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Financial & Economic Crisis – Law Firms

United States And Shareholders vs. Corporate Fraud

Bruce I. Goldstein

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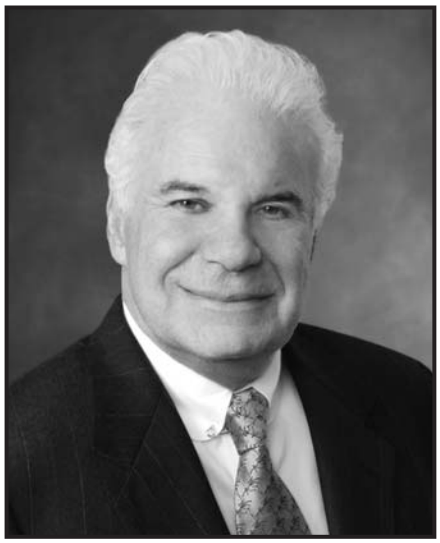
If there is one theme that has dominated the headlines of our newspapers and the dockets of our courthouses during the first decade of the 21st century, it has been the revelation of massive fraud and the criminal prosecution and civil litigation against those responsible for the losses sustained by so many investors.

The decade had hardly begun when Enron became a household name. While the publicly traded stock of the company reached a high of $90 in 2000, that same company sought bankruptcy protection by the end of December 2001 as a result of the disclosure of massive fraudulent conduct involving the creation and concealment of fictitious financial transactions that were not reflected on the books and records of the company. Investors lost nearly $11 billion, and senior executives of Enron were ultimately convicted of fraud.

The collapse of Enron also was responsible for the demise of Arthur Andersen, LLP, then one of the five major accounting firms in the nation, which served as the auditing firm for Enron. Arthur Andersen was indicted and convicted of obstruction of justice by allegedly concealing some of the fraudulent activities of Enron's senior executives, and although the conviction was reversed on appeal, the vindication was Pyrrhic because the company died in the interim.



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It was against this backdrop that Congress passed the Sarbanes-Oxley Act in 2002 (SOX). The thrust of SOX was to restore integrity to corporate governance and to ensure the investing public that the financial records of publicly traded corporations would accurately reflect the true financial condition of the company.

To do so, Congress imposed new standards of corporate governance, redefined the responsibilities of the officers and directors of a publicly traded corporation and imposed civil liabilities and criminal sanctions for violations of the Act.

The passage of SOX represented a legislative attack on corporate fraud. It increased criminal penalties for the commission of fraud against shareholders of companies like Enron and WorldCom to a maximum prison sentence of 25 years, from a former criminal penalty of a maximum of five years imprisonment. It also imposed a criminal penalty of 20 years imprisonment for altering, destroying, or falsifying records with the intent to impede, obstruct, or influence any federal investigation or bankruptcy. SOX also made it unlawful for any officer or director of a public company to fraudulently influence, coerce, manipulate or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statement materially misleading.

SOX required the principal executive and financial officer(s) to certify, in each annual and quarterly report filed with the SEC, that the report does not contain any untrue statement of a material fact or omit a material fact necessary to make the statements not misleading, that the signing officers were responsible for establishing and maintaining internal controls and that the signing officers had evaluated the effectiveness of the corporation's internal controls within the last 90 days prior to the issuance of the report. SOX also required that the signing officers have disclosed to the company's auditors or to the audit committee "any fraud, whether or not material, that involves management or other employees who have had a significant role in the company's internal controls."

Congress also federalized Rules of

***Bruce I. Goldstein**, a Member of the Firm, focuses his practice on litigation where he has gained a reputation as a take-charge litigator managing large complex cases. He also focuses on defending companies and individuals who are targets of white-collar criminal investigations as well as representing and defending law firms. The views and opinions expressed in this article are those of the author and do not necessarily reflect those of Sills Cummis & Gross P.C.*

Please email the author at bgoldstein@sillscummis.com with questions about this article.

Professional Responsibility for Attorney, requiring a lawyer to report evidence of a material violation of securities law or breach of fiduciary duty by any officer of the company to the chief legal officer. It also required the lawyer to report the evidence to the audit committee of the board or a Qualified Legal Compliance Committee (QLCC) if the lawyer concluded that there was no appropriate response or remedial steps taken in response to the evidence he had previously submitted.

On August 28, 2005, Hurricane Katrina struck Louisiana and Mississippi causing the loss of over 1,800 lives and at least $81 billion in property damage. President Bush declared the area a major disaster and emergency pursuant to the provisions of the Robert T. Stafford Disaster Relief and Emergency Relief and Assistance Act, and in the months and years that followed the federal government spent billions of dollars to assist in the restoration of the devastated areas.

It was almost predictable that in the wake of so much money being targeted for hurricane relief that some of these monies would be diverted through fraud. Congress passed the Emergency and Disaster Assistance Fraud Penalty Enhancement Act of 2008 in response to allegations of massive fraud.

The legislation amended the federal mail fraud and wire fraud statutes to provide that whoever engaged in any scheme or artifice to obtain a financial benefit in connection with a presidentially declared major disaster or emergency as defined by the Robert T. Stafford Disaster Relief and Emergency Assistance Act shall be subject to a fine of not more than $1,000,000 and/or a prison sentence of not more than 30 years.

The Act also required that the United States Sentencing Commission promulgate existing guidelines or amend existing guidelines to provide for increased penalties for persons convicted of having violated the Act to ensure that the sentencing guidelines and policy statements reflect the serious nature of the offenses proscribed by the Act.

The next domestic disaster to strike the United States in 2008 was the potential demise of major Wall Street financial institutions as a result of underwriting failures, the collapse of collateralized securities that turned out to be vacuous and the cratering of the American real estate market caused, in part, by unrestrained speculation fueled by banks and mortgage companies that had inadequate underwriting policies, or who simply extended loans to borrowers who were in no position to pay the loans back.

Once again, the federal government came to the rescue to bail out the financial industry. Loses were estimated to be in the hundreds of billions of dollars, and once again the Congress was required to address the subject matter of fraud. On May 20, 2009, the Congress passed the Fraud Enforcement and Recovery Act of 2009 (FERA). The stated purpose of the Act was "to improve enforcement of mortgage fraud, securities and commodities fraud, financial institution fraud and other frauds relating to federal assistance and relief programs, and for the recovery of funds lost to these frauds…"

To that end, the Congress appropriated to the Attorney General $165,000,000 for each of the fiscal years 2010 and 2011. Additional provisions of tens of millions of dollars were also allocated to the Postal Inspection Service, the Inspector General of the Department of Housing and Urban Development, the United States Secret Service of the Department of Homeland Security, the Securities and Exchange Commission and the Office of the Inspector General of the Securities and Exchange Commission.

The passage of FERA has also given the federal government and shareholders of publicly traded corporations a much stronger hand in uncovering fraud in the mortgage-lending business, the securities and commodities industry and in projects financed by the federal government.

FERA has expanded the definition of a "financial institution" to include mortgage-lending businesses that make federally related mortgage loans. This expanded definition of the term "financial institution" is of great significance because it now subjects any person or entity who has been convicted of having engaged in mail fraud or wire fraud in connection with a mortgage-lending business to a fine of up to $1,000,000 and a term of imprisonment of up to 30 years.

FERA has also criminalized false statements made by mortgage brokers and mortgage-lending businesses and imposed a fine of up to $1,000,000 and a prison sentence of up to 30 years.

In passing FERA, Congress also expanded the breadth of 18 U.S.C. 1848 which criminalizes securities fraud by including fraudulent schemes involving commodities futures and options on commodities futures within the ambit of the statute.

FERA has strengthened the False Claims Act. The statute's definition of "claim" has been clarified to make clear that any person or entity who "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim" violates the provisions of the statute even if the claim is submitted by a sub-contractor to a contractor who in turn submits the claim to the federal government. It overturns prior Supreme Court law and no longer requires a prosecutor to prove that the person or entity who made the misrepresentation actually intended to defraud the government or that the claim was submitted to a representative of the government. A subcontractor who knowingly submits a false claim to a contractor falls within the ambit of the False Claims Act.

FERA also proscribed fraud committed in any grant, contract, subcontract, subsidy, loan, guarantee, insurance, or other form of federal assistance through the Troubled Asset Relief Program (TARP) or the government's purchase of troubled assets as defined in the Emergency Stabilization Act 2008 as a major fraud against the United States punishable by up to ten years' imprisonment and fines of up to $10,000,000.

Finally, the Congress expanded the reach of the money-laundering provision by providing that the proceeds of a money-laundering operation include the gross proceeds of the criminal enterprise – not just the net proceeds as previously construed by the Supreme Court.

Only history will tell us whether the statutes which have been passed by the Congress in the first decade of the 21st century will reduce the amount of fraudulent conduct or merely increase the volume of civil and criminal litigation permitted by these new statutes. There can be no doubt, however, that fraud litigation is here to stay and will become even more complex as case law evolves in construing these new statutes.