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CRIMINALIZATION OF CORPORATE LAW

The Impact on Director and Officer Behavior

I HAVE BEEN VERY FORTUNATE TO BE AN EXPERT WITNESS in about seventy-five corporate governance and securities cases over the last fifteen years. I have been the expert witness in many of the big cases, as I said, for the directors in *WorldCom*¹ and *Adelphia Communications*² and *HealthSouth*.³ I am just getting into the *Fannie Mae* and *Freddie Mac* cases⁴ now.

Although I could easily overemphasize my role, I am really just a fly on the wall but one (fly, that is) that is in a great position from which to observe. When the plaintiffs took my deposition in the *WorldCom* case,⁵ 115 to 125 lawyers were in the UBS Building every day. There would be six to eight depositions going on at once. It was like a multiplex theater. While I was being deposed, people would come in, go out, pass notes, and so on. I think that the greatest number of spectators I had in the room was fifteen, but it all was bizarre.

So, I can overemphasize my role and I do not want to do that. But, based upon my experiences, I first want to talk about civil, rather than criminal, liability. I do not think that you can predict the future from the past, at least not completely. *Enron* and *WorldCom* were doozy, headline-grabbing cases.⁶ They may not repeat themselves, so they may not be good predictors either, but I will predict away nonetheless.

In those cases, the person who pushed for personal out-of-pocket liability of directors was the lead plaintiff, the New York State Employees Retirement System

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1. *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003).

2. *United States v. Rigas*, 258 F. Supp. 2d 299 (S.D.N.Y. 2003).

3. *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298 (N.D. Ala. 2003).

4. *In re Fannie Mae Sec. Litig.*, 355 F. Supp. 2d 261 (D.D.C. 2005).

5. *WorldCom*, 263 F. Supp. 2d 745.

6. See, e.g., Roland Hefendehl, *Enron, WorldCom, and the Consequences: Business Criminal Law between Doctrinal Requirements and the Hopes of Crime Policy*, 8 BUFF. CRIM. L. REV. 51 (2004) (discussing the changes the Enron and WorldCom scandals have had on business criminal law); Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9 (2002) (discussing the need for greater independent professional advice in the wake of Enron); David S. Ruder et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103 (2005) (discussing the changes the SEC made to disclosure rules following the Enron case).

trustee and state treasurer, Alan Hevesi, a political person.⁷ He pushed hard. In *WorldCom*, the ten independent directors paid \$18 million out-of-pocket,⁸ \$900,000 at the low end and over \$3 million at the other. The Dean of the Georgetown University Law Center, who was also on the WorldCom board's audit committee (and who is now president of the American Association of Law Schools), was at the low end, while a couple of the high net worth directors paid over \$3 million at the high end. The formula Hevesi's attorneys originally advanced was thirty percent of directors' net worth had to be contributed to the settlement, after the directors had backed out their primary residence, retirement, and assets in their spouses' names. I think that was ultimately negotiated down to twenty percent,⁹ but it was very painful because while these are wealthy people, they are not super wealthy people. Paying \$3 million for a person whose net worth is \$20-25 million is a big hit.

Well, with the Private Securities Litigation Reform Act¹⁰ and its procedure for selecting the most appropriate plaintiff, we did not see many institutional investors bringing suit at first. But we are seeing them now, becoming named plaintiffs and lead plaintiffs in class actions. My thought is that many more of those newer kind of plaintiffs eventually might take a page out of Hevesi's playbook. They might demand that there be out-of-pocket liability on directors' parts, at least in egregious cases.

I agree with other symposium participants that civil, rather than criminal, liability is probably a better solution to holding corporate officials accountable for governance failures. In addition to what I just described, I think that we are seeing a little bit of further civil liability with Sarbanes-Oxley:¹¹ penalties on earnings restatements,¹² forfeitures of compensation,¹³ and the like. So that is a snapshot on civil liability.

Now with criminal liability, I think that we are going overboard. One of the less-noticed reasons may be that these corporate defendants are choosing lousy lawyers to defend them, resulting in more convictions and harsher penalties than there should be.

The big-shot corporate defendants seem mostly to be going for big law firm litigators—a lawyer from Steptoe & Johnson in Ebbers's case;¹⁴ Dan Petrocelli from O'Melveny & Myers in the Skilling and Lay *Enron* case.¹⁵ In my opinion, these guys

7. Hevesi v. Citigroup Inc., 366 F.3d 70 (2d. Cir. 2004).

8. Jonathan D. Glater, *A Big New Worry for Corporate Directors*, N.Y. TIMES, Jan. 6, 2005, at C1.

9. *Id.*

10. Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4 (2006).

11. Sarbanes-Oxley Act, 15 U.S.C. § 7201 (2006).

12. 15 U.S.C. § 7243(a) (2006).

13. 15 U.S.C. § 7243(a)(1) (2006).

14. United States v. Ebbers, 458 F.3d 110, 112 (2d. Cir. 2006), *petition for cert. filed*, 75 USLW 3248 (Oct. 26, 2006) (No. 06-590).

15. United States v. Causey, 309 F. Supp. 2d 917, 918 (S.D. Tex. 2004).

do not litigate to win cases—they litigate to impress clients. Their first rule is to beat the stuffing out of everybody. Their second rule is to generate piles of paper because the clients like that—they think that it is winning their case for them. Clients also like seeing the stuffing beaten out of people on the other side.

So these big-name lawyers get into a case and it becomes my version versus your version, which is another thing defendants want to hear. Petrocelli did that in the *Enron* criminal trials.¹⁶ Everything Skilling and Lay did, according to Petrocelli's defense, was above the board and legal.¹⁷

"No, it is not." "Yes, it is." "No it is not." The cases these big-shot lawyers advance against the prosecutor become like a fight with your brother or sister. They make a criminal case resemble that childhood fight. You do not know who to believe, so you settle it with a coin flip. It is a fifty-fifty proposition.

What happened to reasonable doubt? Maybe everything was not above the board, but here is an alternative explanation for you to hang your hat on.

There is an explanation like that in *Enron*: it was a corporate governance failure. The Chairman and the CEO referred the CFO, Andrew Fastow, to the board of directors. The board's audit committee then heard him out, granting, not once, but twice, requests by Fastow that the board committee waive the conflict of interest provisions of the Enron code of ethics.¹⁸ The directors gave him a waiver twice but designed a monitoring program.¹⁹ The trouble was that the audit committee never informed the finance committee that it was the finance committee that was to follow up. Then, a year later it comes to light that Fastow has abused the trust reposed in him, receiving \$45 million from the partnerships LJM1 and LJM2 and creating 900 special purpose entities.²⁰

I do not know why the attorneys did not advance that explanation, but it may just come down to their macho style of lawyering. They want to deny that there was ever anything wrong in the first place. Skilling and Lay were not only purer than the driven snow—they never once drifted.

If ever I had to choose a lawyer in one of these cases, I would choose a person who has some criminal law background and some securities and corporate governance background. In fact, I might choose one of the panelists that could not be here today, Frank Razzano, of Washington, DC. Why is Frank's name on the list in my sock drawer? Because Frank is tough, but he knows when to give ground and when to push it—he just doesn't go and butt heads with the federal prosecutors or with the federal government.

16. Greg Burns, 'Big Sell' Strategy Fails, CHI. TRIB., May 26, 2006, at C7.

17. *Id.*

18. Reed Abelson, *Enron's Many Stands: The Directors; Enron's Board Quickly Ratified Far-Reaching Management Moves*, N.Y. TIMES, Feb. 22, 2002, at C6.

19. *Id.*

20. Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W'LY. REV. 163, 179 n.60, 212 (2003).

CRIMINALIZATION OF CORPORATE LAW

As far as I can see, that is what happened in the Ebbers trial²¹ and in the Skilling and Lay trial.²² They just let their lawyers butt heads with the prosecution, day after day, and they lost. In the *HealthSouth* matter,²³ Scrushy went out and got a good ol' boy. He got somebody with criminal law experience, a Birmingham lawyer (and he also carried a well-worn Bible to the courtroom every day).²⁴ True, it was Birmingham, Alabama and not New York or Houston. True, behind the scenes, behind that good ol' boy, scores of sophisticated attorneys researched and theorized.

I do think, however, that if corporate officers and directors exercised better judgment in choosing their lawyers, we would see fewer convictions and, ultimately, fewer allegations and less criminalization of corporate law.

21. Greg Farrell & Jayne O'Donnell, *In Defense of Disgraced Execs*, USA TODAY, Oct. 24, 2002, at B3.

22. Thomas S. Mulligan, *Lay Says Articles Hurt Faith in Enron*, L.A. TIMES, Apr. 26, 2006, at C1; Leslie Wayne, *Enron's Many Strands: Legal Counsel; Top Defense Lawyer with Low Profile Represents Enron's Former Chief*, N.Y. TIMES, Feb. 8, 2002, at C6.

23. SEC v. HealthSouth Corp., 61 F. Supp. 2d 1298 (N.D. Ala. 2003).

24. *Id.* at 1300.