Observations on the Dearth of Criminal Prosecutions After the Financial Meltdown

JAMES M. KENEALLY AND SERENA B. DAVID

The authors suggest that prosecutors may ramp up their prosecutions of high-ranking corporate executives to quell the public outcry to hold individuals responsible for the current economic crisis. They add, however, that it is equally likely that the reversal of the convictions in U.S. v. Ferguson *will reinforce the difficulties in successfully prosecuting these complex financial cases, and prosecutors will be less inclined to do so.*

"Can that many companies have collapsed — large financial firms — and not one criminal case comes out of it?"[1] Since the financial meltdown of 2008, a great deal has been written about the lack of prosecutions of members of the financial sector. Some have expressed incredulity that banks such as Goldman Sachs and their executives have escaped prosecution, especially in light of Senate Finance Committee reports that have excoriated them for creating the financial vehicles that investors bought into and then betting against those vehicles.[2] Writers have asked why the meltdown has not led to widespread investigations and prosecutions, when by contrast, major economic events such as the savings and loan crisis in the 1980s,[3] and the collapse of Enron in

---

James M. Keneally, a member of the Board of Editors of the *Financial Fraud Law Report*, is a partner in the New York office of Kelley Drye & Warren LLP. Mr. Keneally focuses on the defense of clients in white collar crime and investigation matters. He can be reached at jkeneally@kelleydrye.com. Serena B. David is a litigation associate at the same office and can be reached at sdavid@kelleydrye.com.

2001, resulted in significant prosecutions.[4] Others have criticized the government for not going after the rating agencies that failed to recognize the inflated value of these financial instruments and rating them much higher than they deserved.[5] More recently, the protesters taking part in Occupy Wall Street have asked the question in a more rhetorical setting.[6]

There have been attempts to answer this question. It has been suggested that the dearth in prosecutions might be a result of concern over the financial system's fragility, and the unintended effects that investigations and prosecutions might have.[7] Some writers have discussed the difficulties inherent in prosecuting and proving large-scale financial frauds. The failed prosecution of two Bear Stearns executives has been cited as an example.[8]

Of course, this notion is rejected by those who cite the Savings and Loan and Enron prosecutions, and, of course, they may have a point. On the other hand, however simplistic or lame it may sound, it is also true that financial fraud prosecutions can be lengthy, expensive, and dicey propositions. We've considered this possibility, and a Second Circuit decision from back in August illustrates this.

U.S. v. Ferguson[9] is not ground-breaking, and its facts do not arise from the 2008 meltdown (although the alleged motives of the actors are not far afield of those ascribed to the financial titans involved in the meltdown). However, it does offer a real-life example of why the government might be reticent to bring fraud cases against high-ranking executives as a result of the most recent financial crisis.

On August 1, 2011, the Second Circuit vacated the convictions of five Wall Street executives, who had been convicted of conspiracy, mail fraud, securities fraud, and making false statements to the Securities and Exchange Commission ("SEC"). Of the five defendants, four were executives of General Reinsurance Corporation ("Gen Re") and one was from American International Group, Inc. ("AIG").[10] The charges against the defendants resulted from an allegedly fraudulent reinsurance transaction between AIG and Gen Re in an attempt to bolster AIG's declining stock price.

At issue was a "finite reinsurance" transaction called a "Loss Portfolio Transfer" ("LPT"). Its purpose was to reallocate risk in a way that would enhance AIG's dwindling loss reserves, which were thought to be one of the main causes of AIG's declining stock price. Finite insurance, whereby

a limited, or finite, amount of insurance risk is ceded from an insurer to a reinsurer, is a generally accepted accounting measure in the insurance industry and typically entails a low measure of risk. However, some risk transfer is required to comply with Financial Accounting Standards. As the opinion noted, FAS 113 requires a reinsurance transaction to have "'significant risk' so that it is 'reasonably possible' that the reinsurer may realize a 'significant loss' from the deal."[11]

Maurice "Hank" Greenberg, AIG's CEO, initially reached out to Ronald Ferguson, Gen Re's CEO, in October 2000. Greenberg was convinced that the AIG's loss reserves were the reason the company's stock price had been depressed. Since AIG was Gen Re's biggest client, Ferguson was happy to help. The deal between AIG and Gen Re in this case was unusual in several respects. Greenberg requested a deal in which AIG would borrow a specified range of loss reserves over the course of a six- to nine-month time period. Reinsurance deals are not usually predicated on the transfer of a specific amount of loss reserves. Further, it was atypical for AIG to be the reinsurer because it was usually the party seeking reinsurance from Gen Re. This transaction was also going to be booked as a "funds withheld" arrangement. While not inherently irregular, this allowed AIG to show a substantial change in loss reserves but did not require Gen Re to remit an equally large payment.

Ferguson created a deal team at Gen Re shortly after his conversation with Greenberg, and that team, along with some colleagues at AIG, were responsible for working out the details of the deal as it had been laid out by Greenberg and Ferguson. By mid-November 2000, the general scope of the deal had taken shape, and Ferguson was able to get Greenberg's approval. This included some of the more suspicious aspects of the deal, such as the no-risk element, the repayment of Gen Re's $10 million premium, as well as a side agreement that netted Gen Re an additional $5 million fee. On December 7, 2000, Christian Milton, Vice President of Reinsurance at AIG, accepted the deal on AIG's behalf and also requested that Gen Re create a paper trail to disguise how this transaction came to be. Approximately ten days later, an offer was circulated to AIG, indicating that the deal had first been envisioned at Gen Re. In January, the offer letter and a draft slip contract were sent to an assistant comptroller at AIG,

who then booked $250 million in loss reserves for the fourth quarter of 2000 and another $250 million for the first quarter of 2001.

In a typical reinsurance relationship, the ceding party files claims with the reinsurer, which pays the claims, and this reduces the loss reserves amount. Here, Gen Re never made any claims, AIG never paid any claims, and no adjustments were ever made to AIG's loss reserves. By February 2005, the SEC and the Office of the New York Attorney General were investigating the LPT. By May of that year, AIG determined that the LPT transferred an insufficient amount of risk to be in accordance with reinsurance accounting, and decided to restate its financials for the remaining portion of the LPT.

The five defendants were charged with conspiracy, mail fraud, securities fraud, and making false statements to the SEC. At trial, the government relied on the testimony of two cooperating witnesses, Napier and John Houldsworth, the CEO of Cologne Re Dublin, a subsidiary of Gen Re, along with corroborating emails and telephone conversations recorded on Houldsworth's office telephone in the ordinary course of business. The veracity of the cooperators' testimony, particularly Napier's, did not go unchallenged. In addition, the government introduced stock price data to prove the LPT's materiality.

The five defendants were all convicted of the charges against them. On appeal, the defendants raised a host of issues, two of which led the Second Circuit to vacate their convictions: (1) that the district court abused its discretion by admitting stock-price data as evidence in the trial and (2) that the district court had issued a jury instruction that directed the verdict on causation.

STOCK PRICE DATA

Materiality is an element of most of the offenses with which the defendants were charged. Under the line of cases beginning with *Basic, Inc. v. Levinson,*[12] the government had to prove that there was a "substantial likelihood" that misstatements related to the LPT would be important to, and relied on, by reasonable investors. To prove materiality, the government introduced evidence of articles discussing the impropriety of the trans-

action and related those articles to falling stock prices at that time. The government also attempted to use graphic evidence of a link between the defendants' actions and AIG's stock price.

The district court excluded a line graph tracing AIG's stock price from February through March of 2005 as overly prejudicial, but allowed similar charts to be used during opening statements and allowed into evidence three bar charts that depicted the one-day drop in AIG's stock price the day after each publication. Because the LPT was only one of several problems impacting AIG's stock price, the defendants were forced to either allow the jury to attribute the entire decline of the company's stock price to the finite reinsurance transaction or allow the government to introduce evidence of other potential wrongdoing and illegal activity at AIG in order to explain that the LPT was only part of the reason for the decline in AIG's stock price.[13] The Second Circuit concluded that this was an abuse of discretion on the part of the district court and that "the defendants' substantial rights were affected."[14] The court explained:

> The district court's rulings on the stock-price charts were inconsistent. The chart showing the full decline in the stock price was excluded as overly prejudicial, but it was functionally identical to the chart shown during the government's opening argument. In any event, the court's solution, to allow only isolated ranges of stock-price data, did not mitigate the prejudice; instead of a downward line, there were three dropping sets of dots; it is inevitable that jurors would connect them. So the risk that jurors would attribute the full 12% decline to the LPT was unabated by the court's precaution.[15]

The Second Circuit further noted that "[a]lthough the evidence was admitted only to show materiality, the government exploited it to emphasize the losses caused by the transaction," and that the charts "prejudicially cast the defendants as causing an economic downturn that has affected every family in America."[16]

The court's second ground for vacating the convictions related to the jury instruction regarding the definition of "willfully caused." Each party offered its own suggested phrasing of the particular jury instruction and,

in seeking to appease both sides, the district court erroneously ended up with a jury charge that failed to adequately define the causation piece of "willfully caused" and thus allowed for conviction without actually finding causation.[17] Although the defendants had not specifically objected to the district court's charge with respect to its lack of a causation definition, the Second Circuit held that the charge constituted plain error, because it was unlikely that the jury had based its verdict on a properly grounded instruction.

The reversal of the convictions for the five *Ferguson* defendants, and the possibility that the defendants will not be retried, will likely be viewed as another blow to the Justice Department, which has already come under fire for the lack of prosecutions of bank executives and other high-ranking corporate figures in the wake of the most recent financial crisis. It has been widely noted that this dearth of recent prosecutions is in stark contrast to the prosecutions and convictions that resulted from the savings and loan scandal of two decades ago. In the late 1980s, there were hundreds of referrals from the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS") to the Justice Department. The referrals led to prosecutions and ultimately incarceration for many of the targets of those investigations. The most well known of them were "Junk Bond King" Michael Milken, Charles Keating Jr. of Lincoln Savings and Loan, and David Paul of Centrust Bank. Even during the more recent financial accounting scandal in the earlier part of the last decade, many financial executives were successfully prosecuted. High-ranking individuals from Enron, WorldCom, Tyco, Adelphia, and ImClone were all convicted and incarcerated. During this current financial crisis, however, the OCC and the OTS have not referred a single case to the Justice Department for prosecution, and no senior executives have faced imprisonment.

This raises the obvious question of why there has been such a drastic decline in prosecutions in general, and successful prosecution in particular, of the corporate executives involved in the current financial crisis. There appears to be a general consensus that, with respect to these types of cases, prosecutors face an uphill battle, while defense attorneys' jobs have gotten slightly easier. Some defense lawyers have commented that they are often able to make a more persuasive case for acquittal because

prosecutors must rely on outside companies to actually run the investigations and, as a result, the prosecutors themselves are less familiar with the evidence that has been uncovered.

Prosecutors, on the other hand, point to a dearth of investigative resources and the fact that these types of complex cases are very difficult to explain to juries and can often take years to actually bring to trial. Moreover, because prosecutors are judged based on their success rate as well as based on the amount of money which they are able to recover, prosecuting a high-profile, complex case can sometimes be a risky career move, and many prosecutors are not interested in taking on this type of challenge. Law enforcement officials and prosecutors are also at a disadvantage because they do not investigate violations as they are occurring, but rather, long after these violations have taken place.

In addition, it is often extremely difficult to prove the criminal intent of the executives. In *Ferguson*, for example, whether the initial conversation between Greenberg and Ferguson was the beginning of a criminal conspiracy, or merely two senior executives brainstorming with each other about a way to fix a problem, is unclear. Prosecutors have the burden of proving intent, which can be close to impossible when banks are able to defend their actions by using documents to show that they were acting properly. Even Lanny Breuer, assistant attorney general in charge of the Justice Department's criminal division, is keenly aware of the uphill battle facing prosecutors. In a speech in November 2010, Breuer noted that he "understand[s] the impulse and desire to hold someone accountable," but that Justice Department "can, and will, only bring charges when the facts and the law convince us that we can prove a crime beyond a reasonable doubt." Given this philosophy, it is not surprising that it still remains to be seen whether the attorney general will seek to retry the AIG and Gen Re defendants.

The reversal of the convictions in the *Ferguson* case, however, is just one example of how difficult it actually is to prosecute senior executives and, once these cases are brought, how difficult it is to actually get convictions. In *Ferguson,* the prosecutors did not commit a huge tactical gaffe or engage in egregious misconduct. They attempted to place the defendants' actions in a context jurors could understand, by showing a correlation to stock price, and went along with the trial court's inartfully drafted charge.

These two less-than-glaring errors cost the government its case.

Another case reminiscent of this situation resulted from the collapse of Bear Stearns. In *U.S. v. Cioffi*,[18] the district court suppressed evidence from one of the defendant's personal email account, holding that the search warrant was unconstitutionally overbroad and that the evidence was not admissible under either the good faith exception to the exclusionary rule or the inevitable discovery doctrine. The warrant was found to be overbroad because there was no provision that limited the emails to be seized to those that contained evidence of the crimes with which the defendant was charged in his indictment. Due to this flaw, the prosecution could not introduce into evidence a particular email that the defendant had sent to himself that contained relevant information and insight into his mindset surrounding the alleged crimes. Ultimately, the Justice Department lost this case in 2009, and there have not been any additional indictments at major companies in connection with the current financial crisis.

What remains to be seen is what the status of this situation will be going forward. Criminal referrals to the Justice Department may be filed up to ten years after an infraction, so there is still time for authorities to file charges against senior executives in relation to the current financial crisis. That said, these allegations become much more difficult to investigate, and therefore more difficult to prosecute, as more time passes. Now, in the aftermath of the *Ferguson* decision, it will be interesting to see the effect it has on future prosecution. It is possible that prosecutors may ramp up their prosecutions of high-ranking corporate executives in order to quell the public outcry to hold individuals responsible for the current economic crisis. It is equally likely, however, that the reversal of the convictions in *Ferguson* will reinforce the difficulties in successfully prosecuting these complex financial cases and prosecutors will be less inclined to do so.

NOTES

[1] Justin Blum, *Prosecutors Faulted on Failure to Charge 'Bandit' in U.S. Market Collapse,* Bloomberg, May 23, 2011, quoting Professor Peter Henning of Wayne State University.

[2] Matt Taibbi, *The People vs. Goldman Sachs,* Rolling Stone, May 26, 2011.

[3] Joe Nocera, *Biggest Fish Face Little Risk of Being Caught,* N.Y. Times,

February 25, 2011.

[4] Jesse Eisinger, *The Feds Stage a Sideshow, While the Big Tent Sits Empty,* N.Y. Times, December 8, 2010.

[5] Colin Barr, *Gross Rips the Ratings Agencies,* CNN Money/Fortune, May 5, 2010.

[6] Michael Daly, *Arrests for Protesters, Not Bankers,* The Daily Beast, October 6, 2011.

[7] Gretchen Morgenson and Louise Story, *In Financial Crisis, No Prosecution of Top Figures*, N.Y. Times, April 14, 2011.

[8] Justin Blum, *Prosecutors Faulted on Failure to Charge 'Bandit' in U.S. Market Collapse,* Bloomberg, May 23, 2011.

[9] *U.S. v. Ferguson*, 08-6211-cr (L) (2d Cir. August 1, 2011).

[10] The five defendants were: (1) Ronald Ferguson, CEO of Gen Re; (2) Christopher Garand, Senior Vice President and Head Chief Underwriter of Gen Re's finite reinsurance operations; (3) Robert Graham, Legal Counsel and Senior Vice President at Gen Re; (4) Christian Milton, VP of Reinsurance at AIG; and (5) Elizabeth Monrad, CFO of Gen Re.

[11] Slip Op. at 7.

[12] 485 U.S. 224, 231 (1988).

[13] At trial, the defendants attempted to avoid the charts' prejudicial effect by proposing to stipulate as to materiality. The government turned down defendants' proposal. While the Second Circuit did not cite the government's refusal to stipulate as grounds for vacating the judgment, the court noted that the charged offenses "do not require a showing of loss causation ('a causal connection between the material misrepresentation and the loss'). *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 342 (2005)" and thus were introduced only to show materiality. Slip Op. at 25. The court pointed out the "charts suggested that this transaction caused AIG's shares to plummet 12 percent during the relevant time period, which was without foundation, and (given the role of AIG in the financial panic) prejudicially cast the defendants as causing an economic downturn that has affected every family in America." Slip Op. at 26.

[14] Slip. Op. at 24.

[15] Slip Op. at 24.

[16] Slip Op. at 26.

[17] Slip Op. at 29.

[18] *U.S. v. Cioffi*, 668 F.Supp.2d (E.D.N.Y. 2009).