

Fraud Examiner Newsletter Article

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Fraud and the Financial Meltdown: Critical Current and Future Lessons

By Peter Goldmann

Whenever the dust settles from the current economic disaster, one major element of the crisis will make news headlines for years to come. That element is – you guessed it—*fraud*.

The question now is not whether fraud played a role in bringing about the current crisis, but rather how extensive and complex the fraud factor is. And those answers will only emerge over time as prosecutors, auditors, defense attorneys, regulators, investigators, judges and juries toil over the next months and years to determine (among other things)...

- Who is guilty of fraud.
- What kinds of fraud were committed in the run-up to the meltdown.
- Why fraud was not detected—and acted on—before things got “out of hand”.
- Who will pay for the damage attribute to fraud...and how much.

If there is a silver lining in the worst financial catastrophe since the Great Depression, it is that an array of new insights into the dynamics of financial crime is certain to emerge from the shocking events of recent months.

WHAT WE KNOW SO FAR

A crystal ball would certainly come in handy right about now — to tell us how the financial system will be “fixed” to prevent another 2008-style meltdown... and particularly what sorts of anti-fraud measures will be implemented as part of the inevitable new, re-regulated business environment. For now, though, we’ll have to settle for the few facts about the fraud factor that have come to light so far to glean lessons from these unprecedented events.

Among the important facts known already is that the “fraud problem” will be big. Fraud-related litigation in connection with the current crisis is already exploding. The high-profile FBI probes into fraud at AIG, Lehman Brothers, Freddie Mac and Fannie Mae are just the tip of what will likely prove to be a massive iceberg. The *New York Law Journal* recently published an article stating that: “with public anger reaching a boiling point over plunging stock prices and Wall Street ‘greed,’ white-collar defense attorneys are preparing for an inevitable surge in criminal prosecutions.”

Also clear at this early stage: As the lawsuits drag on, it will come down to the all-too-familiar issue of who knew what and when. We’ll undoubtedly hear echoes of Enron and WorldCom as corporate defendants try to convince judges and juries of their innocence, just as former Lehman CEO, Richard Fuld argued in September before the House

Oversight and Government Reform Committee that the decisions he made leading up to the collapse of the 160-year-old Wall Street icon were "prudent and appropriate" based on information available "at the time."

In an early assessment of the types of meltdown-related frauds likely to generate the biggest legal fees in coming years, former federal judge William Wilkins, now in private practice as a white-collar crime defense attorney, said: "we can be pretty confident that prosecutors will be looking closely at numerous incidents of misrepresentation of the value of asset-backed securities, fraudulent financial reporting, misrepresentation of the level of risk of various arcane derivatives and, of course, mortgage fraud."

***Interesting side note:** If it is eventually determined that fraudulent financial reporting and weak internal controls played a direct role in the demise of Lehman Brothers, AIG and other major public companies, the simmering debate about the efficacy of Sarbanes-Oxley will be re-ignited, with critics chanting "We told you so" about what they see as the inadequacy of Section 404 to prevent book-cooking and other forms of fraud and executive deception.*

HOW DID WE GET INTO THIS MESS?

Concurring with many experts, Judge Wilkins attributes the current state of affairs in large measure to years of deregulation and unbridled Wall Street greed. He also predicts that the fraud, mismanagement and incompetence that catapulted the U.S. financial system into unprecedented chaos will result in a "sea change in the way American companies do business." For starters, he firmly believes that Congress will act "decisively" to re-tighten the rules and regulations on financial institutions in reaction to the grassroots outrage that has gained momentum as the crisis continues to unfold.

WHAT ABOUT HONEST COMPANIES?

In keeping with the history of economic and financial crises, a few bad apples do tend to spoil things for everyone. As the Enron, Worldcom and Tyco mega-frauds brought on budget-busting compliance costs for all public companies with the enactment of Sarbanes-Oxley, the same can be expected in the aftermath of the current fraud-riddled crisis.

***Major problem:** State, local and federal judicial, investigative and prosecutorial resources are way too thinly spread to cope with the inevitable tsunami of criminal and civil cases that already have litigators scrambling to keep pace.*

As the [New York Times](#) reported on October 19, the FBI is severely under-staffed to handle the growing demands on its white-collar crime investigative resources. The same will inevitably become the norm at many cash-strapped state and local investigative agencies.

Result: As several white-collar crime attorneys point out, plaintiffs in federal cases will need to pony up their own cash to pay private fraud examiners and other forensic specialists to investigate, document and more or less “pre-package” cases if they want the FBI to take them on.

In the end, a large number of investment firms, mortgage brokers, attorneys, appraisers and lenders that share in the criminal blame for the meltdown probably will never be brought to justice.

Nevertheless, as Judge Wilkins points out, organizations with skeletons in their closets are taking a big risk if they opt to cover up their misconduct. While there’s always the chance that the shortage of legal and prosecutorial resources will allow some offenders to “get away with it,” there are many that will regret not having come clean if investigators do come knocking.

Forensic and legal experts suggest that these organizations would be well served by investigating themselves... and if sufficient evidence of fraud is found, self-reporting specific cases to appropriate prosecutorial offices.

Reason: By cooperating, companies with culpability greatly improve their chances of receiving lenient treatment by prosecutors. While doing so provides no guarantee that charges won’t be brought and that guilty executives won’t go to jail, it does substantially increase the likelihood that judges will apply the elements of federal sentencing guidelines allowing them to impose lighter sentences than would apply if the company chose not to cooperate with prosecutors.

GOING FORWARD...

Ellen Zimiles, CEO of Daylight Forensic Advisory, a New York City-based regulatory consulting and investigative firm, aptly points out that while the multiplicity of frauds that were instrumental in bringing on financial chaos will result in lengthy and expensive legal, political and financial repercussions, management and boards of honest companies must focus their attention on the future. She points out that the dynamics of the Fraud Triangle are in full force — as growing pressure on management to perform in what increasingly appears to be a serious economic downturn creates new incentives to cook the books. All the while, people who were making massive amounts of easy money during financial boom times override controls and exploit other weaknesses in an effort to misappropriate assets so that they may continue financing their over-the-top lifestyles.

Add to that a huge population of rank-and file employees enraged about the severe hit taken already by their retirement nest eggs and you’ve got the third element of the Triangle: rationalization by these workers to take what they feel they deserve by means either legal or illegal.

This requires urgent action by top management to identify and rectify any and all weaknesses in the organization's internal controls, anti-fraud monitoring and auditing.

This may be easier said than done as organizations struggle to figure out how to get the biggest bang for their limited bucks in building new defenses against an inevitable rising tide of financial malfeasance.

But hoping for the best is now even less of an option than it ever was.

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