Business Accounting and Finance

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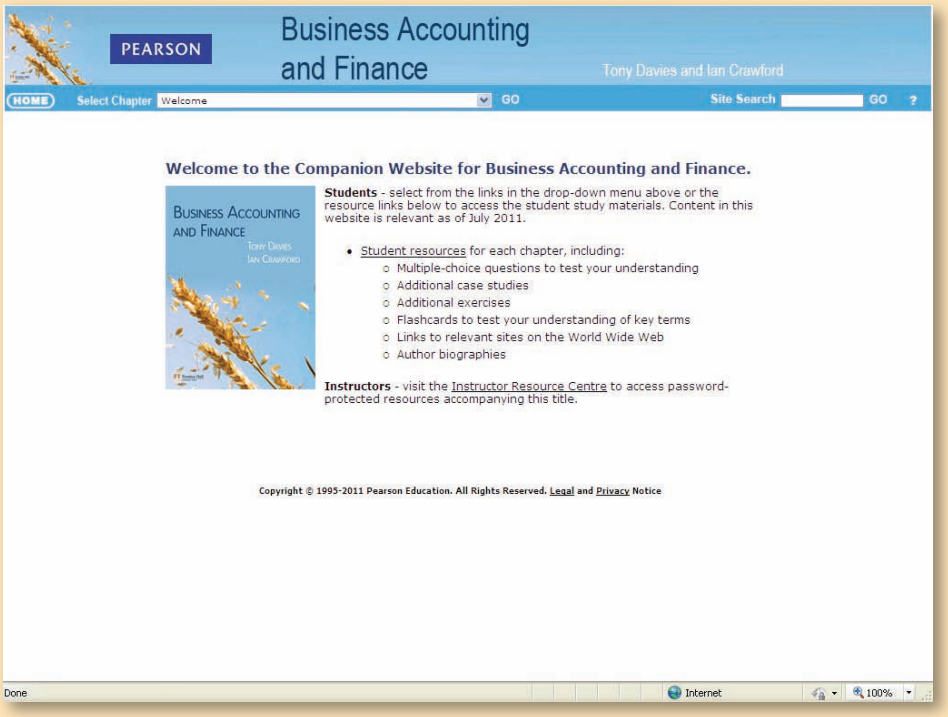

Anything you can do I can do better

On Mar. 12, victims of Bernard Madoff's Ponzi scheme finally had one of their wishes come true. After a judge denied bail, Madoff is going directly to jail, and he isn't passing 'go'. But Madoff's victims still want answers.

They want to know where the money went. They want to know who else was involved. And they want to know how they got scammed.

At the courthouse, many victims said there were no warning signs and Madoff himself, in his courtroom statement, backed them up on at least one count. 'The clients receiving trade confirmations and account statements had no way of knowing by reviewing these documents that I had never engaged in the transactions', Madoff said during his guilty plea.

Maybe not. But to Harry Markopolos, the risk manager who alerted the SEC to Madoff's fraud in 1999 to no avail, the foul play seemed obvious. Madoff was supposedly using a complex trading system to generate returns, a strategy he dubbed the 'split-strike conversion strategy'. He would buy stocks in the Standard & Poor's 100 and sell options to reduce volatility. But Markopolos' firm was running a similar strategy and couldn't match the returns. A look at the returns was all it took for Markopolos to know something was up.

Preying on a Community

Markopolos had plenty of incentive to doubt Madoff; he was a competitor irked by Madoff's claims of too-good-to-be-true returns. For most of Madoff's clients, the math that Markopolos employed would have been out of their league. Some Madoff investors were sophisticated enough that they might have dug deeper into their statements and trade confirmations. A quick comparison of their returns with those of the actual markets might have been enough to tip them off that at least some of the trades were phony. Some of them might have realized that the average returns were too high and too constant, based on the mathematical probabilities. 'If the standard deviation is too low and the mean too high, something is wrong', says Utpal Bhattacharya, finance professor at the Indiana University Kelley School of Business. Still, 'the retail investor would need some help.'

Experts say investors can avoid Ponzi schemes and other scams without relying on math. The first step: Take a look around; who are your fellow investors? Often in a scam, a pattern emerges. There's a reason why many Madoff-like scams are called 'affinity crimes'. Charles Ponzi, for whom the scam is named, targeted Italians. Joseph Forte ripped off his friends. And before Madoff branched out into Europe in recent years, his clients were primarily Jews and Jewish foundations.

'Ponzis involve preying on people who have some association. The same clubs, religion, geographic location', says Tim Kochis, chief executive of financial advisory firm Aspiriant. 'Madoff's investors all trusted each other. They assumed that was good enough.' If investors get a sense that their adviser caters to a very narrow group, they should probably dig a little deeper.

Do Your Own Due Diligence

That starts with doing your own due diligence. Scamsters often make claims to bolster the confidence of investors that they're dealing with a heavyweight. Allen Stanford built an image of a successful businessman whose family's financial-services roots went back to 1932. In fact, his banking empire consisted of a Montserrat bank founded in 1986 that had its license revoked by the local government. Go back further, and Stanford filed for bankruptcy not once, but twice.

Victims of Tom Petters, the mastermind behind another recent Ponzi scheme in Minnesota that cost investors $2 billion, didn't check out basic claims, such as Petters' assertion that he was a major supplier to Sam's Club. He wasn't, which the investors could have figured out if they'd picked up the phone and made a call.

Madoff's investors might have been able to determine if their trades were legitimate if they'd checked how a stock or option traded on any given day. Even something as trivial as the accounting firm can be a tip-off. Both Madoff and Stanford used tiny accounting firms that would have been hard-pressed to handle the job. 'Investors have to do their own due diligence', says Gregory Hays, managing principal of Atlanta-based Hays Financial Consulting. 'They need to make sure what they're investing in is accurate.'

Investors also should dig into the firm and the background of its managers. A quick check on the Financial Industry Regulatory Authority, or FINRA, Web site could alert investors to a black mark on an adviser's record. Its Broker Check function alerts investors to any regulatory proceedings against an adviser, from bad record-keeping to misuse of client funds for firms and advisers. If the firm doesn't have a solid explanation, it could be time to look elsewhere.

The Defense of Skepticism

Even a quick search of Google can be revealing, yet it's a step few victims take. It would have revealed accusations from the 1990s that Madoff was front-running his customers, that is, buying or selling shares before filling their orders. The charges may amount to nothing. 'But', says Billy Procida, founder of William Procida Inc., a turnaround management firm for middle-market real estate companies, 'do I really want to take that chance?'

Still, the best defense may be a healthy dose of skepticism. Most people with money to invest with people like Madoff worked very hard for it. In business, they wouldn't have taken anybody's word for something. They'd have checked it out. But they didn't do the same with their advisers.

Richard Friedland, a CPA and Madoff investor, said on Mar. 12 that he could have recognized the scam if he had been looking for it. But he saw no reason to look for it. 'Madoff was the chairman of Nasdaq', Friedland said.

And that's what the Madoffs of the world depend on to build their webs of deception. They have fancy offices, fancy cars, and travel in private jets. They have pictures of governors, mayors, movie stars, and athletes.

'People love that', Procida says. 'They want to be with a star.'

Source: **Madoff: Lessons from a Disaster,** by Ben Levisohn

- Health and Safety (Offences) Act 2008
- Financial Services Act 1986
- Corporate Manslaughter and Corporate Homicide Act 2007.

In addition, it should be noted that further statutory provisions giving rise to vicarious liability of directors for corporate offences are included in Acts of Parliament, which currently number well over 200! Directors can be:

- forced to pay a company's losses
- fined
- prevented from running businesses
- imprisoned.

The Directors' Remuneration Report Regulations 2002 (Statutory Instrument 2002 No. 1986) are now in force and require the directors of a company to prepare a remuneration report that is clear, transparent and understandable to shareholders. Many smaller companies without continuous legal advice are unaware about how much the rules have tightened. It is usually not until there is wide publicity surrounding high-profile business problems that boards of directors are alerted to the demands and penalties to which they may be subjected if things go wrong.

It was not only the 1980s and early 1990s that saw corporate scandals and irregularities (for example, Polly Peck and the Maxwell companies). At the end of 1999, accounting irregularities caused trading in engineering company TransTec shares to be suspended, with Arthur Andersen called in as administrative receiver. The case was fuelled by the revelation by former TransTec chief accountant Max Ayris that nearly £500,000 of a total of £1.3m in grants from the Department of Trade and Industry was obtained fraudulently. TransTec, founded by former Government minister Geoffrey Robinson, collapsed in December 1999, after the accounting irregularities were discovered, with debts of more than £70m. Following the collapse of the company the role of the auditors to the company, PricewaterhouseCoopers, was also to be examined by the Joint Disciplinary Scheme, the accountancy profession's senior watchdog.

Also during 1999, the trade finance group Versailles discovered that there had been some double counting of transactions, which prompted the Department of Trade and Industry to take a close interest in its affairs. Actual and apparent corporate misdemeanours continued, on an even larger scale, through the late 1990s and on into the twenty-first century (note the Barings debacle, Enron, WorldCom and Tyco).

Non-executive directors are legally expected to know as much as executive directors about what is going on in the company. Ignorance is not a defence. Directors must be aware of what is going on and have knowledge of the law relating to their duties and responsibilities. Fundamentally, directors must:

- use their common sense
- be careful in what they do
- look after shareholders
- look after creditors
- look after employees.

Progress check 6.5

What are the main responsibilities of directors with regard to the accounting and financial reporting of their companies?

Duty of care

It is the duty of a director to exercise his or her powers in the best interests of the company, which includes not acting for his or her personal benefit, nor for an improper use. In the year 2000, Greg Hutchings, the chairman of a major plc, Tomkins, was criticised for alleged excessive perks, unauthorised donations, and inclusion of members of his family and household staff on the company payroll, without proper disclosure. Investors' concern over corporate governance practices at the group had been triggered by a fall in the share price of over 50% in two years. The resignation of the chairman followed an initial investigation. The new chairman very quickly launched a full inquiry into executive perks within the group, overseen by him personally.

Duty of care means doing the job with the skill and care that somebody with the necessary knowledge and experience would exercise if they were acting on their own behalf. Delegation of directors' power must be 'properly and sensibly done'. If a director of a company does not choose the right people or supervise them properly, all the directors may be liable for the misdeeds and mistakes of the people they have appointed.

When a company fails and is found to be insolvent, the **receiver** appointed will leave no stone unturned to identify whether any money may be recovered in order to pay off creditors. This will include checking for any oversights by directors for items they should have spotted 'if they had exercised their proper level of skill'.

Fiduciary duty

Directors must act in the best interests of the company. Courts will support directors who act honestly and in good faith. Acting in the best interests of the company includes not making personal profit at the company's expense, not letting personal interest interfere with the proper running of the business, or doing business which favours directors or their close associates. In the late 1990s and early 2000s there were several business failures within the dot.com sector, where directors did act in the best interests of the company although their business plans may not have been commercially successful (for example, *www.breathe.com*).

Corporate manslaughter

There is an offence of corporate manslaughter, which a company may be guilty of if a failure by its management is the cause of a person's death, and their failure is because their conduct is well below what can be reasonably expected. Before 1999 there were only five prosecutions in the UK for corporate manslaughter, resulting in two convictions. The risk for companies and their directors is remote but very real, and should therefore be managed in terms of awareness, training, preventative measures and liability insurance.

In earlier years companies were outside the criminal law. As one judge put it, 'a company had a soul to damn and no body to kick' – meaning that because a company did not have an actual existence it could not be guilty of a crime because it could not have a guilty will. In 1965 a case established the validity of the indictment of a company for manslaughter. Since then over 19,000 people have been killed as a result of corporate activity, but no company stood trial for manslaughter, apart from P&O European Ferries (Dover) Ltd after the capsize and sinking of the *Herald of Free Enterprise* off Zeebrugge in 1987. The directors of P&O Ferries did stand trial, but were acquitted because the trial collapsed halfway through. Currently, to succeed in a case of corporate manslaughter against a company there is a need to prove gross negligence and to prove that at least one sufficiently senior official was guilty of that same gross negligence.

Although each year hundreds of people are killed at work or in commercially related activity, if companies have been prosecuted at all they have been charged under the Health and Safety at Work Act (1974) and other regulatory legislation. Many of the companies implicated in work fatalities and public transport disasters operate with diffuse management systems and much delegated power. Such systems that appear to have no 'controlling mind' make it difficult to meet the requirement of the law because of the difficulty in identifying the individual(s) who may possess the mental element for the crime.

A case that was successfully prosecuted involved a small company, OLL Ltd, which organised a canoe expedition at Lyme Bay in 1993, in which four teenage schoolchildren died. In 1994 the jury in the case found OLL Ltd guilty of manslaughter – a historic decision. Peter Kite, the managing director of the activity centre responsible for the canoeing disaster, was jailed for three years for manslaughter, and OLL Ltd was fined £60,000. OLL Ltd was the first company in the UK ever to be found guilty of manslaughter, in a decision that swept away 400 years of legal history.

The Lyme Bay case was atypical of corporate homicide incidents. The company was small, so it was relatively easy to discover the 'controlling mind'; the risks to which pupils were exposed were serious and obvious and, critically, they were not technical or esoteric in any way. However, in the case of a large corporation with many levels of management it is virtually impossible to identify a controlling mind. The Corporate Manslaughter and Corporate Homicide Act (2007) replaces the concept of the controlling mind with a consideration of the way in which an organisation's activities were managed or organised. The Act puts emphasis on examining management systems and practices across the organisation to establish whether an adequate standard of care was applied to the fatal situation. At the time of writing this book the first attempted prosecution under the rules of the new Act was being tried in the courts, following several adjournments (the importance of this landmark case is illustrated in the press extract on the next page). The defendant was found guilty on 15 February 2011.

Great Western Trains was fined £1.5m over the Southall (1997) rail crash in which seven people were killed, following a Health and Safety Executive (HSE) prosecution. But no individual within the company was charged with manslaughter.

The Paddington (1999) rail crash case, again brought by the HSE, resulted in 31 people killed and over 400 injured. The company, Thames Trains, was fined £2m in April 2004, but even though the HSE said its enquiries had revealed 'serious failing in management', there was no prosecution for corporate manslaughter.

A few years ago the legal profession considered that the promised review of the Law Commission's recommendation for an involuntary homicide Act 'could result in company directors being made personally responsible for safety and therefore potentially liable in cases of avoidable accidents'. The Corporate Manslaughter and Corporate Homicide Act 2007 is now expected to dramatically increase the level of directors' accountability to ensure the provision of safe work environments for their employees.

Other responsibilities

Directors do not owe a direct duty to shareholders, but to the company itself. Directors have no contractual or fiduciary duty to outsiders and are generally not liable unless they have acted in breach of their authority. Directors must have regard to the interests of employees but this is enforceable against directors only by the company and not by the employees.

Progress check 6.6

What is meant by a duty of care and fiduciary duty with regard to company directors?

A new chapter in English law on corporate manslaughter?

In law, small cases often mark major milestones. When the prosecution of Cotswold Geotechnical Holdings begins next week at Stroud Magistrates' Court, a new chapter in English law will begin. It will be the first case brought under the Corporate Manslaughter and Corporate Homicide Act 2007 and it signifies a new approach to prosecuting companies for alleged crimes.

The case concerns the death of Alexander Wright, 27, a geologist, who was taking soil samples from a pit that had been excavated as part of a site survey when the sides collapsed, crushing him.

The first chapter of corporate manslaughter law began on February 2, 1965, but it was rather an empty one. The Times reported what was then an innovation in English law: a company had stood trial for manslaughter. Glanville Evans, a 27-year-old welder, had been killed when the bridge at Boughrood that he was demolishing collapsed and he fell into the River Wye. The company had evidently been reckless in instructing him to work in a perilous way but an attempt to convict it for manslaughter at Glamorgan Assizes failed on the evidence.

Nonetheless, the court accepted that a company could be prosecuted for manslaughter. A new crime was recognised. Since then more than 40,000 people have been killed at work or in commercial disasters, such as those involving ferries and trains, while prosecutions for corporate manslaughter have totalled just 38.

The old common law made it very difficult to prosecute companies because the doctrine of identification required the prosecution to pin all the blame on at least one director whose will was identified as the "mind" of the company. As companies commonly had responsibility for safety matters distributed across more than one directorial portfolio, pinning all the blame on one person was difficult. Various directors claimed to know only a fragment of the lethal danger that materialised. It was not permissible to incriminate the company by aggregating the fragmented faults of several directors.

The new law aims to criminalise corporate killing without the need to find all the blame in one individual. The offence is committed where an organisation owes a duty to take reasonable care for a person's safety but the way in which its business has been 'managed or organised' amounts to a gross breach of that duty and causes death.

The law says that, for a conviction, a 'substantial element' of the gross negligence must come from 'senior management' (as opposed to a maverick worker) but any company trying to evade the law by not making safety the responsibility of a senior manager would, by virtue of that very stratagem, be open to legal attack.

Companies convicted of manslaughter can be made to publicise their wrongdoing in the national press and are subject to an unlimited fine. The Sentencing Advisory Panel has suggested a level of fine of between 2.5 and 10 per cent of a convicted company's average annual turnover during the three years before the offence. This is a dramatic change. Most large companies convicted of fatal safety crimes are now fined at a level that is less than one 700th of annual turnover.

Directors can be prosecuted for safety offences alongside a corporate manslaughter prosecution and the Health and Safety (Offences) Act 2008 has widened the range of offences for which prison is a possible punishment.

The new corporate manslaughter law obliges the jury to consider whether a company is guilty by looking at what happened in the context of general safety law. Jurors are also invited to consider how far the evidence shows that there were 'attitudes, policies, systems or accepted practices within the organisation' that were likely to have encouraged the safety failures that resulted in death.

Historically, the law was chiselled to govern individuals accused of homicide and it could not properly be adapted to prosecute corporations. That became more problematic once companies became so powerful – of the world's 100 largest economic entities today, 49 are countries and 51 are companies. Having corporate citizens that are more powerful than governments is a challenge for good social governance.

Globally, more people are killed each year at work or through commercial enterprise – more than two million – than die in wars. If the Act works well in the United Kingdom it will be a good template to be adopted in other countries, and that would confer a substantial social benefit.

Source: **The small cases that will have a big influence on the way we work; Gary Slapper reflects on the deaths that have led to changes in corporate manslaughter law**

Insolvency

Insolvency, or when a company becomes insolvent, is when the company is unable to pay creditors' debts in full after realisation of all the assets of the business. The penalties imposed on directors of companies continuing to trade while insolvent may be disqualification and personal liability. Many directors have lost their houses (as well as their businesses) as a result of being successfully pursued by the receivers appointed to their insolvent companies.

The Insolvency Act 1986 (as amended by the Enterprise Act 2002) provides guidance on matters to be considered by liquidators and receivers in the reports that they are required to prepare on the conduct of directors. These matters include:

- breaches of fiduciary and other duties to the company
- misapplication or retention of monies or other property of the company
- causing the company to enter into transactions which defrauded the creditors
- failure to keep proper accounting and statutory records
- failure to make annual returns to the Registrar of Companies and prepare and file annual accounts.

If a company is insolvent, the courts assess the directors' responsibility for:

- the cause of the company becoming insolvent
- the company's failure to supply goods or services which had been paid for
- the company entering into fraudulent transactions or giving preference to particular creditors
- failure of the company to adhere to the rules regarding creditors' meetings in a creditors' **voluntary winding-up**
- failure to provide a **statement of affairs** or to deliver up any proper books or information regarding the company.

Progress check 6.7

How does insolvency impact on directors and what are their responsibilities in this regard?

Wrongful trading

A major innovation of the Insolvency Act 1986 was to create the statutory tort (civil wrong) of **wrongful trading**. It occurs where a director knows or ought to have known before the commencement of winding up that there was no reasonable prospect of the company avoiding insolvency and he or she does not take every step to minimise loss to creditors. If the court is satisfied of this it may:

- order the director to contribute to the assets of the business, and
- disqualify him or her from further involvement in corporate management for a specified period.

A director will not be liable for wrongful trading if he or she can show that from the relevant time he or she 'took every step with a view to minimising the potential loss to the company's creditors as (assuming him or her to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he or she ought to have taken'. A company goes into insolvent liquidation, for this purpose, if it does so at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of winding-up.

Both subjective tests and objective tests are made with regard to directors. A director who is responsible, for example, for manufacturing, quality, purchasing, or human resources, is likely