Legal Backgrounder

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IS CRIMINAL ENFORCEMENT NEEDED TO COMBAT ALLEGED CORPORATE CONFLICTS OF INTEREST?

by

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When Enron and other corporate giants collapsed, imperiling public confidence in corporate America, President Bush responded by forming the Corporate Fraud Task Force ("CFTF") in July 2001. In his speech introducing the task force, President Bush articulated his plan to change the government's approach to corporate misconduct:

> This broad effort is sending a clear warning and a clear message to every dishonest corporate leader: You will be exposed and you will be punished. No boardroom in America is above or beyond the law.

See President's message to Corporate Fraud Conference 38 *Weekly Comp. Pres. Doc*. 1626 (Sept. 26, 2002).

Strengthening the Fed's Muscle. The task force was comprised of representatives from several existing regulatory, criminal and investigative agencies. CFTF's focus was to be on three primary areas: (1) falsification of financial information; (2) insider trading; and (3) obstruction of justice designed to conceal either of these types of criminal conduct, particularly when that obstruction impedes the regulatory inquiries of the Securities and Exchange Commission ("SEC") or other agencies. "The President's Corporate Fraud Task Force" by Andrew Hruska, *United States Attorneys' Bulletin*, May 2003.

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One of the targets of this new area of purported protection against corporate greed has been Qwest. In 2002, the SEC, along with the U.S. Attorney's Office and members of the CFTF, launched an investigation that resulted in the indictment of four former Qwest executives for conspiracy, securities fraud, filing false statements, and wire fraud. Punishment for these crimes includes up to ten years in prison and fines of $1 million. In addition, the SEC filed a civil suit, which named the same defendants in the criminal indictment, as well as seven former and one current Qwest executives regarding the same interactions with the Arizona Facilities School Board and two other transactions. These alleged statutory violations may result in fines and additional sanctions against company officers, such as being barred from serving as corporate officers or as members of boards of directors.

When the Qwest indictment was announced, Attorney General John Ashcroft addressed a press conference where he clearly enunciated the government's intention to seek criminal charges against Qwest and other corporations and their employees for corporate misconduct. Attorney General Ashcroft proclaimed:

> As we continue our efforts to battle corporate fraud, our message is clear. We will protect the integrity of our markets by punishing those who falsify information out of sheer greed.

See The Department of Justice Press Release (Feb. 25, 2003). To further emphasize the goal of eradicating corporate misconduct, Ashcroft stressed:

> As we continue our efforts to battle corporate fraud, our message is clear; no board room is beyond the law. No executive is above the law.

Id. Formerly, this conduct was addressed through *civil* enforcement actions seeking civil monetary remedies.

In furtherance of the federal government's crusade against corporate wrongdoers, another grand jury has been convened to review information about alleged stock purchases made by Qwest executives. These stock purchases may have created a conflict of interest when the executives personally acted on offers to buy stock in new companies that were interested in becoming Qwest's clients. The company may have been deprived of the opportunity to invest in the stocks and subsequently reap some of the millions gained by the purchasing executives. In addition, questions have been raised about subsequent Qwest executives' decisions that directed increased business to the newly formed companies. The grand jury will scrutinize testimony of Qwest executives and employees to determine whether the stock holding executives directed the company to make purchases that were financially harmful to the company's interest. Witnesses are anticipated to testify that purchases were made of equipment that was stored in warehouses and never taken out of the boxes. The increased purchases of the equipment improved the stock price and financial picture of the newly formed company and enhanced the profit Qwest executives made by selling their stock.

Has a Corporate Executive Committed a Crime When He Engages in Behavior that Creates a Conflict of Interest with the Company to Which He Owes a Fiduciary Duty? The civil justice system has historically been the arena for addressing business actions that create conflicts of interest. The SEC and other enforcement agencies are well versed in seeking redress for wrongful conduct through fines, which can be very substantial, and restitution. Shareholder lawsuits are also on the rise against corporate executives alleged to have recommended some type of action or failed to take action that would have benefited the company, especially when such actions were in conflict with the executive's personal interests.

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The federal government is now seeking to expand the arena for addressing behaviors that create conflicts of interest by adding criminal prosecutions. One of the primary tenets of the United States Constitution under Article 1, sections 9 and 10, is the prohibition against ex post facto laws. If an act was lawful when it was performed, the actor may not be convicted for the crime as a result of a law enacted after the conduct. Placing the cloak of "criminal conduct" around the issue of conflict of interest is akin to changing the rules of the game at half-time. An executive may have had many reasons for making a business decision but, in almost all circumstances, he or she did not have an understanding that the conduct was "criminal in nature." Business executives are frequently very aggressive with their accounting practices. When executives run afoul of SEC directives, recourse has historically been sought through the SEC administrative and legal enforcement processes. If the rules are changed and an executive who purchased stocks from an IPO is going to be criminally charged, he or she should be aware that a conflict of interest has been transferred out of the civil arena and into the criminal arena. Criminal charges are not appropriate for such conduct. There are sufficient means to address conflicts of interest without expanding the reach of the federal criminal system into corporate America's every business decision.

If an indictment is issued by the grand jury against the Qwest executives for ignoring or failing to recognize that a conflict of interest arose when the executives purchased stocks, it is uncertain how those charges will be drafted. What is the "crime?" If the "opportunity" should have been disclosed to Qwest, the failure to disclose the information may have resulted in the "usurpation of corporate opportunity." The stocks purchased would more rightly have been the "property" of Qwest. If the executives co-opted the opportunity for purchasing the stocks, the executives then possess an interest which belongs to the company. Prosecutors might also try to get an indictment for mail or wire fraud if the information exchanged about the opportunity was not conveyed to Qwest, the intended recipient, despite the executive representations that the offer would be directed to Qwest.

A successful prosecution would require proof beyond a reasonable doubt of several key items including: who had knowledge of the option to purchase the stock?; under what circumstances was the stock made available — voluntary or coerced?; what disclosure, if any, was given by the executive involved to the board or other corporate decision-makers about the opportunity and about the personal purchases?; and what was the board's response to such disclosure? The more difficult task will be presenting evidence that can directly tie actions by the executive to the alleged misconduct of purchasing goods or services from the companies to inflate their financial status and stock values. Other queries are: whether, apart from buying the stock, any of the executives had any ongoing contact with the companies to influence their client relationship with Qwest?; Were any services or goods that Qwest offered diminished to the detriment of Qwest because the executives directed Qwest to use or recommend the goods or services of the companies?; Did the executives steer any large contracts toward the companies to improve their revenues?; Did the executives make decisions that raised the stock value and resulted in income at the time of sale that could or should have gone to Qwest?

It is anticipated from the investigations undertaken and testimony before government committees that the executives will defend against any charges by maintaining that:

(1) the stock purchase was made to diversify their portfolios;

(2) the purchases were made through bankers and brokers without direct interaction by the executive officers;

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(3) the executives had no day-to-day interaction with the companies and had no ability or interest in managing the volume of purchases from the company or awarding contracts to the company; and

(4) the purchase of IPO stocks from a prospective client was business as usual — not a criminal act.

Enough is Enough. The SEC and other regulatory agencies should be the sole venue for addressing transactions that result in conflicts of interest. These agencies have served as tenacious watchdogs to combat corporate wrongdoing for decades, and no reason exists to expand the criminal justice system to include executive decision making. These acts are a demonstration of the exercise of business judgment and the operation of the business world. An executive's decision to purchase stock does not amount to taking the property interest of any person or entity. The sanctions and fines that can be issued for successful civil suits brought by the SEC against corporate wrongdoers are large enough to drum home the message that executive misconduct will not go unnoticed or untouched.

Shareholders have already brought suit against the executives and Qwest for some of these stock transactions. This companion type of litigation addresses the same facts from a different angle. The recourse is restitution--being made whole for the lack of opportunity to buy stocks and make the same profit, or for loss of revenue due to unnecessary purchases or issuing unnecessary contracts.

Just Say No. In light of all the current and prospective criminal and civil lawsuits brought against Qwest for mischaracterizations of financial data and alleged fraudulent disclosures of inflated revenue, there will be plenty of opportunities for judges or juries to review the behavior of Qwest executives and determine if they have fulfilled their fiduciary duties. Permitting the imposition of criminal charges for a business decision is unprecedented and unnecessary. The federal government already acted speedily to pass the Sarbanes-Oxley Act, which provides new and enhanced sanctions for violations of the SEC regulations. The Act sets forth the conduct that may subject an executive to being charged with a violation. There are no existing regulations or criminal laws that specifically enunciate that a crime has been committed if an executive purchases stock or makes other decisions that result in a conflict of interest between the executive and the corporation.

The federal government already has enough tentacles of authority through the SEC, combined with shareholder lawsuits to respond to executives who violate the SEC regulations or their fiduciary duties. The federal regulatory octopus does not need a new prosecutorial tentacle to protect against conflicts of interest.

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