

DAILY BUSINESS REVIEW

SPECIAL REPORT SECURITIES LAW

Feds must learn difference between poor decisions and fraud

Commentary by **Ivan Harris and Melissa Mitchell**

Special to the Review

In the wake of the financial crisis, the federal government vowed to crack down on financial fraud and punish those believed to be responsible for the economic meltdown.



Harris



Mitchell

For example, when Attorney General Eric Holder announced the objectives of President Obama's Financial Fraud Enforcement Task Force, he promised its members would "be relentless in [the] investigation of corporate and financial wrongdoing, and [would] not hesitate to bring charges where appropriate for criminal misconduct on the part of businesses and business executives." Robert Khuzami, director of the Securities and Exchange Commission's enforcement division, has described the credit crisis as the division's

"highest priority."

To date, law enforcement agencies have investigated and brought cases stemming from the financial crisis that alleged defendants sent positive messages about their business to investors while secretly harboring doubts about their business models or products. Although the federal government should be lauded for seeking to bring to justice those who knowingly defrauded investors and caused billions of dollars in financial damages, the government must be sure that it not simply alleging fraud by hindsight.

A recent experience shows the government will lose the battle to punish those responsible for the credit crisis if it ignores well-established case law permitting companies and individuals to take a positive

outlook on their prospects. In June 2008, the Justice Department brought the first criminal securities fraud charges stemming from the credit crisis against two former Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, over the collapse of several Bear Stearns hedge funds. At the same time, the SEC brought civil charges against the two men.

The criminal case went to trial last October with prosecutors building their case on a series of e-mails from 2007 in which Cioffi and Tannin internally expressed concern about the health of the funds and the subprime mortgage market. Despite these concerns, prosecutors alleged that Cioffi and Tannin continued sending positive messages about the funds to their investors.

The defense combated the prosecution's case by showing that Cioffi and Tannin's concerns for the health of the funds were ever-shifting as unprecedented market conditions took hold. Defense lawyers accused the government of looking at the world "through dirty glasses," and seeking to criminalize bad investment decisions. After deliberating for a mere six hours, jurors acquitted both men. One juror even noted she would have invested with the defendants if she had the money.

POSITIVE OUTLOOK

The verdict should not have been a surprise to the government. The acquittal falls in line with a body of civil case law that permits companies to take a positive outlook on their businesses.

For example, in *Shields v. Citytrust Bancorp, Inc.*, the 2nd U.S. Circuit Court of Appeals said, "People in charge of an enterprise are not required to take a gloomy, fearful or defeatist view of the future; subject to what current data indicates, they can be expected to be confident about their stewardship and the prospects of the business that they manage."

More recently, a federal judge in California

dismissed a case involving the collapse of the troubled IndyMac bank by observing a plaintiff must show more than that defendants "were simply unable to shield themselves as effectively as they anticipated from the drastic change in the mortgage and housing markets."

Similar to these cases, it appears jurors in the Cioffi and Tannin case correctly decided not to criminalize conduct that amounted to nothing more than an incorrect prediction or false hope of better days to come. The Bear Stearns case should prompt federal regulators to think carefully about their theories in current or upcoming prosecutions. Various government agencies are reported to be investigating former executives of AIG's failed financial products unit, where internal e-mails reveal the executives' struggle to analyze and handle the mounting financial crisis. The SEC has also brought securities fraud charges against Angelo Mozilo, the former CEO of Countrywide Financial, alleging Mozilo painted an optimistic picture to investors while internal e-mails allegedly reveal his fear that Countrywide was operating under a toxic business model. The federal government is at risk of defeat if its allegations boil down to nothing more than second-guessing good faith business decisions.

Although fraud deterrence and seeking to punish those who contributed to the financial crisis are noble goals that certainly should not be abandoned, the Bear Stearns verdict and case law show the government must be careful to avoid looking at the world through "dirty glasses." Doing so risks flawed prosecutions that allege little more than fraud by hindsight.

Ivan P. Harris is a partner in the securities litigation and enforcement practice of Morgan Lewis & Bockius in Miami. He is a former senior enforcement official with the Securities and Exchange Commission's Miami regional office. Melissa Mitchell is an associate at Morgan Lewis.