CORPORATE CRIME

What's a lawyer to do?

With the growth in corporate crime likely to outstrip the resources of law enforcement agencies in the near future, lawyers are urged to take a more proactive role in assisting clients. **Niall Coburn** explains how this can be achieved.

Corporate fraud investigations into individuals and corporations by enforcement agencies, statutory regulators and internal company committees have increased in intensity over recent years.

However, most of the large investigations have occurred long after the corporate horse has bolted and have shown, in many circumstances, a complete lack of compliance programs in place, legal advice taken and common sense used.

There is a requirement for companies, statutory authorities and businesses generally to frequently review their legal, auditing and compliance procedures and have the capacity to conduct internal audits and investigations in a timely manner.

Lawyers can be more proactive in ensuring that their clients have appropriate corporate governance mechanisms implemented and play a bigger part in assisting their clients to have the proper tools to fight financial crime.

All too often legal teams are called in as a rearguard, rather than clients having their advice and best practice procedures in place as a preventative measure. >>

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This would enable proper compliance or at least putting governance systems in place to detect financial crime to avoid losses that cannot be insured against. An observation is that large accountancy firms have been on the front foot in developing in-house forensic departments to conduct investigations whereas, interestingly, law firms have kept away from this domain even though they could operate in a similar arena.

Increased regulation in many fields will require lawyers to be more proactive in assisting their clients to implement best practices. This article provides an overview of what lawyers can look out for to assist their clients.

No amount of legislation can protect against dishonesty

The reality is that no amount of legislation can protect against dishonesty. Where there are no proper independent internal compliance and investigation procedures within the body corporate, the organisation will be susceptible to fraud and manipulation by those who control it or those employed by it.

No amount of regulation or legislative provisions can protect corporations or investors from dishonesty or misconduct, although financial crime can be reduced by having a culture of strong corporate governance and properly structured internal committees to prevent and deter fraud. Too often legal advice is requested after an event rather than as a preventative measure. Lawyers can assist clients by recommending appropriate initiatives within a client's business to counteract any internal misconduct.

What is white-collar crime?

Financial crime, or "white-collar crime", can be broadly defined as "offences that are committed by those in professional occupations who are conducting dishonest activities, either by themselves or through their agents, for financial gain."[1]

Such crime is usually committed by persons in positions of trust or by other persons within organisations who take advantage of their position. However, the dimension of crime extends to the activities or organisations being involved in illegal conduct.

In the last decade corporate crime has been given new dimensions. The growth of information technology, environmental protection and increased regulation of corporations is making it a very complex area for directors and their advisors to keep abreast of the changes.

Corporate crime can be characterised as crimes committed:

- against corporations by officers, directors and/or employees
- against corporations by outsiders, or
- for corporations by internal forces.

Corporate crime pervades every aspect of modern living, including company dealings, securities markets, trade practices, government dealings, environmental protection, occupational health and safety, employment and discrimination, immigration and taxation. These areas can interact so that criminal offences can involve one or more of these areas.

Traditionally, corporations have relied on government agencies to conduct their investigations and prosecute white-collar crime. However, in the next decade, I foresee that law enforcement agencies will not have the resources to investigate most financial crime. There will be an increase in the role of private investigations to supplement some of the roles of enforcement agencies and law firms, and accountancy firms will be more proactive in this area.

Further, recent corporate frauds intuitively tell us that large corporations may need investigative capabilities in-house to ward off a major collapse. If effective, it will act as an insurance policy for its own survival. Companies have become increasingly complex and can operate through international holding companies which have the ability to confound some of the best audit firms that oversee them.

Dimensions of corporate crime

The dimensions of corporate crime investigation are wide ranging and include:

- frauds, financial or otherwise
- internal audit fraud and compliance breaches
- money laundering
- securities contraventions, including non-disclosure to the publi
- bribery
- insider dealing
- market manipulation
- corruption
- taxation avoidance
- trade practices and market conduct
- insolvent trading
- fictitious or false accounting
- misleading financial statements
- corporate governance, related party transactions and directors duties
- prudential non-compliance
- food standards
- road and rail standards
- economic offences against and by employees
- discriminatory workplace and employment practices
- environmental law contraventions, and
- occupational health and safety.

Corporate crimes will occur where there are gaps in procedures. Individuals see weaknesses in the existing system and take advantage of an opportunity that is presented to them. David Coderre, in his work, 'Fraud Detection', explains that the reasons for committing fraud are understood by reference to a "fraud triangle" which allows opportunity, pressure and rationalisation. The author explains: "The opportunity for fraud arises when controls are weak and/or when an individual is in a position of trust. While the pressures on those to commit fraud are often financial, unrealistic corporate targets can influence employees to commit fraud to meet targets. The rationalisation for fraud often includes beliefs that the activity is not criminal, their actions are justified."[2]

In many instances, management in corporations is just not up to date on the different developing frauds. Often, corporations only act when they are awoken to the fraud. It is important for lawyers to assist their clients to constantly review internal procedures. Lawyers can assist by providing fraud awareness programs to clients and suggest best practice risk management requirements. Any cost would be recouped in fraud deterrence, which would only value add to the business of the client.

According to the most recent Price Waterhouse Coopers 2009 survey, " . . . of those respondents who reported economic crime in the last 12 months, 38% reported experiencing accounting fraud. This form of economic crime has significantly increased since 2007, and this appears to be linked to the economic cycle".

The survey results highlight that accounting manipulations are most common within listed organisations and least common in family-owned organisations.

Accounting fraud encompasses a variety of fraudulent actions, including accounting manipulations, fraudulent borrowing/raising of finance, fraudulent application for credit and unauthorised transactions/rogue trading.[3]

There is growing support for companies to have capability to launch internal investigations into corporate crime to determine contraventions of the law or breaches of ethical standards. Independence of boards is essential. Directors should also keep away from, or be wary of, "yes" men or women on the boards and in

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senior management. A non-questioning manager or director, who goes along with others without asking relevant questions or making proper inquiries, is a useless one. If you have a board of "mates" or "friends", you are entertaining disaster and the herd mentality will prevail.

Knowing what to look for

There is little use in conducting an investigation unless you have professionals of substance who know what they are looking for and have a methodology for achieving it.

It is interesting how many senior compliance persons, auditors and investigators have never uncovered any frauds in their corporations. This is more surprising when regulators or enforcement agencies, when investigating frauds, reveal that the fraud or compliance breach had been going on for a number of years.

Each corporation should review their compliance standards and procedures and the substance of the incumbent compliance officers and auditors. The most important issue to arise out of recent corporate collapses is the conduct of directors and auditors, and whether the audit and compliance oversight committees had exercised their duties properly and been effective in doing their job. Lawyers could suggest reviewing corporate governance and committee structures to assist clients meet best practice governance requirements.

Timely in-house investigation and referral to enforcement agencies

Corporations and statutory agencies have the propensity to keep a lid on their dirty washing. They fear that their reputation will be tarnished if a financial crime is made known.

International corporation protocol requires timely referrals of suspected contraventions of the law. However, it is interesting that, in many cases, these referrals take many weeks before being reported. The consequence is that documents can be destroyed, electronic messages erased and money can also be transferred offshore. When a compliance breach comes to light, it is important that it is considered in a timely manner and internal procedures are put in place to secure evidence.

The breach may lead to other matters that have to be considered, which would also require a review of an expanded scope of transactions. An example of a wider scope of investigation was where a manager of a stockbroking firm had three companies on his client list which were the top three performing clients. A complaint was received on one of his client files about poor advice. The compliance officer reported the complaint and reviewed all client files with the regulator. The investigation revealed that the stockbroker was the de facto director of the three high-performing companies. His interests had not been disclosed and he had used the firm's information to advance his own financial interest.

Lawyers can assist clients by recommending best practice internal procedures for directors to make proper market disclosure and for disclosure of conflicts of interest.

This example shows that one complaint or concern may lead to other breaches and reveal the need for a full investigation of surrounding transactions and circumstances.

Investment fraud

Investigation of numerous corporate frauds reveal that the victim, whether it be the investor or the company, rarely seeks independent verification through official channels before handing over funds. Most corporate/investment frauds can be avoided. They can be detected through sensible inquiry and by investors not believing in high returns or reports of corporate success unless they can be properly verified through basic due diligence.

Investigations have shown that investors need further awareness and education. They should check basic facts, such as whether an adviser is licensed or whether there is a prospectus registered reflecting the information and seek independent advice.

Evidence reveals that, in some large frauds involving bogus banks, insurance companies or international managed investment frauds, not a single investor telephoned the Reserve Bank, financial regulator or requested their lawyer or accountant to verify any information. The extent of mistakes made by investors and consumers revealed through corporate investigations leads to the conclusion that it is not always greed which is the prime initiator to invest. What leads to loss is the lack of understanding of the investment and not obtaining adequate independent advice.

In essence, it appears that many frauds can be avoided if the investor seeks independent verification of:

- The financial adviser's qualifications and licence
- whether a prospectus is registered with the regulator in the jurisdiction
- whether the investment is recommended by well known financial institutions
- searches of the relevant institution in the country of origin claimed
- advice from an adviser
- bankruptcy/company searches, and
- director searches.

There are countless investment scam warnings in media releases and on the websites of security regulators all over the world. Lawyers can assist clients by providing checklists of what their clients should look out for from a legal perspective when their clients are considering an investment. Many bogus investments or advisors can be caught out when simple searches are conducted.

Audit fraud

Often auditors do not pick up basic issues that would raise red flags and do not obtain legal advice when issues arise. For example, booking of expenses to capital expenditure, allowing the company to write its costs down over time rather than immediately, non-clarified intercompany loans, non-detected outstanding payments of creditors, and fictitious profits are but a few of the issues.

In particular, accounting fraud has attracted the most recent attention simply because of the billions of dollars involved.

Sub-prime mortgage collapses shook the confidence of investors and financial institutions in the world markets. We only have to look at the recent revelations of stockbroking firms, corporates and professionals which all emphasise that "cooking of the books" is still very much alive.

The recent PWC survey[4] indicates that accounting fraud has become increasingly prevalent in the last three years. To properly assist clients, lawyers can identify weaknesses in structures and put in place compliance procedures, draft terms of reference for investigating committees to protect against financial crime and be involved in reviews.

Market disclosure

A lack of compliance programs in place also has precipitated serious non-disclosure to the market about factors that may have dampened investor enthusiasm in companies long before their demise.

Failure to disclose to the market is perceived as a corporate fraud. However, it is a new type of fraud. This is because the failure to disclose material issues to the market goes to the very heart of the financial system that is based on a level playing field economic philosophy.

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Lawyers can be proactive in advising corporate clients about disclosure requirements. There is now more emphasis on disclosure requirements and the timeliness of that by directors.

Lawyers can assist clients by recommending best practice internal procedures for directors to make proper market disclosure and for disclosure of conflicts of interest.

Review internal and audit procedures – put systems in place

Fraud is a commercial amoeba that is ever evolving; how it looks today will be different tomorrow. Authors Chapman and Smith (2001) noted that from "the information currently available, financial institutions are frequently targeted by fraudsters who often inflict considerable financial harm on the organisation".[5]

Other research indicates that banks lose five times more to embezzlement than to armed robbers.

The picture does not seem to be changing in 2010, except that recent corporate failures show that the Trojan horse is often from within.

Corporations need to review and update audit and accounting procedures and this will require proper legal advice on corporate governance.

Lawyers can assist clients by conducting internal investigations into suspected internal misconduct matters to determine whether there has been a crime committed or a serious breach in compliance.

Such investigations, if handled professionally, send an important message within the organisation that the corporate will not tolerate any misconduct that can harm the corporation or its employees and ensure that best business practices are maintained.

Foster trust and be open about whistleblowing

A whistleblower is defined as a person who exposes or brings to executive or public attention any irregularity or crime from within an organisation. Whistleblowers are often courageous and are conscious of a deep sense of wrong. Mostly, they gain nothing by coming forward and often act in the public interest.

In one of the few articles on the subject, Professor Latimer (2002) makes the point that very little reward is given to whistleblowers for their trouble, "of 23 whistleblower studied, 90 percent were sacked or demoted for their pains and 27 percent faced law suits, usually for breach of confidence and defamation".[6]

Likewise, in corporate governance, you can have pretty charts and structures for "looking good", but what is needed is an effective adherence to the requirements.

Nobody wants to talk of corporate issues of concern because they are regarded as sacred cows and the "shoot-the-messenger principle" is very much alive within corporations as there are political agendas at stake.

The individuals who bring these issues to the attention of senior management are usually not popular and suffer as a result. In many instances they are stating what everyone knows, but others are too afraid of the repercussions to say. There is a high probability that this is where the early warning signs of a major fraud or wrongdoing will come from.

Conclusion

Recent events teach us that financial crime, if unchecked, can bring down an entire company together with its external advisors. No amount of legislation and regulations will stop misconduct, but we must be on alert.

What can we learn? Lawyers can be more proactive in giving advice to ensure effective corporate governance, relevant best practice procedures and compliance structures are in place. These compliance structures must be flexible and innovative in their operations to combat new and emerging financial crime.

There is little doubt that in the future many companies and statutory agencies will have to have the ability to conduct internal investigations or outsource investigations within short timeframes.

Financial crime can only be properly confronted where there is a willingness to appreciate that a lack of best practice procedures to deal with financial crime is the real danger. Lawyers are best placed to suggest to clients and assist them to protect their businesses or investment by ensuring that their clients are in a state of readiness to deal with financial crime.

Notes

1 J. Bologna and P. Shaw (1997), 'Corporate Crime Investigations', Butterworth-Heinemann, Oxford, p1.

2 D. Coderre (1999), 'Fraud Detection', Global Audit Publication, p19.

3 The Global Economic Crime Survey, PWC, November. 2009, p7.

4 The Global Economic Crime Survey, PWC, November 2009.

5 A. Chapman and R.G. Smith (2001), 'Controlling financial services fraud', Report No.289, Australian Institute of Criminology, February 2001, p2.

6 P. Latimer (2002), 'Reporting Suspicions of Money Laundering and "whistle blowing" the Legal and Other Intermediatories and Their Legal Advisors, Whistle Blowing in the Financial Services Sector', Corporate Crime Workshop, Melbourne.