** got 14 former top **HealthSouth** executives to plead guilty and cooperate in the government’s ongoing criminal case against the company’s founder and former CEO. She has also pursued criminal charges against a small retailer that declared bankruptcy, and against a small steel company accused of environmental violations.
- **Philadelphia, Pennsylvania**. U.S. attorney **James Sheehan** has been focusing on alleged fraud in health-care and retailing (especially fraud against the U.S. government by contractors). In 2004, **Sheehan** has successfully brought cases against **Adelphia**, **Rite Aid**, and **Medco Health Solutions**. Recently, under **Sheehan’s** watch, **Schering Sales Corp.**, the sales and marketing subsidiary of drug manufacturer **Schering-Plough Corporation**, pled guilty to criminal charges and paid a fine of \$52.5 million, while **Schering-Plough Corp.** agreed to pay more than \$290 million to resolve civil liabilities stemming from its fraudulent pricing of **Claritin**, its allergy medication. The case was brought to **Sheehan** by employee whistleblowers at a **Schering-Plough** subsidiary.

- **Boston, Massachusetts.** U.S. attorney **Michael Sullivan** has been active in the healthcare arena. To name just two examples, in June 2004, he brought a health care fraud case against **Warner Lambert** and secured a \$240 million criminal fine. Last year, his office brought a false-claims-act case against **Bayer**. The company pled guilty, paid a \$5.5 million criminal fine, and \$251 million to settle civil charges.
- **Los Angeles, California.** U.S. attorney **Deborah Yang** has an unusually high percentage of business cases (84 of 205 cases in 2004, says *Corporate Crime Reporter*). The largest case so far has been against a French firm, **Credit Lyonnais**, which paid \$770 million in fines related to the acquisition of a defunct life insurance company in the U.S.

What Lies Ahead: The 109th Congress

The next Congress could take action to empower the executive branch even more. NACD is keeping an eye on an obscure provision to increase liability exposure of public company directors that **Sen. Carl Levin** (D-MI) successfully tacked onto a charity reform bill earlier this year, S. 476, The Charity Aid Recovery and Empowerment (CARE) Act, sponsored by **Senate Finance Committee** chairman **Sen. Charles E. Grassley** (R-IA)—which passed the Senate in April 2004, but never made it to the House (necessary for passage of certain kinds of legislation).

S. 476 includes a “sleeper” section affecting public companies. Under this section (723), the SEC would be granted new administrative authority to:

- Impose civil monetary fines on any person who violates the securities laws, not just broker dealers or investment advisers now subject to civil fines, but also, for example, publicly traded companies, officers, directors, and auditors.
- Increase SEC civil monetary fine maximums from a range of \$6500–\$600,000 per violation to a range of \$100,000–\$2 million per violation.
- Subpoena financial records as part of an official SEC investigation without notifying the subject of the records request, “which will bring the SEC into line with federal banking agencies that already possess this authority,” claims Levin.⁹

This provision may not be included in legislation next year, but directors should keep an eye on it. More generally, of course, directors should make sure that they comply with securities laws and other relevant laws.

What Directors Can Do

To avoid being caught in this widening net of government lawsuits against corporations and individuals—including corporate directors—boards need to exercise

vigilant oversight of corporate compliance and ethics. Guidance has come from both the federal government and private sector groups.

Government guidance has come from the **United States Sentencing Commission (USSC)** and from SEC rules implemented as **Sarbanes-Oxley**.

USSC Guidance on Legal Compliance

The USSC was founded in 1985 to ensure more even-handed sentencing in federal cases. In 1987, it issued guidance for compliance programs in organizations including corporations. These guidelines (recently amended effective November 1, 2004), recommend seven components for a strong compliance program:

- Establish compliance standards and procedures for employees and other agents (such as directors and officers) to follow.
- Assign overall responsibility for overseeing compliance to specific high-level individuals.
- Use due care not to delegate substantial discretionary authority to people the company knew, or should have known, had a propensity to engage in illegal activities.
- Take steps to communicate effectively the compliance standards and procedures to all employees and other agents.
- Take reasonable steps to achieve compliance with its standards.
- Consistently enforce its standards through appropriate disciplinary means.
- Take all reasonable steps, after detecting an offense, to respond to and prevent further similar offenses.

The amendment to the seven points above “strengthens the criteria an organization must follow in order to create an effective compliance and ethics program,” says a USSC press release announcing the amendment. “In particular, the amendment requires *boards of directors and executives* to assume responsibility for the *oversight and management of compliance and ethics programs*. Effective oversight and management presumes active *leadership in defining the content and operation of the program*.”

At a minimum, the amendment explicitly requires organizations to:

- Identify areas of risk where criminal violations may occur.
- Train high-level officials as well as employees in relevant legal standards and obligations.
- Give their compliance and ethics officers sufficient authority and resources to carry out their responsibilities.

SEC Guidance on Codes of Ethics

Further guidance is available from an SEC rule implementing section 406 of Sarbanes-Oxley.¹⁰ Its definition of a “code of ethics” can be helpful to directors in ensuring an ethical tone at the top. According to the SEC rule, a code of ethics comprises written standards that are reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest.
- Full, fair, accurate, timely, and understandable disclosure in reports and documents [in SEC filings] and in other public communications.
- Compliance with applicable governmental rules and regulations.
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code.
- Accountability for adherence to the code.

Although all of these items are critical, the third item (compliance) is clearly the most challenging, as there are thousands of laws on the books, and every company’s legal exposure is different. In this regard, the use of qualified legal counsel is more imperative than ever, as is continuing director education.

NACD Guidance on Compliance and Ethics

Private sector guidance has come from many organizations including the NACD, the **Business Roundtable**, and **The Conference Board**, as well as specialized organizations such as the **Ethics Resource Center** of Washington, D.C., and ethics centers at universities.

The following recent NACD publications offer detailed guidance on creating and implementing a strong compliance program, and on creating an ethical tone at the top:

- *Directors Monthly* (regularly features articles on compliance, which may be sought under the term “compliance” in the *Directors Monthly* archives).
- *Corporate Director’s Ethics and Compliance Handbook* (contains guidance on preventive compliance, sample codes of conduct, and a detailed bibliography).
- *Delaware Discourses, Vol. 1, No. 1: Executive Compensation* (contains views of Delaware judges on the role of directors in setting and approving compensation).
- *Blue Ribbon Commission Series Reports* (reports on the *Audit Committee* and *Compensation Committee* outline best practices for compliance in these critical areas; reports on *Risk Oversight* and *Board Leadership* both contain guidance on what the board can do in a crisis such as a corporate scandal. The response of Marsh McLennan’s board to Spitzer’s investigation was a factor in New York attorney general Spitzer’s

decision not to press criminal charges against that company—although charges against individuals are still possible.¹¹)

All of these publications can be accessed at <http://nacdonline.org/publications>.

Meanwhile, to keep up with changing compliance issues and trends, ongoing director education is imperative. NACD’s upcoming topics include:

- Role of the Governance Committee (Nov. 9 in Los Angeles, CA).
- What the Board Expects from the General Counsel and Corporate Secretary (Nov. 10 in Los Angeles, CA).
- Role of the Board in Corporate Strategy and Risk Oversight (Nov. 16 in Research Triangle, NC).
- Director Professionalism (Nov. 17 in Research Triangle, NC; Dec. 8th in Salt Lake City, UT).
- What the Board Expects from the CFO (Dec. 1st in Washington, DC).
- Audit Committee (Dec. 2 in Boca Raton, FL).

For more details, call **Cindy Magill**, NACD director of education at 202-775-0509, visit the NACD website at <http://nacdonline.org/seminars>.

Better safe than sorry!

Endnotes

- 1 Quoted by Jacqueline Gold, “Is Hank Greenberg Next?,” *CNN/Money* on October 26, 2004, <http://money.cnn.com>.
- 2 Quoted in Gene Healy, “Lessons of the Martha Stewart Case,” July 16, 2004, on the website of the Cato Institute. <http://www.cato.org/dailys/07-16-04.html>.
- 3 For a *CFO* magazine article highlighting some of the risks of cooperation, see http://www.cfo.com/article.cfm/3008874/4/c_3036074.
- 4 Ibid.
- 5 Quoted in *Corporate Crime Reporter*, August 13, 2004. <http://www.corporatecrimereporter.com>.
- 6 Quoted in Carrie Johnson, “Motivated to Prosecute,” *Washington Post*, October 19, 2004.
- 7 Wendy McElroy, “Criminal vs. Civil Remedies for Intentional Wrongdoing,” August 13, 2004, on the website of the Future of Freedom Foundation: www.fff.org/comment/com0408f.asp.
- 8 An indictable offense means a violation of law that can result in a formal charge. It does not prove guilt.
- 9 For Sen. Levin’s press release, see <http://levin.senate.gov/newsroom/release.cfm?id=209261>.
- 10 See <http://www.sec.gov/rules/final/33-8177.htm>.
- 11 According to a Reuters News account dated October 26, 2004, “a spokesman for the attorney general said Spitzer will not press criminal charges against Marsh, citing the new leadership and Marsh’s willingness to discuss reforms.”