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Articles

White-Collar Crime and Economic Recession

Anton R. Valukas[†]

INTRODUCTION

The United States experienced twenty-one recessions in the twentieth century.¹ In the twenty-first century, we have already experienced two recessions: one in 2001, the other our current economic crisis, which began in 2007.² Recessions are a regular,

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¹ The United States experienced recessions in 1900, 1902–04, 1907–08, 1910–12, 1913–14, 1918–19, 1920–21, 1923–24, 1926–27, 1929–33, 1937–38, 1945, 1948–49, 1953–54, 1957–58, 1960–61, 1969–70, 1973–75, 1980, 1981–82, and 1990–91. *A History of Recessions*, CNBC.com (Sept 4, 2007), online at <http://www.cnbc.com/id/20510977> (visited Apr 11, 2010).

² According to the National Bureau of Economic Research, the U.S. economy has been in recession since December 2007. Chris Isidore, *It's Official: U.S. in a Recession since Dec. '07*, CNN.com (Dec 1, 2008), online at <http://money.cnn.com/2008/12/01/news/>

apparently inevitable feature of the business cycle. So, apparently, are the steps we as a country take in response to these recessions, in an attempt to address criminal behavior that is revealed by—or believed to contribute to—economic downturns.

In this article, I will suggest that the interplay between the American legal system and economic cycles has assumed a regular, predictable pattern consisting of two phases. First, in periods of economic growth, there is a breakdown in regulatory oversight of the market, generally caused by pressure on regulators not to stand in the way of economic prosperity. The more sustained the period of economic growth, the less people see the need for regulation and the more complacent the regulators become. Regulatory complacency allows deleterious practices to develop undetected and go unpunished. The second phase begins with the onset of an economic recession, which brings with it a wave of white-collar prosecutions and calls for tighter regulation. In good times, the public turns a blind eye to questionable practices that develop, but in a recession, a spotlight is shone on people making money through dubious means. The worst offenders are thrown in jail and millions of dollars are spent on prosecutions, but at the end of the day, the justice system is rarely able to come close to righting the damage caused by practices that could have, and should have, been prevented by sound regulation during times of prosperity.

The current recession, with its attendant wave of prosecutions and calls for further regulation, provides an opportune time for us to make a simple point: we should be equally determined to ferret out financial wrongdoing in times of economic prosperity as we are in down cycles.

We will probably never be able to eliminate economic cycles, but we can and should learn from malfeasance exposed in previous recessions in order to think about how best to deter the business community from making white-collar crime and financial fraud a routine feature of the business cycle.

When I was an Assistant US Attorney in Chicago in the 1970s, some of the first cases I prosecuted involved mortgage fraud. We investigated and prosecuted individuals who defrauded the government by processing mortgages guaranteed by the Fair Housing Administration but extended to unqualified buyers. Not surprisingly, these buyers would default when they could not keep up the payments, and the government was left with a large

number of foreclosed homes. It was the government guarantee of the mortgage that facilitated the fraud.

Thirty years later, little has changed. The current recession has been accompanied by revelations of widespread mortgage fraud, and young Assistant US Attorneys across the country are currently cutting their teeth by prosecuting dozens of individuals who made millions by providing phony statements on mortgage applications.³

It need not be inevitable that, thirty years from now, a generation of young prosecutors not yet born will conduct yet another wave of prosecutions for mortgage fraud in the midst of some future recession—but to avoid that possibility, we need to learn the lessons of history. The biggest obstacle we face is that every time we experience a period of sustained prosperity, there is a tendency to simply believe that widespread financial misconduct can never happen again. When prosperity reigns, we choose to believe the systems that we have put in place will protect us against misconduct and excessive practices. We ignore warning signs of dangers that in retrospect seem obvious. We forget that human beings are given to greed and avarice and will take advantage of opportunities for short-term gain at the expense of long-term stability.

As we follow the prosecutions coming in the wake of the current recession and examine possibilities for regulatory improvements, it is a good time to pay attention to the lessons that recessions can teach us. The first step is simply to recognize the types of wrongdoing that have often been exposed at times of economic downturn. Secondly, we should understand why these practices are allowed to flourish during times of economic prosperity, only to be exposed during recessions. Finally, we should consider what we can do now and what we should do when this recession is over to ensure that the next downturn does not provide us with yet another shocking revelation of widespread fraud and abuse in our economy.

I. RECESSIONS EXPOSE PREVIOUSLY UNDETECTED SCHEMES

During times of economic prosperity, neither government nor the public generally shows much interest in scrutinizing the

³ See generally Federal Bureau of Investigation, *2008 Mortgage Fraud Report "Year In Review"* (2009), online at http://www.fbi.gov/publications/fraud/mortgage_fraud08.htm (visited Sept 28, 2010); Peter Henderson, *U.S. Mortgage Fraud "Rampant" and Growing—FBI*, Reuters (July 7, 2009).

activities of business and the financial sector. This tendency is understandable: why should we spend limited resources on regulators or criminal investigations to investigate why things are going so well? However, when the economy plummets and investors are burned, people naturally ask the question, "How could this have happened?", and its corollary, "Who is to blame?" Regulators and prosecutors fix their gaze on the business world and find no shortage of wrongdoing and corruption. Wrongdoing and corruption are not necessarily the cause of economic recessions, but typically recessions bring them to light.

The most obvious, though still stunning, example from our current economic downturn is the case of Bernard Madoff, the purveyor of what may well be the largest financial fraud in American history.⁴ Over the course of the 2000s Madoff was able to run a \$65 billion Ponzi scheme. He offered his investors steady 15 percent returns. His investors spread news of the fund by word of mouth, and only a select few were invited to join the club and share in Madoff's spectacular returns. The fund's exclusivity added to its allure. Indeed, there was a waiting list for those eager to invest their money in some of Madoff's funds.

So long as everyone was happy and reaping the benefits of Madoff's scheme, no one was interested in investigating the source of Madoff's returns, which turned out to be derived from the money that other investors were paying into the scheme. It was only when the economy soured and investors needed to pull their money from Madoff to cover other losses, and when new investment dollars could not be found to replace these withdrawals, that the scheme collapsed. Law enforcement did not catch Madoff: the economy did.

We now know that the Securities and Exchange Commission had received credible warnings from multiple sources that Madoff's returns defied market realities.⁵ But the SEC had no interest in investigating successful funds whose investors were delighted with their returns. It therefore made only cursory investigations of Madoff's funds. Opportunities to expose his blatantly illegal practices were overlooked because of his very success. Only the recession brought his wrongdoing to light.

⁴ For an overview of the Madoff fraud, see generally James Bandler, Nicholas Varchaver, and Doris Burke, *How Bernie Did It*, 159 *Fortune* 10 (May 11, 2009).

⁵ US Securities and Exchange Commission Office of Investigations, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme - Public Version 1*, 1 (Aug 31, 2009), online at <http://www.sec.gov/news/studies/2009/oig-509.pdf> (visited Sept 28, 2010).

Madoff is the latest in a long line of wrongdoers who were only exposed in the midst of economic downturn. The Great Depression revealed that several abusive practices had become widespread among stock speculators and short sellers during the 1920s, including the offering of totally worthless securities. In some instances these abuses escaped detection throughout the 1920s even though they were clearly criminal. There were many reasons for that: the abuse may not have been seen as significant, the abusive practice may have not been the target of enforcement resources, the sheer complexity of some of the schemes may have concealed their illegality, or there may simply have been no regulatory scheme in place to identify them.

In other instances, though, the abuses of the 1920s were not necessarily criminal. They were, rather, what we might call “excessive practices”—destructive economic behavior that may have been legal or operated in a gray area at the time that the conduct took place. In some instances, this conduct may have even been praised as being creative, though it was later revealed to have negative consequences. It was only once the negative consequences became evident that the behavior was exposed to public scrutiny and legislators scrambled to regulate or criminalize it.

A more recent example of excessive practices came in the 1990s. Business executives and accountants devised complex transactions that yielded profits or tax savings but which had no economic substance. At the time, many of those executives and accountants were praised as “creative” professionals. In 2000 and 2001, however, the profits of some of the most admired Fortune 500 companies were revealed to have been purely ephemeral. Enron, which had been named by *Fortune* magazine as the “most innovative” company for six consecutive years prior to its collapse and which had been lauded in the press as the handiwork of the “smartest guys in the room,” went bankrupt. Enron’s profits were discovered to have been driven by creative accounting, not by a sound business model.⁶ Another darling of Wall Street, WorldCom, soon followed Enron into bankruptcy when it was revealed that WorldCom had also been using accounting tricks to grossly overstate its profits.⁷

Most recently, our current economic downturn has drawn attention to the excessive practices that apparently became perva-

⁶ For an overview of the Enron scandal, see generally Bethany McLean and Peter Elkind, *Enron: The Smartest Guys in the Room* (Portfolio 2003).

⁷ For an overview of the WorldCom scandal, see generally Lynne W. Jeter, *Disconnected: Deceit and Betrayal at WorldCom* (Wiley 2003).

sive on Wall Street in the 2000s, including encouragement and celebration of risk-taking without setting boundaries or recognizing the consequences. The result was the collapse of essentially the entire US financial sector. In this instance, excessive practices have the potential to be even more devastating than criminal conduct. Excessive practices that were not clearly illegal wreaked havoc on our financial system and contributed to an economic downturn.

II. WHY CRIMINAL CONDUCT AND EXCESSIVE PRACTICES FLOURISH DURING TIMES OF ECONOMIC PROSPERITY

When the economy turns sour, revelations of criminal conduct and excessive practices that appear to have contributed to the downturn often lead the public to demand a swift and forceful response. The government responds by passing laws criminalizing the behavior at issue, increasing punishments for established offenses, and increasing the number of prosecutors and regulators. Unfortunately, this government response is often driven as much by the politics of the day as by any rational consideration of how to design a system that will prevent criminal conduct and excessive practices from becoming widespread during the next bull market.

If we are serious about deterring these practices in a meaningful and systematic way, we must first answer two questions: (1) who are the people who engage in these practices, and (2) what systemic factors allow these practices to flourish?

A. Who Engages in Criminal Conduct and Excessive Practices?

I believe that most white-collar crime is deterrable. To understand how best to deter white-collar crime, we should begin by looking at who has the propensity to engage in white-collar criminal activity and who can be dissuaded from doing so.

We can divide people into four categories. At one extreme are the “incorruptibles” or “untouchables.” The incorruptibles are those who will never engage in questionable or criminal conduct under any circumstances. For me, the prime example of an “incorruptible” is Edward Levi, late Dean of the University of Chicago Law School, who, as Attorney General of the United States during the Ford Administration, restored the nation’s faith in the Justice Department in the wake of Watergate. At the other extreme are those who are corrupt to the core and are unlikely to be deterred by any measures that we in a free society will allow ourselves to take. In this category, I place Al Capone.

Many individuals, however, fall between these two extremes, and here, we can take measures that will influence their behavior. These individuals can perhaps be divided into two classes: the “opportunists” and the “go along” crowd.

The opportunists are likely to engage in questionable practices or criminal activity when the reward is great and the likelihood of being caught is low. This category could include people who trade on insider information. However, these people can be dissuaded from committing these crimes if they think they will be caught and subjected to penalties that outweigh the reward.

The next group is the “go along” crowd—people who get swept up by others’ misdeeds and convince themselves that what they are doing is really not so bad, that it is safe, or that it is the norm. Those who backdated stock options may fall in this group.⁸ These people think, “Everyone else is doing it, so it must not be so bad.” This group, too, can be deterred from criminal conduct and excessive practices.

B. Systemic Factors That Allow Criminal Conduct and Excessive Practices to Flourish during Economic Prosperity

Few people are “born white-collar criminals.” Most individuals who commit white-collar criminal activity or engage in excessive practices fit into the categories of “opportunists” or members of the “go along” crowd. These individuals will engage in criminal or excessive practices when faced with certain systemic or environmental factors and will not commit crimes when faced with different systemic or environmental factors.

Based on my experience in the criminal justice system, I suggest that there are three environmental or systemic factors that allow white-collar crime and excessive practices to flourish: (1) a lack of effective prosecution; (2) a lack of knowledge and understanding by regulators and the public about potentially excessive or criminal practices; and (3) failures by the regulatory

⁸ The 2006 prosecution and subsequent conviction of former Brocade CEO Gregory Reyes shocked Silicon Valley because the practice of backdating options was so common that virtually any Silicon Valley CEO could have been prosecuted for similar backdating. See Daniel Fisher, *Option Play*, *Forbes* (Aug 17, 2006), online at http://www.forbes.com/2006/08/16/back-dating-options-cz_df_0817options.html (visited Sept 28, 2010); Carleen Hawn, *Silicon Valley Copes with Guilty Verdict*, *Financial Week* (Aug 13, 2007), online at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070813/REG/70810031/1036> (visited Sept 28, 2010). The deterrent effect of this prosecution was great and is unlikely to be lessened by the fact that Reyes’s conviction was recently overturned. See Philip Shishkin, *Backdating Conviction of Reyes Overturned*, *Wall St J C3* (Aug 19, 2009).

systems and gatekeepers that society relies upon to prevent improper conduct.

1. Lack of prosecution.

During times of prosperity, the resources of the enforcement and regulatory agencies are frequently allocated to areas other than those involving potential financial fraud. In calculating where to devote our prosecutorial resources during boom times, we tend not to focus on complex white-collar crimes. The general thought seems to be, “Why tinker with a system that is working?” Instead, we commit our resources elsewhere. In the 1980s, enormous resources were committed to drug task forces created to fight drugs, gangs, and street violence. It was only after the scandals on Wall Street and the Savings and Loan (S&L) crises, that the government put significant resources into fighting financial fraud.⁹ In the wake of 9/11, vast resources were understandably shifted to fighting terrorism. Now, the government is trying to plug the holes left by that shift, moving agents, resources, and prosecutors back to prosecuting complex white-collar crime.¹⁰

2. Lack of knowledge and understanding.

The second environmental factor that allows these fraudulent financial practices to flourish is a lack of knowledge about them. Because these practices are often complex, or the resulting harms are not obvious, they tend to operate without public scrutiny during times of economic prosperity and we do not focus on their implications. When the economy falters and people begin to look for answers, however, these practices are reviewed more carefully.

For example, in 2000 there was nothing illegal or even improper about an accounting firm earning millions of dollars in consulting fees from the very companies whose books it was auditing. At the time, it was just good business. It was only in the aftermath of the accounting scandals that regulators recog-

⁹ US Department of Justice, Office of the Deputy Attorney General, Corporate Fraud Task Force, *First Year Report to the President 2.2* (July 22, 2003), online at http://www.justice.gov/archive/dag/cftf/first_year_report.pdf (visited Sept 28, 2010).

¹⁰ See generally US Department of Justice, Office of the Deputy Attorney General, Corporate Fraud Task Force, *2008 Report to the President* (2009), online at <http://www.justice.gov/archive/dag/cftf/corporate-fraud2008.pdf> (visited Sept 28, 2010).

nized the obvious and inherent conflict in this practice and took steps to rein in excessive practices in this area.

But the problem goes beyond just acknowledging that the practices exist—it goes to whether we can understand them well enough to regulate or prosecute them.

When we undertook to prosecute financial fraud in the wake of the S&L crisis and scandals, what we found was something similar to our fight against terrorism in the Middle East: we were hampered by our lack of expertise and the knowledge of the customs and language of the area. We were slowed by our lack of FBI agents, IRS agents, and postal inspectors who had the type of sophisticated financial background necessary to investigate and prosecute this criminal conduct. Prosecutors confronted with a complex securities case had a steep learning curve. This pattern continues as increasing complexity underlies the economy, financial practices, and financial transactions that may be excessive or criminal; the expertise of enforcement agencies tends to lag behind. Just as Daniel Burnham said “make no small plans,” the common wisdom is that white-collar criminals should “commit no small crimes” because bigger and more complex financial crimes are also more difficult to prosecute.

3. Failure of the regulatory system and gatekeepers.

The third and possibly the most significant factor allowing criminal and excessive practices to flourish is failure by the regulatory system to control these practices—not just by government regulators, but also by private gatekeepers. This is particularly important in our complex economic system. As a society, we rely on accountants, lawyers, ratings agencies, and auditors to act as a check on illegal and excessive practices.

Gaps or failures in the regulatory scheme provide opportunities for individuals to engage in practices that we may later question or deem criminal. White-collar crime is often a crime of opportunity, and opportunities present themselves most often when there are gaps in the regulatory system or where the gatekeepers fail to perform their functions. Not only does the lack of regulatory oversight provide opportunities for criminal behavior on an individual scale, but these regulatory failures may also play a significant role in causing the downturns in the first place.

In the early part of this decade the Enron and WorldCom scandals and the dot-com bust illustrated a wholesale failure of gatekeepers, including regulators, accountants, lawyers and stock analysts. Stock analysts, who became the rock stars of the

late 1990s and early 2000s, were not the objective observers of the economic scheme that we believed them to be. Instead, they had a financial stake in the advice that they provided. Yet their advice was relied on to sell billions in stocks and helped brokers to sell stocks that they had every reason to believe were overvalued.

At the same time, corporate America sought out “can do” lawyers and accountants. Law firms and accountants looked for ways around the regulatory scheme and gave opinions that, in many instances, were central to assisting either the underlying fraud or its subsequent concealment. In some instances they provided opinions that served as the excuses and rationales for what was later determined to be excessive or criminal activity. In other instances, they failed to ask the hard questions and accepted explanations that were lame at best. They did not press for answers; they valued their relationship with their clients over their duty to serve as gatekeepers. And they were richly rewarded for their loyalty.

One prominent example was Gemstar, which had purchased TV Guide and which provided guide services on television sets. In March 2001, at the height of the tech frenzy, Gemstar was creating quite a buzz. *Business Week* said, “Gemstar is something of a Wall Street darling these days, winning a rush of new fans with analysts putting out buy recommendations in the past two months.”¹¹ Just a year later, in March 2002, Gemstar disclosed \$330 million in revenue restatements. By April 2003, the CEO and CFO had been fired for cause and an alleged fraudulent scheme had been exposed.¹² The CEO was later charged with fraud.¹³ The following year, the company’s auditor, KPMG, was sanctioned for improper professional conduct and fined \$10 million.¹⁴

What is clear from the Gemstar debacle is that one of the key gatekeepers—the accounting firm responsible for certifying the company’s financial statements—had failed in its responsibil-

¹¹ Ronald Grover, Tom Lowy, and Larry Armstrong, *Henry Yuen: TV Guy*, *Business Week* (Mar 12, 2001), online at http://www.businessweek.com/magazine/content/01_11/b3723001.htm (visited Sept 28, 2010).

¹² Saul Hansell, *S.E.C. Says Ex-Gemstar Officials Used Deception to Inflate Revenue*, *NY Times* C1 (June 20, 2003).

¹³ Jane Spencer and Kara Scannell, *As Fraud Case Unravels, Executive Is at Large*, *Wall St J A1* (Apr 25, 2007).

¹⁴ SEC, *Press Release, KPMG LLP and Four Auditors Sanctioned for Improper Professional Conduct in Connection with Gemstar-TV Guide International, Inc. Audits* (Oct 20, 2004), online at <http://www.sec.gov/news/press/2004-147.htm> (visited Sept 28, 2010).

ity as a critical gatekeeper. Much of the information upon which the government relied in prosecuting its fraud case had been available to KPMG. In sanctioning KPMG, the SEC declared its intent to “reinforce the message that accounting firms must assume responsibility for ensuring that individual auditors properly discharge their special and critical gate keeping duties.”¹⁵

Sometimes the failure of the regulators is simply an inability to understand the opportunities for fraud created by their own actions. A very simple rule change, done for reasons that seemed appropriate at the time, may be at the heart of regulatory failures—particularly when the regulators do not foresee the consequences of the change.

For example, one cause of the S&L crisis was a rule change that allowed savings and loans, which had been driven to the verge of bankruptcy by the high inflation of the 1970s, to expand their lending activities.¹⁶ While banks were permitted to lend in a number of different areas prior to the deregulation of the early 1980s, the activities in which S&Ls could engage were severely limited. By the mid-1980s however, the pendulum had swung in the other direction and S&Ls were allowed to engage in a wide variety of lending practices. However, they still were not subject to the regulations applicable to normal banks.¹⁷ The intentions were good—save the S&Ls—but Congress inadvertently created an economic crisis.

Similarly, one cause of the mortgage crises that helped trigger the current recession was a relaxation of lending standards, designed to give more people access to the American dream of owning a home. A 1999 *New York Times* article discussing easing credit requirements for subprime borrowers noted:

[I]n moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic

¹⁵ Id.

¹⁶ Federal Deposit Insurance Corporation (FDIC), *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s* 167, 167–72 (1997), online at http://www.fdic.gov/bank/historical/history/167_188.pdf (visited Sept 28, 2010).

¹⁷ The Savings and Loans industry was deregulated by the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub L No 96-221 (1980), codified at 12 USC § 226 (2006) and the Garn-St. Germain Depository Institutions Act of 1982, Pub L No 97-320 (1982), codified at 12 USC § 226 (2006). According to the Federal Deposit Insurance Corporation, “Legislative actions in the early 1980s were designed to aid the S&L industry but in fact increased the eventual cost of the crisis.” FDIC, *Banking Crises* at 175 (cited in note 15).

times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s.¹⁸

We chose to ignore the risks and plunged ahead, relying on the safeguards, the gatekeepers, the presumed sufficiency of the regulatory practices in place, and perhaps the unrealistic hope that the next downturn would not come. We were wrong.

III. DETERRING CRIMINAL CONDUCT AND EXCESSIVE PRACTICES DURING THE NEXT TURN OF THE BUSINESS CYCLE

Although we will never be able to stop white-collar crime entirely, it is possible for us to alter the systemic and environmental factors that lead “opportunists” and members of the “go along” crowd to engage in deleterious behavior. Increased resources should be dedicated to investigating and prosecuting white-collar crime—in good economic times as well as bad. Excessive practices with negative consequences for society should be criminalized, and penalties should be raised on other crimes to increase their deterrent value. Better regulatory systems should be developed. Perhaps most importantly, we should foster a spirit of transparency in the business world through the use of mandatory disclosure.

A. Increased Prosecutions and Penalties

One of the most powerful deterrents to misconduct is an increased threat of prosecution. Prosecutions are essential to punish wrongdoers, maintain the rule of law, and deter future wrongdoing.

When the threat of prosecution is more certain than speculative, an opportunist will not take risks. A “can do” accountant is less likely to provide questionable opinions if there is a substantial certainty that he will be caught and punished.

Prosecution is often the first line of response when criminal behavior or excessive practices are exposed. As is happening today, task forces are created to determine what went wrong and what should be done. Increased resources are devoted to prosecution, allowing for more prosecutors, investigators, field agents, and accountants. Prosecutions are publicized.

¹⁸ Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, NY Times C2 (Sept 30, 1999).

Prosecutors may also pursue cases against those engaging in excessive practices that do not fall clearly within the scope of existing law, but rather in legal gray areas that have not previously been prosecuted. Such cases are more likely to be pursued where the losses have been massive or the victims are widespread. Convictions are more likely to occur in a climate of anger over the economy.

Congress rushes to enact new laws to criminalize conduct that previously may not have been covered by criminal laws, and to increase the penalties for established offenses. For example, in 1986, before the Sentencing Guidelines, there were circumstances in which you could have participated in a financial fraud in which losses totaled in the millions, been convicted, and received only probation for that offense. If you committed the very same offense in 2006 after the Enron and WorldCom debacles, you would have faced a very different outcome. Under the Sentencing Guidelines in effect at that time—still widely followed though no longer mandatory—a conviction would have required the court to impose a sentence of a minimum of thirty years to life without parole.¹⁹

The recent financial crisis has prompted a similar reaction. For example, on May 20, 2009, President Obama signed the Fraud Enforcement and Recovery Act of 2009.²⁰ This new law increased funding to add prosecutors and agents; authorized \$165 million per year for hiring fraud prosecutors and investigators in the Justice Department, including special agents and forensic analysts for the mortgage and financial fraud program;²¹ and amended the fraud statutes to include TARP and stimulus funds.²²

This type of legislation tracks the historical responses to economic downturns. But expanding prosecutorial resources and increasing prosecutions alone are not enough.

¹⁹ For an offender with no criminal history, the Guidelines impose a sentence of 360 months to life for an offense classified as an Offense Level of 42. US Sentencing Commission, *Guidelines Manual* (USSG) § 5A (2009). Beginning with a base Offense Level of 6 for all basic economic offenses, USSG § 2B1.1(a), the Guidelines increase the Offense Level by 30 for offenses involving the loss of \$400 million or greater, USSG § 2B1.1(b)(1)(P), and by a further 6 levels if the crime involved 250 or more victims, USSG § 2B1.1(b)(2)(C), bringing the crime's Offense Level to 42.

²⁰ Fraud Enforcement and Recovery Act of 2009 (FERA), Pub L No 111-21 (2009), codified in various sections of Title 18 and 31.

²¹ *Id.* at § 3.

²² *Id.* at § 2 (cited in notes 19 and 20).

Simply put, not everyone who engaged in wrongdoing can be prosecuted. The US Attorney for the Northern District of Illinois is responsible for all federal criminal prosecutions, as well as all civil cases in which the United States is a party, that occur in the eighteen counties in the Northern District—home to a population of approximately nine million people. Yet the Office employs only approximately 160 Assistant United States Attorneys.²³ By contrast, the largest law firms in Chicago have over 300 attorneys each in Chicago alone. It is simply not possible for the 160 Assistant US Attorneys to prosecute every federal offense that occurs in the Northern District.

Moreover, prosecutions consume vast amounts of time and money. The process of prosecution is long and complex. During the investigation phase, grand jury subpoenas are issued, agents conduct interviews, and the parties retain counsel. This all takes time; the course of an average investigation is measured in years. If an indictment issues, it is limited to a small number of people. Trials themselves can last for months, and the appeals process goes on for years. For example, Enron collapsed in 2001. The Department of Justice's Enron Task Force was formed in 2002.²⁴ In October 2009, more than eight years after Enron collapsed, the Supreme Court agreed to hear Jeff Skilling's appeal.²⁵ The prosecution of a single individual consumes huge amounts of DOJ time, money, and resources, with the risk of no return if the defendant walks free.

Even when the prosecution is successful, it is simply impossible for the amount of loss to be recouped by prosecution alone. In the S&L crisis of the 1980s, it is estimated that S&Ls lost \$160.1 billion, with the US government spending \$124 billion to shore up failed banks.²⁶ The government responded by creating strike forces in twenty-seven cities, and a thousand FBI agents secured six hundred convictions—but only \$130 million in restitution was recouped.²⁷

²³ "About Us," United States Attorney's Office Northern District of Illinois, online at <http://www.justice.gov/usao/1ln/aboutus/index.html> (visited Sept 30, 2010).

²⁴ Corporate Fraud Task Force, *2008 Report to the President* 1.3 (2009) (cited in note 9).

²⁵ John R. Emshwiller, *Supreme Court to Hear Appeal of Enron's Skilling*, Wall St J A6 (Oct 14, 2009).

²⁶ General Accounting Office, *Financial Audit: Resolution Trust Corp.'s 1995 and 1994 Financial Statements*, 13 (1996), online at <http://www.gao.gov/archive/1996/ai96123.pdf> (visited Sept 28, 2010).

²⁷ Proposals to Fight Fraud and Protect Taxpayers, including: HR 1748, the "Fight Fraud Act of 2009"; HR 1292, to amend Title I of the Omnibus Crime Control and Safe Streets Act of 1968; HR 1667, the "War Profiteering Prevention Act of 2009"; HR 1788,

In sum, prosecutions are necessary, but it is important to remember their role and their limitations.

B. Better Regulatory Systems

For the reasons identified above, prosecutions in the midst of an economic downturn are no substitute for effective regulation during times of economic prosperity. A regulatory system that identifies problems before they become significant and that prohibits excessive practices will have a significantly greater impact than will subsequent prosecutions.

C. Understanding and Disclosure

To successfully deter problematic behavior, there must be a third element besides increased prosecution and effective regulation. The final systemic factor that encourages the growth of criminal and excessive behavior is lack of knowledge and understanding by the regulators.

To address this factor, we must do two things. First, regulators must be aware of the problematic conduct, which means setting up reporting systems and incentivizing self-reporting of those practices that have potential for abuse. And second, once regulators become aware of the conduct, they have to understand the implications of these practices. If the regulators who review the reports and disclosures do not understand the nature of the conduct and its consequences, they cannot address it appropriately.

Many of these financial transactions are so complex and sophisticated that to develop adequate reporting systems and to understand what is revealed by those systems requires a serious commitment of substantial resources. It is clear from the financial disaster of the last two years that the regulators did not understand many aspects of the market that they were called upon to regulate.²⁸ Indeed, it is clear that many of the products that

the "False Claims Corrections Act"; HR 1779, the "Financial Crimes Resources Act of 2009"; HR 1793, the "Money Laundering Correction Act of 2009"; and HR 78, the "Stop Mortgage Fraud Act" before the House Committee on the Judiciary, 111th Cong, 1st Sess 37 (Apr 1, 2009) (statement of John S. Pistole, Deputy Director, Federal Bureau of Investigation), citing S 331, 11th Cong, at § 2(3).

²⁸ See, for example, Binyamin Applebaum and David Cho, *Fed's Approach to Regulation Left Banks Exposed to Crisis*, Wash Post A1 (Dec 21, 2009) ("The Fed's failure to foresee the crisis or to require adequate safeguards happened in part because it did not understand the risks that banks were taking, according to documents and interviews with more than three dozen current and former government officials, bank executives and regulatory experts.").

were being sold and that contributed to this disaster were understood by very few people. The lack of regulation of these products turned out to have devastating consequences.

The collapse of Bear Stearns provides an interesting example.²⁹ At one point the chairman of Bear Stearns, a lifelong Wall Street investment banker, visited the trading floor to talk with traders and see how things were going. One of the traders of fixed income securities interviewed for the book commented that based on the dialogue during that visit, he believed the chairman never really understood the esoteric financial products that Bear Stearns was selling or what it was that they owned. Indeed, he said it would take years to understand what he was doing.³⁰

One way the government can and does deal with limited enforcement resources is to incentivize private organizations to police themselves and disclose what they have learned. Twenty years ago, the government understood the need to take this approach when it promulgated the Sentencing Guidelines for Organizational Offenders.³¹ The Guidelines provided that an organization convicted of a crime would face a significantly enhanced sentence if high-level personnel were involved.³² Conversely, it would face a significantly reduced sentence if it had an effective compliance program in place and if it voluntarily disclosed conduct to—and otherwise cooperated with—prosecutors.³³

In the wake of those Guidelines, other government agencies such as the SEC and the Department of Health and Human Services also began providing incentives to corporations to police themselves and increasing penalties for those that did not voluntarily comply. As a result, more and more corporations made a real effort to adopt strong compliance programs. As they did so, our society's basic expectations about corporate responsibilities changed. Twenty years ago, a corporation with a strong compliance program that required self-reporting of misconduct was ahead of the curve. Today, strong compliance programs are commonplace, and the failure to have one at all is viewed as

²⁹ See generally William D. Cohan, *House of Cards: A Tale of Hubris and Wretched Excess on Wall Street* (Doubleday 2009).

³⁰ *Id.* at 291 (cited in note 27) ("Cayne, the former broker, had only a vague understanding of all of these exotic financial instruments that Specter's salesmen and traders were creating.")

³¹ See Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations*, 87 Iowa L Rev 697 (2002).

³² USSG at § 8C2.5(b) (cited in note 18).

³³ USSG at § 8C2.5(f) (cited in notes 18 and 30).

grossly negligent.³⁴ The question is no longer “Do you have a compliance program?”—rather, it has become “How well did you implement it?”

Indeed, a few years ago the government took the position in a False Claims Act case that the mere failure to have an effective compliance program satisfied the “knowingly and willfully” standard of intent under the False Claims Act. The court did not reject that theory.³⁵ Civil suits against corporate officers and directors alleging failures to investigate and report wrongdoing have also served as a strong incentive to change the way corporations do business.

Yet in the middle of this changing regime came the Enron debacle and other accounting scandals of the last decade. The response was the Sarbanes-Oxley Act.³⁶ Before Sarbanes-Oxley, corporate officers could point to the auditors, accountants, and lawyers, and say, “It was their fault, not mine.” Sarbanes-Oxley changed that. It not only introduced a new regulatory scheme, it added reporting and disclosure requirements as part of the matrix. Sarbanes-Oxley has significantly reduced the likelihood of the type of corporate practices that led to the WorldCom and Enron situations.³⁷ The main drivers of this change have been the threat of prosecution, the obligation to report questionable conduct, and the obligation of CEOs and CFOs to put their own signatures on public filings. These officers must now certify that financial statements comply with securities laws and fairly present the company’s finances, with the threat of personal liability if those filings are later shown to be inaccurate.

³⁴ See, for example, Jeffery M. Cross, *Corporate Antitrust Liability and Compliance Programs*, in Frederick Z. Banks and Theodore L. Banks, eds, *Corporate Legal Compliance Handbook, 2008 Supplement* § 2.04[C] (*Guttman v. Huang*, 823 A.2d 492 (Del Ch 2003) (“raises the possibility that there may be liability for a director’s gross negligence in failing to institute an adequate system to monitor a corporation’s compliance with the laws”).

³⁵ *US v Merck-Medco Managed Care, LLC*, 336 F Supp 2d 430, 440–41 (ED Pa 2004) (refusing to dismiss case where lower-level employees allegedly submitted false claims even though there was no allegation that upper management was aware of the actions of the lower-level employees).

³⁶ Pub L No 107-204 (2002), codified at 15 USC § 7201 et seq (2006).

³⁷ See, for example, Alan Rappeport, *Report: Financial Fraud a Challenge Despite Sarbox*, CFO.com (July 22, 2008), online at <http://www.cfo.com/article.cfm/11779692/?f=rsspage> (visited Sept 28, 2010) (noting that a recent report from the Association of Certified Fraud Examiners found that “publicly traded companies suffered fewer losses from frauds of all types if they had implemented Sarbanes-Oxley controls. Indeed, their median losses from all types of fraud were 70 to 96 percent lower than corporations that had not yet implemented those controls”).

Coupled with Sarbanes-Oxley's increased criminal and civil penalties, these requirements have forced corporate officers to pay attention and take responsibility for the actions of the corporations. Officers can no longer rely upon "can do" accountants to relieve them from their responsibilities because they are now individually liable. Lawyers who practice in the areas of white-collar crime and corporate governance generally agree that Sarbanes-Oxley—and the certification requirements in particular—have resulted in a sea change in the behavior of many corporate officers and directors.

D. Creating an Effective Regime to Deter White-Collar Criminal Behavior and Excessive Practices

So does a system using all three approaches—prosecutorial attention, self-reporting and public disclosures, and an enhanced regulatory system—work? Our experience with Sarbanes-Oxley suggests that it does.

A second example of an effective regime can be found in Illinois, where lawyers have first-hand knowledge of the change in attitudes that such regulatory and reporting schemes, coupled with the threat of prosecution, can bring. The catalyst for those changes was Operation Greylord—the federal undercover investigation of the corrupt Cook County court system in the 1980s.³⁸ The investigation revealed that certain Cook County judges were routinely accepting bribes and fixing cases. Operation Greylord ultimately resulted in the indictment of ninety-two people, including seventeen judges, forty-eight lawyers, eight policemen, ten deputy sheriffs, eight court officials, and one state legislator.

In all the years leading up to Greylord, nobody said anything about corruption in the courts. Nobody reported the misconduct. Nobody complained that clerks took bribes to call cases. Lawyers believed they did not have an obligation to report misconduct. There were no consequences for failing to report misconduct. Quite the opposite: many believed that reporting the misconduct would have adverse consequences.

Despite the Greylord prosecutions and their publicity, it was the Illinois Supreme Court, in exercising its regulatory function, that ultimately played a significant role in deterring corruption in the Illinois judicial system. In 1988, that court handed down

³⁸ For an overview of Operation Greylord, see James Tuohy and Rob Warden, *Greylord: Justice, Chicago Style* (Putnam 1989).

its most well-known ethical pronouncement, *In re Himmel*.³⁹ The court announced that members of the legal profession have an ethical obligation to report ethical violations by other lawyers, and that failure to report another lawyer's violation may put one's own law license in jeopardy. Faced with the knowledge that their own law licenses could be revoked for failure to report possible misconduct, lawyers took the Supreme Court's decision very seriously and ethical complaints increased dramatically. The practice of ex parte meetings between lawyers and judges came to an abrupt halt. Moreover, once lawyers and judges realized that they could no longer trust their colleagues and counterparts to keep quiet, judicial corruption was no longer able to flourish.

So requiring an individual or corporation to report misconduct and punishing those that engage in misconduct significantly increases deterrence, especially among the group of people who are tempted to commit crimes because they think their conduct will go unreported. And it deters those who simply go along with others' misdeeds when there is no consequence for doing so.

CONCLUSION

Very little has changed since the Lehman collapse a year ago. Perhaps even more troubling, as the economy begins to recover, we have lost focus on the failures of the recent past and have shifted focus to other issues.⁴⁰ We may not have learned the lessons of this recession.

In October 2009, the Inspector General of the Treasury Department testified in front of Congress about widespread fraud in connection with the first-time home-buyer tax credit, an \$8,000 tax credit for the purchase of a first home.⁴¹ This program was put into place only within the last year. Because no controls were established when the program was implemented, people have already claimed tax credits without having to prove they deserved them. The IRS has now identified 167 suspected criminal schemes and has started nearly 107,000 examinations of potential civil violations where the money was not used to purchase a home; the potential violations total approximately \$856 mil-

³⁹ 533 NE2d 790 (Ill 1988).

⁴⁰ See, for example, Mark Whitehouse, *Economic Crisis Ebbs, Systemic Risks Don't*, Wall St J A2 (Dec 8, 2009).

⁴¹ Luke Mullins, *First-Time Home Buyer Tax Credit: All Sorts of Sketchy Claims*, US News & World Rept (Oct 22, 2009), online at <http://www.usnews.com/money/blogs/the-home-front/2009/10/22/first-time-home-buyer-tax-credit-all-sorts-of-sketchy-claims> (visited Sept 30, 2010).

lion. Much could have been prevented by having an appropriate regulatory framework—perhaps by merely requiring proof of home ownership.

As we have seen from past experience, the regulatory failures exposed by the current downturn must be addressed now, while these problems are fresh, in order to effectively deter future misconduct. We cannot make the mistake we have made in the past of assuming that the troubles are behind us. Paul Krugman, in a recent article in the *New York Times*, quoted some of the world's great economists who over the last several years "believed they had things under control" and who said that "the central problem of depression-prevention had been solved."⁴² These economists, including Ben Bernanke, expressed the belief that "markets were inherently stable, indeed that that stocks and other assets were always priced just right."⁴³ Indeed Mr. Bernanke stated in 2004 that "changes in economic institutions, technology, business practices or other structural features of the economy have improved the ability of the economy to absorb shocks."⁴⁴

As we begin to climb out of the recession, we must not assume that it cannot happen again. We cannot assume that oversight failures will not result in financial scandals like the ones that have occurred over the last decade. What we have learned as the global economy becomes ever more complex and ever more interconnected is that it takes less of a trigger to cause a meltdown, and meltdowns can be more severe when they do happen. This means that it is more important than ever to focus on prevention as well as prosecution.

It is possible to address these problems and thus minimize the dangers caused by future recurrences. The Dodd-Frank Wall Street Reform and Consumer Protection Act⁴⁵ was signed into law by President Obama on July 21, 2010.⁴⁶ According to the

⁴² Paul Krugman, *How Did Economists Get It So Wrong?*, *NY Times Mag* 36, 36 (Sept 2, 2009), quoting Robert Lucas, online at <http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html> (visited Sept 30, 2010).

⁴³ *Id.* (cited in note 38).

⁴⁴ Ben S. Bernanke, *Speech to the Eastern Economic Association* (Feb 20, 2004), online at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2004/20040220/default.htm> (visited Sept 30, 2010).

⁴⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, 124 Stat 1376 (2010).

⁴⁶ Doug Mills, *Obama Signs Overhaul of Financial System*, *NY Times* (July 21, 2010), online at <http://www.nytimes.com/2010/07/22/business/22regulate.html> (visited Oct 4, 2010).

Act's supporters, the Dodd-Frank Act will provide transparency for exotic instruments; provide tough new rules for transparency and accountability on Wall Street; and dramatically increase the amount of resources dedicated to enforcing laws already on the books.⁴⁷ However, it will be years before rules and regulations promulgated under the Act go into effect and considerable amounts of money will be spent in an attempt to shape the rule-making process.⁴⁸ Thus the debate continues, and as the economy improves, the appetite for increased regulation will likely diminish. But without meaningful prosecution, regulation, and disclosure, we can be sure that when the next recession comes, it will be attended with the same revelations of financial and business scandal as always.

⁴⁷ See, for example, United States Senate Committee on Banking, Housing, and Urban Affairs, *Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, online at http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (visited Oct 4, 2010).

⁴⁸ Phil Mattingly, *'Torturous' Dodd-Frank Rulemaking Can Succeed, Regulators Say*, Bloomberg Businessweek (Sept 30, 2010), online at <http://www.businessweek.com/news/2010-09-30/torturous-dodd-frank-rulemaking-can-succeed-regulators-say.html> (visited Oct 4, 2010).

