

WHITE-COLLAR CRIME

Expert Analysis

## Why So Few Prosecutions Connected to the Financial Crisis?

In a recent interview, Attorney General Eric Holder told *The Wall Street Journal* that he expects to announce in the coming months significant cases arising from the financial crisis of 2008.<sup>1</sup> The Attorney General's remarks follow criticism that the administration has not done enough to prosecute individuals and institutions said to be responsible for the crisis. One commentator, noting that the Attorney General did not say whether the new cases would be civil or criminal, dismissed the prospect of new cases with the quip, "I'll believe it when I see it."<sup>2</sup>

In fact, the Department of Justice has brought few, if any, high-profile criminal cases since 2008 charging important figures in the mortgage and financial industries, or otherwise addressing in criminal charges the financial transactions that contributed to the crisis. We have seen charges against Ponzi schemers exposed by the sharp decline in securities prices in 2008 to 2009,<sup>3</sup> and a slew of charges involving relatively low-level mortgage frauds,<sup>4</sup> but the criminal cases brought by the department are widely seen as missing the heart of what caused the financial crisis.<sup>5</sup>

In several instances, the department has brought criminal charges that relat-



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ed, broadly speaking, to the financial crisis, but ultimately skirted its edges. In one case, against hedge fund managers of Bear Stearns, the charges stemmed from statements to investors about their funds' mortgage-related investments, but the prosecution did not challenge the underlying issuance or sale of the financial instruments.<sup>6</sup> In other cases, the charges stemmed from inflated valuations of mortgage-related securities.<sup>7</sup>

The high-profile criminal cases of the past several years, involving insider trading and Bank Secrecy Act and money laundering violations, bear little or no relation to the financial crisis.<sup>8</sup> These cases have held prominent individuals and companies accountable for serious wrongdoing, but even then, have not satisfied the critics who complain that the institutions have gotten off too lightly, and that the company officers and employees involved in the illegal conduct were wrongly given passes.<sup>9</sup>

The disparity between perceived financial misdeeds and criminal prosecutions contrasts sharply with the period, about 10 years ago, when prosecutors and defense lawyers were heavily engaged in criminal

investigations and prosecutions of accounting fraud and misstatements in financial statements. These investigations and prosecutions led to high-profile convictions of officials at Enron, WorldCom, Adelphia and many other companies.

The contrast between these two periods is reflected in the work of the financial fraud taskforces created by the administrations of George W. Bush and Barack Obama. In this article, we compare the work of the two taskforces and then consider some possible reasons for the relative dearth of high-profile criminal cases arising from the financial crisis.

### An Overview

In November 2009, President Obama announced the creation of a joint federal and state taskforce, the Financial Fraud Enforcement Taskforce, to combat financial fraud. The FFETF replaced the Corporate Fraud Taskforce created by President Bush in July 2002 in response to the bursting of the tech bubble and a spate of reported false and misleading financial statements by public companies. Although the stated mission of both taskforces is almost identical—to strengthen the investigation and prosecution of "significant financial crimes" and "ensure the just and effective punishment of those who perpetrate" those crimes<sup>10</sup>—the work of the two taskforces looks very different.

While the Bush taskforce released regular reports to the president and the public with detailed information, the FFETF has issued only one report in almost four years, and the

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information was vague. In addition to the infrequent reporting, the type of work done by each taskforce differs as well. The Bush taskforce took credit for thousands of criminal convictions, boasting in its 2008 Corporate Fraud Taskforce Report to the President of nearly 1,300 corporate fraud convictions, including the conviction of almost 400 CEOs, CFOs, corporate presidents and vice presidents.<sup>11</sup> These prosecutions included the Justice Department's Enron-related prosecutions, the Computer Associates securities fraud prosecution in the Eastern District of New York, and options backdating and tax shelter prosecutions in the Southern District of New York, to name a few.

This administration's taskforce, on the other hand, has talked primarily of civil cases and regulatory enforcement actions. To the extent the FFETF has made reference to criminal cases, it is not clear whether and how they relate to the financial crisis. The single report released by the FFETF in 2011, documenting its first year accomplishments, contained no summary statistics and did not separately identify criminal and civil enforcement efforts.<sup>12</sup> Rather, the report listed the enforcement groups established within the taskforce and significant enforcement actions in each of those areas. Criticized for its slow start,<sup>13</sup> the FFETF appears to be largely a clearinghouse of information and resources to facilitate enforcement by other government agencies.

While the First Year Report provided some data on criminal cases, information on civil enforcement cases seemed to predominate. On the criminal side, the Mortgage Fraud Working Group noted an increase in the number of defendants charged with mortgage fraud by U.S. Attorney Offices and a corresponding increase in the severity of sentences imposed in those cases. The Securities and Commodities Fraud Working Group, cochaired by Preet Bharara, the U.S. Attorney for the Southern District of New York, reported that in fiscal year 2010, more than 95 percent of the Commodity Futures Trading Commission's major injunctive fraud cases related to criminal investigations and that at least 65 percent of those cases resulted in criminal charges.

On the civil side, the work of the Residential Mortgage-Backed Securities Working Group, established after the release of the FFETF's first year report and cochaired by New York Attorney General Eric Schneiderman, is illustrative. Schneiderman brought the working group's first case in October 2012, filing a Martin Act lawsuit against JPMorgan Chase Bank alleging fraud in the package and selling of residential mortgage-backed securities.<sup>14</sup>

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In addition, agencies that belong to the FFETF have relied heavily on civil statutes to pursue wrongdoing. In the most recent example, Attorney General Holder announced a suit against Bank of America under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), alleging fraud in connection with the sale of over \$850 million of residential mortgage-backed securities, as part of the ongoing efforts of the FFETF.<sup>15</sup> Earlier this year, the taskforce announced a lawsuit filed against Golden First Mortgage and its owner and president under the FIRREA and the False Claims Act, another civil statute frequently relied on by the federal government in pursuing financial fraud.<sup>16</sup>

Although the FFETF has not released new statistics since 2011, those released by member agencies of the taskforce confirm that the government is pursuing more civil remedies in response to the 2008 financial crisis. Enforcement statistics from the SEC reveal a constant steady uptick in enforcement actions. Fiscal years 2011 and 2012 brought the highest numbers ever for the agency, with 735 and 734 total actions in those respective years. In the SEC's 2012 annual report, Chairwoman Mary Schapiro noted that in connection with the financial crisis, the SEC has filed actions against 117 entities and individuals (in 80 actions) including more than 50 CEOs, CFOs and other senior corporate

officers, and obtained over \$2.2 billion in monetary relief.<sup>17</sup>

A similar upward trend has been documented at the CFTC. Fiscal year 2011 brought record highs with 99 enforcement actions, the highest tally in the agency's history and a 74 percent increase over the prior year, and more than 450 new investigations opened. In fiscal year 2012, the agency filed 102 enforcement actions and opened 350 new investigations.<sup>18</sup>

### Why So Few?

Several explanations have been offered for the relative dearth of crisis-era criminal cases. We venture some preliminary conclusions of our own.

First, the financial instruments and transactions underlying the recent crisis are immensely complex and involve many individuals performing highly technical tasks with large volumes of data. These circumstances present substantial challenges to prosecutors not only in understanding the relevant facts, but also in explaining the transactions to a jury. In fact, labor in many financial transactions is so divided among different individuals that any one individual's guilt can be quite difficult to articulate, much less prove beyond a reasonable doubt.

In this light, the Justice Department's reliance on theories of civil liability and lower burdens of proof in cases involving complex mortgage-related financial products makes a lot of sense from a strategic standpoint, even if it leaves some critics unhappy. The Department has turned to FIRREA and the FCA to file civil charges against financial institutions for false statements and fraud in connection with the complex financial deals underlying the financial crisis. The department has likewise charged entire firms rather than individuals, no doubt because of the great difficulty showing sufficient participation and knowledge by any one individual to warrant criminal sanction.<sup>19</sup>

Second, the very depth and breadth of the recent financial crisis makes it difficult to separate criminal behavior from business misjudgment and mistake. That situation in which virtually all financial institutions were buying, selling and holding, in varying degrees, the same type

of products, and virtually all such institutions suffered losses, the government naturally finds it difficult to show that a particular individual had a criminal state of mind. In the months leading up to the collapse of the housing market in 2007, market participants (and government officials) had certain beliefs and made certain predictions, typically based on past behavior, of what would happen in the future. Most of these beliefs and predictions turned out to be wrong, but when entire industries and government agencies are wrong, it is difficult for prosecutors to show that one person, or even institution, knew the truth and chose to hide or distort it.

In contrast, when the government aggressively pursued accounting fraud cases following the tech bubble, the relevant facts were largely company-specific; forensic accountants could come in after the fact and show the inflated revenue, disguised expenses, and hidden liabilities; and often subsequent restatements by the company (commonly, by new management) provided a clear road map of how prior financial statements were wrong.

Third, since the last wave of financial fraud cases following the tech bubble, we have arguably witnessed substantial changes in the way companies and prosecutors deal with one another during an investigation. Above all, the recent financial crisis seems to have generated substantially fewer long and searching internal investigations than did the accounting scandals of the early 2000s—perhaps because, when the survival of institutions was in doubt, few saw the need or ability to conduct such investigations—and when those investigations took place they tended to be smaller in scope. As a result, companies did not report to the government the fruits of extensive internal investigations, thus depriving the government of important theories and leads in building criminal cases.

Beyond the relative absence of detailed internal investigations, the rules under which the fruits of such investigations would be shared with the government have changed dramatically following the KPMG-related litigation in the Southern

District of New York<sup>20</sup> and revisions to the department's policies toward what would be required of companies seeking to avoid prosecution.<sup>21</sup>

In short, following the financial crisis the government has not been given the same head start in figuring out what happened and a road map of evidence to prove who was culpable. Because of the structure of large institutions, the government faces inherent hurdles in proving that high-level officers of a company had the requisite knowledge and intent to commit a financial crime. The lack of substantial assistance from thorough internal investigations, combined with the complex circumstances giving rise to the financial crisis, has substantially increased the difficulties of charging high-level officials with criminal wrongdoing.

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### Conclusion

The new crisis-era cases promised by Attorney General Holder will no doubt tell us something important. They may show us that the crisis can give rise to criminal prosecutions of high-level individuals, or they may reinforce the sense that financial wrongdoing during the crisis is most appropriately addressed through civil charges against institutions. Whatever these cases reveal, claims of not doing enough are likely to follow.

Despite the inevitable criticism, federal law enforcement agencies, including the Justice Department and the SEC, have sought to hold many individuals and institutions accountable for actions contributing to the financial crisis, just not in the manner that the financial industry's harshest critics would want—more criminal cases.

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1. Devlin Barrett, "Justice Department Plans New Crisis-Related Cases," *The Wall Street Journal* (Aug. 20, 2013).

2. Solomon L. Wisenberg, "Financial Meltdown Prosecutions Against Elite Actors? File Them Under 'I'll Believe It When I See It,'" *White Collar Crime Prof Blog* (Aug. 22, 2013).

3. See, e.g., Justice Department Website, "United States v. Bernard L. Madoff and Related Cases" (available at: [http://www.justice.gov/usao/nys/vw\\_cases/madoff.html](http://www.justice.gov/usao/nys/vw_cases/madoff.html)).

4. See, e.g., Press Release, FFETF, "Former Officers of American Mortgage Specialists Inc. Sentenced for \$28 Million Fraud Against BNC National Bank" (June 28, 2013).

5. See Elkan Abramowitz and Jonathan Sack, "The 'Civilizing' of White Collar Criminal Enforcement," *NYLJ* (May 7, 2013); John C. Coffee, Jr., "Securities Enforcement: 2013 Report Card," *NYLJ* (May 16, 2013).

6. Zachery Kouwe and Dan Slater, "2 Bear Stearns Fund Leaders Are Acquitted," *The New York Times* (Nov. 10, 2009).

7. See Press Release, U.S. Attorney's Office Eastern District of New York, "Jury Finds Former Credit Suisse Broker Guilty of Securities Fraud" (Aug. 17, 2009).

8. See, e.g., Press Release, U.S. Attorney's Office for the Eastern District of New York, "HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit \$1.256 Billion in Deferred Prosecution Agreement" (Dec. 11, 2012); Press Release, FFETF, "Hedge Fund Founder Raj Rajaratnam Sentenced in Manhattan Federal Court to 11 Years in Prison for Insider Trading Crimes" (Oct. 13, 2011).

9. See Elkan Abramowitz and Jonathan Sack, "Why So Few Individuals? Government's Prosecution of Corporate Misconduct," *NYLJ* (March 5, 2013); Evan Weinberger, "Warren Wants More Info on \$225M FHA Settlement," *Law360.com* (Aug. 21, 2013).

10. See Corporate Fraud Taskforce, Report to the President, "Message from the Chairman" (2008); Press Release, U.S. Securities and Exchange Commission, "President Obama Establishes Interagency Financial Fraud Enforcement Taskforce" (Nov. 17, 2009).

11. Corporate Fraud Taskforce, "Report to the President" at p. iii (2008).

12. Financial Fraud Enforcement Taskforce, "First Year Report" (available at: <http://www.stopfraud.gov/docs/FFETF-Report-LR.pdf>).

13. See Evan Weinberger, "Obama's MBS Taskforce Primed for Fights with Big Banks," *Law360* (Aug. 9, 2013); Associated Press, "US Gov. Sues BoFA Over Mortgage Bond Sale" (Aug. 6, 2013).

14. Press Release, FFETF, "Residential Mortgage-Backed Securities Working Group Members Announce First Legal Action" (Oct. 2, 2012). See also Press Release, FFETF, "Residential Mortgage-Backed Securities Working Group Members Announce Charges Against Credit Suisse" (Nov. 20, 2012).

15. Press Release, Department of Justice, "Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over \$850 Million of Residential Mortgage-Backed Securities" (Aug. 6, 2013).

16. Press Release, FFETF, "Golden First Mortgage Corp. and David Movtady Named in Mortgage Fraud Lawsuit for Fraudulently Certified Loans" (April 4, 2013).

17. U.S. Securities and Exchange Commission, Fiscal Year 2012 Agency Financial Report (available at: <https://www.sec.gov/about/secfr2012.shtml>).

18. Commodity Futures Trading Commission, Agency Financial Report, Fiscal Years 2011 and 2012 (available at: <http://www.cftc.gov/reports/>).

19. See Abramowitz and Sack, "Why So Few Individuals? Government's Prosecution of Corporate Misconduct."

20. See, e.g., *United States v. Stein*, 541 F.3d 130 (2d Cir. 2008) (holding that the government violated defendants' Sixth Amendment rights by pressuring KPMG to cut off payment of individual employees' legal fees).

21. See Letter from Mark Filip, Deputy Attorney General, to Chairman Patrick J. Leahy and Senator Arlen Specter (July 9, 2008) (announcing changes to Justice Department's Principles of Federal Prosecution of Business Organization in response to outcry over KPMG decision).