COOK

# 10 TIPS TO AVOID BEING VICTIMIZED BY FRAUD OR CORRUPTION

BY MAX LAUN AND JEFFREY M. KLINK

Most counsel to publicly traded corporations and privately held businesses are experts in transactional work, compliance issues and numerous challenging human resources, business and board matters. Fewer are experts when it comes to identifying and confronting fraud and corruption. Yet corporate counsel in every industry, regardless of the size of the company or the stated role of counsel, face more frequent challenges in dealing with those issues, as well as the US Foreign Corrupt Practices Act (FCPA), anti-money laundering regulation, securities violations and employee misconduct.

Gaining knowledge about fraud and corruption will become vital to counsel as companies grow and expand, especially into emerging economies where such conduct is more common and opportunities are more available. The good news is that resources are available to counsel, and the number of experts in fraud and corruption matters has grown considerably over the years. Much of this growth can be attributed to the emergence of the risk consultancy industry that has grown tremendously since the early 1980s.

The key to identifying and preventing fraud and corruption is to familiarize yourself with the people who work for you by having robust pre- and post-employment screening protocols. Essentially, you must know your agents and business partners. Those who have a history of fraud or crime often have a hard time staying clean. And in some specific jurisdictions, like Russia for example, corruption is an unfortunate part of the landscape and has been for a long time.

Yet fraud has certainly not bypassed more mature and legally sophisticated economies, considering the fallout from the $70 million Madoff fraud and the alleged $7 billion Stanford fraud. Counsel now must comply with Sarbanes Oxley (SOX), already a fixed part of the regulatory landscape in the United States, and contend with significantly increased enforcement of the FCPA and similar legislation as well as anti-money-laundering directives. Issues of ethics and fraud prevention and response will be increasingly paramount across in-house counsel's global portfolio.

Consider just a few of the ways corporate attorneys experience and fight fraud every day:

- Human resources counsel address a plethora of fraud issues relating to job applicants, including resume manipulation and employee misconduct;
- Transactional counsel face fraud in multiple arenas, not the least of which is discovering false financial statements, corrupt suppliers and dealing in the challenging environment of emerging economies where ethics, if any, are minimal;
- Intellectual property counsel frequently must concern themselves with the potential theft of trade secrets and IP;
- Pharmaceutical counsel often deal with off-label and off-hour production and sales by rogue sales staff; and
- Securities counsel routinely handle allegations of fraud relating to stock manipulation, and more frequently, claims of insider trading.

MAX LAUN is assistant general counsel — mergers & acquisitions, with Pittsburgh-based Alcoa's legal department. He heads the energy practice area, and has worked on international mergers, acquisitions, divestitures and investments in his 20+ years with the company. He is a graduate of Rice University, spent two years in Romania as a Fulbright Scholar and received his JD degree from the University of Pittsburgh School of Law. Laun can be contacted at *max.laun@alcoa.com*.

JEFFREY M. KLINK is the founder, president and CEO of Klink & Co., Inc., a global due diligence, litigation support and Foreign Corrupt Practices Act consultancy with offices in the United States, London and Hong Kong. A former prosecutor with the United States Department of Justice, Klink has conducted hundreds of fraud and corruption investigations and is a frequent speaker on due diligence and the FCPA. He can be contacted at *jklink@klink-co.com*.


### The High Cost of Fraud and Corruption

In each of the above situations, fraud and corruption play a daily role in the professional lives of in-house counsel. Those who do not see the potential for problems often end up having to explain to their boards and senior executives why they failed to prevent and identify problems before they ballooned. Training and expertise


Legal excellence
is just the starting point.

in fraud and corruption issues are becoming vital to all types of counsel, as fraud in the United States alone is said by the Association of Certified Fraud Examiners to be nearly $1 trillion in 2009. Additionally, in just the past year, US companies have paid over $1.3 billion in penalties for violating the FCPA, to say nothing of the legal and other costs they incurred in investigating and putting in place compliance plans. In some of those FCPA cases, the bribes paid were minimal. Perhaps more important, the Department of Justice is adding hundreds of investigators and lawyers to pursue violators of the FCPA. Yet few corporate counsel realize or acknowledge that fraud or corruption identification and prevention are central to their role. Further, much of the training is highly segmented (i.e., FCPA training, SOX training or SEC training) and not focused upon general issues of fraud, corruption and a lack of ethics.

### What Did the Madoff Case Teach Us?

The Madoff fraud, yet another Ponzi scheme (pay off the old investors with money from the new), has been called the ultimate in the world of fraud. Every corporate lawyer in the world has looked with awe at the sheer audacity of the scheme that lured in some very sophisticated prey.

It has also been said that this fraud, where some of the most sophisticated firms and people in the world were likely duped, took duplicity to new heights. Some analysts have said that the Madoff disaster will finally end fraud as we know it, because everyone is on guard and certainly knows to be more careful.

At least in terms of the number of zeros attached to it, the Madoff case is a spectacular fraud matter that will be talked about for decades. Yet even that is not the most interesting fraud scheme of late — or the most complex — by a long shot. In fact, the alleged Madoff disaster shouldn't really surprise anyone: Ponzi schemes are common and have been around for a long time. They are only one type of numerous frauds that have been reported of late. Even though the Madoff fraud investigation has spread wider, to include other investors for example, it still is the classic scheme that started years before it was finally named for the Italian, Charles Ponzi.

According to information that can be readily accessed on the SEC website, Charles Ponzi duped thousands of New England residents into investing in a postage-stamp speculation scheme in the 1920s. He claimed to have the ability to exploit the difference between domestic and foreign currency prices by buying and selling mail coupons.

We focus on what's most important. You.

Business Law | Litigation | Intellectual Property | Employment and Labour Law
CANADIAN LAWYERS | MONTREAL | OTTAWA | QUEBEC | TORONTO | LONDON
OGILVY RENAULT LLP ogilvyrenault.com

OGILVY RENAULT

While early investors were paid from the dollars provided by the later ones, ultimately the entire scheme collapsed. It was reported that Ponzi received as much as $1 million within a few hours and only bought about $30 worth of stamps. Ponzi told investors that he could provide a 40 percent return in just 90 days, compared with five percent for bank savings accounts.

So why do we care about Ponzi or Madoff or, for that matter, all of the many other cases — the alleged multi-billion-dollar Stanford case, Enron, WorldCom, Parmalat or the Dreier case, where a noted New York lawyer pleaded guilty to bilking hedge funds out of hundreds of millions of dollars in a fake promissory-note fraud? Why indeed? Corruption is becoming more complex and is in every industry and, in some instances, has led to the destruction of entire businesses. In short, every corporate counsel should be prepared to know it when they see it and their reaction must be quick and sure-footed to avoid trouble.

### Counsel Must Acquire Fraud Awareness

For many years, fraud has been an "un-sexy" area of practice, consigned to security staff, auditors, some members of the corporate counsel's department and specialized outside accountants and lawyers. Corporate counsel's role was designed to primarily put together deals; draft and execute contracts; work with outside counsel; resolve employment disputes, environmental matters and other kinds of problems; while leaving the former prosecutors to look into fraud and corruption. It was thought that years of doing deals and terminating employees didn't prepare one to become an expert in fraud, so looking outside to find

## Ten Tips to Stay Ahead of the Fraudsters

The key is to know the people

1. A comprehensive pre-employment and on-the-job screening program will yield more benefits than any other act. Corporate screening programs are by and large deficient and limited. Check as many different kinds of records as are available, including federal and state criminal records, media reports, government watch lists and sex offender registries. Protect yourself from hiring problems. Talk to knowledgeable people. Most problems come from within, not from the outside.
2. Institute a comprehensive due diligence and screening program for all consultants, agents, distributors and other third parties acting on your behalf. Under multiple theories, third parties acting in violation of the law can make your company liable. Yet few corporations know a lot about their representatives. Know the people you rely on and do not just assume they are okay.
3. Incorporate comprehensive due diligence protocols early in all transactions. Talk to people and do exhaustive research, but do not limit your research to a few places. Do not rely on the word of third parties, including those who claim that they did the due diligence work already.
4. Create and enforce a comprehensive code of conduct and ethics policy and procedures. Train employees and make sure they acknowledge their obligations at least once a year.
5. Make sure your agents and representatives execute the same code of conduct and ethics policy as your employees. Make these procedures part and parcel of third-party contracts. Train your third-party vendors.
6. Ensure you have the right to audit the books and records of all third parties with whom you do business. Have specific language in the agreement that gives you the right to audit within five or 10 business days of making a formal request. Have specific penalties in place if the books and records are not produced.
7. Be vigilant about all of the regulatory requirements that touch on fraud and corruption, including but not limited to the FCPA, anti-money-laundering directives, SEC regulations — and don't forget local laws.
8. Put into place all necessary accounting controls that will accurately track all payments of the company. Audit regularly. Require that your company record all transactions and maintain historical records of all financial transactions, including expense and petty cash disbursements. Audits of internal controls should include unannounced audits.
9. Use the technology and safeguards that are available to protect your intellectual property and trade secrets. Use technology to understand the activities of your employees.
10. Become an expert on fraud and corruption. Know the countries where you are operating and know which fraud schemes are currently being used. Use excellent third-party resources that cover the corruption environments of every economy in the world. First and last, know the people, whether they are working for your organization as employees, third parties or business partners.

someone who knew more about this subject made a great deal of sense: Hire a former federal prosecutor or someone else who knew about this and let the big law firm handle the problem, if ever one appeared.

Unfortunately, as the sheer number and size of frauds continues to increase, a passing knowledge of the subject will no longer be sufficient for most corporate counsel. Transactional counsel have been more attuned to issues of fraud, as many deals over the years have failed due to clever fraudsters who were able to successfully lie to investors and others. Often the failures can be tied to a lack of proper due diligence, where the dealmakers never understood the motives and backgrounds of their putative business partners. There have been a number of major deals over recent years that have failed because of a lack of due diligence and understanding of what was being bought. The result, in some instances, has been catastrophic — consider a notable recent bank acquisition that resulted in billions being lost due to failed due-diligence strategies.

> A primary **reason for failure** in the **due diligence** process occurs when investors **fail to talk to people** who know or knew the **key principals**, especially **former employees** and **others** who may not paint a rosy picture.

Similarly, some employment counsel have seen hundreds of false claims for unemployment compensation or worker's compensation, while others have handled their share of expense fraud matters. Yet overall, we find that many counsel have only a passing, and passive, knowledge of fraud and its many iterations.

Some savvy companies understand the premise that there are long lines of fraudsters waiting to steal your corporate assets. And many know that it takes time and effort to analyze whether an individual or company can pass the due diligence tests and whether they are trustworthy. The most sophisticated among them are willing to commit to the process of getting to know the people with whom they are doing business and analyzing how the deal could fail. However, this process can take several weeks, if not months, and requires committed resources to fully assess the risks.

How often does fraud surface? One of the authors has performed several hundred due diligence, fraud, kickback and asset recovery investigations in over 30 countries and has dealt with multiple fraud schemes. He has met some of the most notorious fraudsters in the world, cloaked in fine suits and fancy apartments, and most of those he met were working out of impressive business offices with administrative staff, nice artwork and the like.

Despite the many kinds of corporate tomfoolery, the typical fraud case is like the reported Madoff scenario: Make yourself and your colleagues look respectable by having class A offices, a nice lifestyle and expensive clothing. Associate with successful people, claim a long track record of success and set up multiple companies with prestigious-sounding names.

How is fraud missed so often? First, the business people and the corporate counsel who work with them often fail to consider that they may have already been duped. Next, due diligence efforts are often cursory or a company succumbs to the pressures to "get the deal done," in turn making the due diligence process less effective or completely ineffective in preventing fraud. Many due diligence investigations of people and businesses are limited to checking references and looking at some public records like criminal and civil court filings, SEC filings and UCC filings.

Corporate counsel often rely on other professionals to find fraud. The investment bankers work the relationship angle. The accountants analyze the (purported) books and records of the business. The team of outside lawyers tells investors about the legalities of the deal. In the end, the acquisition or joint venture deal gets done.

A primary reason for failure in the due diligence process occurs when investors fail to talk to people who know or knew the key principals, especially former employees and others who may not paint a rosy picture. Talking only to *satisfied* customers is not the path to follow for successful due diligence. And as noted above, a review of public records alone often cannot disclose evidence of fraud.

The majority of white-collar fraud cases like Madoff's do not end up in the courts. Evidence of fraud — or merely information that can give rise to suspicions of wrongdoing — can often be found in media reports, blogs and most importantly by talking to people, not in the criminal or civil courts. Due diligence investigations that focus upon criminal or civil records lack the creativity, analysis and critical thought necessary to get good results.

## ACC Extras on…Fraud and Corruption

### *ACC Docket*

- *Managing an Internal Corporate Fraud Investigation and Prosecution (April 2007)* In order for in-house counsel to avoid finding themselves the subject of the next audit committee inquiry at their company, it is vital that they know how to properly investigate and pursue internal allegations of such "white-collar" crimes as fraud, theft and corporate malfeasance. *www.acc.com/docket/mg_intrfraud_apr07*
- *In-house Counsel Responsibilities in the Post-Enron Environment (March 2003)* This article discusses the broad responsibilities of in-house counsel and provides an overview of the post-Enron environment from the in-house perspective. *ww.acc.com/docket/resp_enron_mar03*
- *The Acid Test for Your Compliance Program (April 2006)* A strong and effective compliance program can be crucial to persuading the prosecutor that your company does not deserve prosecution.This article will show you how to strengthen your compliance program for that day. *www.acc.com/docket/compliprog_apr06*

### Quick Reference

- *Designing a Robust Fraud Prevention Program (April 2004)* Lists the five essential elements of an effective internal controls/fraud prevention program outlined by the Committee of Sponsoring Organizations (COSO). *www.acc.com/quickref/fraud_prev_apr03*

### Program Materials

- *Fraud Planning and Prevention for In-house Counsel (Oct. 2008)* Increased levels of corruption, a heightened regulatory environment and pointed questions from their auditors and boards have led companies to be much more vigilant in their efforts to address corporate fraud. This session focused on the role of in-house counsel in designing, implementing and communicating an anti-fraud program. *www.acc.com/pm/fraud_plan_oct08*
- *Fraud and Malfeasance: State and Federal Enforcements (Oct. 2008)* Learn what you can do to help your organization create and execute an effective ethics and compliance program and what to do when the regulators knock at the door. *www.acc.com/pm/statefed_oct08*

ACC has more material on this subject on our website. Visit *www.acc.com,* where you can browse our resources by practice area or use our search to find documents by keyword.

### White-Collar Fraudsters Often Leave No Trail

In point of fact, white-collar crime victims are often embarrassed by fraud, so the crime is never reported and there is no trail to follow. Email scams ("please send money and/or your account information to assist me in getting millions in blocked funds out of my country, and I will pay you a percentage") continue because people actually respond to these inquiries and are often too embarrassed to admit that they have been defrauded. Another problem in tracking fraudsters is that it is easier for the victims of fraud to deem the fraud a failed strategy or business execution rather than a fraud. The victims make no complaints to the criminal authorities, never pursue restitution, and just move on. Because nothing was ever done, there is often no trace that a fraud was committed.

US banks must report fraud to the FBI, but that requires someone to assess whether a fraud has been committed and that doesn't always happen. For every case like Madoff or Dreier, with headlines on the front page of every paper, numerous cases go unreported by multinationals or hedge funds, either because the frauds are not uncovered until too late or because the whole mess is too complicated to understand. Most of the defrauded simply try to recover what they can without notifying anyone.

One common mistake made by banks and funds when looking at key people like Madoff is to limit due diligence investigations to those jurisdictions where a target has lived or in the place where the project or operations will take place. In one recent case, a fraudster had always lived in the United States, Israel and Brazil. We looked for information in those countries and found nothing to impair the deal. We made inquiries in Africa after the investors mentioned that the borrower had a business there for a short time and found that the borrower did not pay back $60 million to a bank. The deal was therefore stopped. Failing to look in Africa could have been fatal to the investors.

The financiers, accountants and lawyers who claim to be surprised at the Madoff case are only surprised because they (always) believe that the last big fraud case is in fact that: the last big fraud case. The thinking goes that after Enron, WorldCom, Parmalat or Societé Generale (the French bank that was possibly victimized of billions earlier this year), or perhaps now after Madoff or Dreier, we have seen the last of fraud. Our controls are good, our due diligence is good, our lawyers and accountants are good and therefore it can't happen to me. But it can and it did. We are not surprised. Fraud is here to stay.

*Have a comment on this article? Email* editorinchief@acc.com.