FRAUD: LITIGATION AND RECOVERY

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Introduction

White-collar crime, and in particular fraud, is of increasing relevance to corporate officers and lawyers in New Zealand. There has been an increasing criminalisation of corporate behaviour in New Zealand, such that there is now a greater risk of corporations, and their office holders, being investigated, prosecuted and convicted of white-collar offences than ever before. Additionally, there has been a significant rise in the reporting of fraud, including workplace theft, in recent times.

The focus of this paper is upon legal responses to suspected white collar crime, and in particular, fraud. The paper begins with some observations about the increased focus upon white-collar crime in New Zealand generally, before commenting briefly on fraud in particular. The paper then suggests a three step approach of *"investigate, analyse, action"*, whenever fraud is suspected. Finally the paper then looks at what specific actions might be taken. In this regard it is important to identify whether the fraud in question has been committed against, or in the name of, the company the perpetrator is from. Additionally, obligations to report, employment issues, and recovery options are also important to identify. Finally the paper considers some of the issues surrounding packaging suspicions of fraud for law enforcement to action.

An Increased Focus on White-Collar Crime

There has been an increased focus on white-collar crime, including fraud, in New Zealand in recent times. In part this has been reflected in new criminal and quasi-criminal offences being implemented by government (for example the proposed criminalisation of insider trading, which will likely take effect later this year). Increases in fines for white-collar offending under many statutes also reflects this increase focus.

In part though, the increased focus has been reflected in a renewed focus on existing criminal and quasi-criminal offences, and the prosecution of them.

Arguably, New Zealand's first significant step toward seriously detecting, investigating and prosecuting white-collar crime came with the establishment of the Serious Fraud Office ("SFO") in 1990. The SFO was established by the Serious Fraud Office Act 1990, which also provided the SFO with the most extensive investigative powers ever provided to a law enforcement agency in New Zealand. Parliament made a deliberate decision to give the SFO broader powers than the Police when investigating serious or complex fraud. For example, section 9 of the Serious Fraud Office Act 1990, allows the Director of the SFO to require any person to attend an interview with, or provide documents to, the SFO to help further their investigation. Under section 9, any interviewee is unable to refuse to answer questions during such an interview, even where doing so would incriminate them. This is contrary to the position at common law, and indeed, the position now affirmed by sections 23(4) and 25(d) of the New Zealand Bill of Rights Act 1990 (it should be noted that statements obtained by the SFO in this manner cannot automatically be used against the interviewee in evidence, however, they can be used to uncover other evidence which is then admissible, and can be used against an interviewee should they later give evidence inconsistent with that provided to the SFO under section 9).

The rationale behind such a power is that it is crucial for the SFO to be able to adequately detect, investigate and prosecute serious or complex fraud. It is recognition of how difficult it can be to detect white-collar crime, and is deemed to be a reasonable limit upon the

rights of individuals given the value to society that is now placed upon the detection, investigation and prosecution of white-collar crime. Similar powers now exist in other legislation also, including, for example, the Securities Act 1978, the Commerce Act 1986, and the Customs and Excise Act 1996 (the powers in that act go even further than those granted to the SFO, in that section 9 of the Serious Fraud Office Act 1990 still allows an interviewee to decline to provide information that is properly protected y legal privilege – no such protection applies to information sought under the Customs and Excise Act 1996).

The SFO has steadily increased its scope of operations since its inception in 1990. By 1997, the SFO had an annual budget of approximately $4m, and investigated over 150 cases, resulting in 14 prosecutions, and 12 convictions in that year. Today that budget has increased by more than 25%, and the SFO's current workload includes nearly 40 cases either pending, or before, New Zealand courts.

Resources to detect, investigate and prosecute white-collar crime are also increasing in other areas. The Securities Commission, Commerce Commission and Police, have all received increased funding in relation to white-collar crime in recent years. In the case of the Securities Commission, staff numbers doubled, from 17 to 34 in the period 2002 to 2004, largely in the area of investigation and enforcement. Over the same period the Securities Commission's budget increased from $2.7m to $6.3 million. Last year the Government announced a further increase in the Securities Commission's available resources in connection with its prosecution of alleged insider trading in the *Tranz Rail* case. The Companies Office is another government department which has significantly increased its capacity to detect, investigate and prosecute white-collar crime. The Companies Office's National Enforcement Unit ("NEU") has increased the number of cases it has prosecuted from 89 charges (23 defendants) in 2001/02, to 272 charges (50 defendants) in 2003/04. That number is set to balloon again this year, with one case alone recently resulting in 294 convictions for breaches of the Financial Reporting Act 1993 as a result of failures of LAQC's in a film partnership venture to prepare, audit and file company accounts in accordance with obligations under that act. Indeed, anecdotal evidence suggests that the NEU is now prosecuting a steadily increasing number of breaches of the Financial Reporting Act 1993 that in the past have largely been ignored, or dealt with by way of informal policing.

The traditional conception of white collar crime as limited to fraud is also changing in New Zealand. In many ways, New Zealand is following in the footsteps of overseas jurisdictions such as the United States and Australia. The United States has considered a broad range of business conduct to be illegal for a long time. Insider trading and cartel conduct are just two examples of broader conduct which have been criminal offences in the United States for some time. Whilst at present, both offences carry only civil liability in New Zealand, there is reason to believe that a change in focus in these two areas is likely in this jurisdiction in the near future. In the case of insider trading, criminal provisions are likely to be introduced this year (as part of the proposed Securities Legislation Bill amendments to the Securities Markets Act 1988 (formerly the Securities Amendment Act 1988)). With respect to cartels, the Commerce Commission has recently introduced a new leniency policy designed to increase the effectiveness of the current civil liability regime targeting cartels. The leniency policy echoes that used in other jurisdictions, including in the United States by the Department of Justice, and is hoped to be an effective tool for detecting cartels. Moves in New Zealand in these two areas follow an increased focus in Australia where insider-trading is already a criminal offence and where serious consideration is currently been given by the Federal Government to criminalising cartel conduct.

Fraud is still the most obvious, and arguably most significant, of the white-collar crimes however, and the increased budget, and workload, of the SFO indicates the increase of fraud in New Zealand in recent times. Not all fraud is at that level however. Less complex workplace fraud and theft is also on the rise. An article from Christchurch daily *The Press* on 18 May of this year, recorded that the number of reported workplace thefts has increased from approximately 1,000 to almost 1,700 cases in the period from 1999 to 2005. At the same time, *The Press* noted that this might only be the tip of the iceberg, highlighting a natural reluctance amongst employers to report offending.

The impetus for the increasing criminalisation and prosecution of business conduct in New Zealand appears to come from two sources. The first is the current, internal, political environment. New Zealand is currently governed by one of the longest serving centre-left governments in its history, with the current government in its fourth parliamentary term. Accordingly, it should come as no surprise that new, left wing, approaches to crime, including an increase focus on white-collar crime, have developed. However, perhaps more significant, and in many respects what has allowed the current government to progress such reforms, are a number of external events that have occurred, such as the high profile collapse of corporate entities in the US and Australia, and the concerns that have arisen over the potential financing of international terrorism, especially post 9/11.

In the United States, the spectacular business collapses of Enron and WorldCom, and the consequent decline of management and accounting firm Arthur Anderson, have increased focus upon issues of corporate governance, and the immense harm that can be caused by white-collar crime. Post-9/11 movement against financial resources for global terrorist organisations has added to the increased focus upon illegal business conduct. In New Zealand this has largely been evidenced by changes to money laundering legislation. Indeed, such amendments continue to be topical, with the Government recently announcing further proposed changes to the principle anti-money laundering legislation in this jurisdiction the Financial Transactions Reporting Act 1996. The driver behind these most recent changes is a desire to bring New Zealand into line with OECD obligations to counter financing of terrorism. In fact, New Zealand's membership of the OECD has been influential in a number of areas *vis a vis* white-collar crime, such as the passage of anti-corruption legislation in the form of section 105C of the Crimes Act 1961, which prohibits the bribery of a foreign public official. This is one of the few laws in New Zealand targeted at actions of New Zealanders outside the jurisdiction, and is in line with other OECD inspired legislation in other jurisdictions, such as the Foreign Corrupt Practices Act 1977 in the United States and the Australian Criminal Code Amendment (Bribery of Foreign Public Officials) 1999.

Another driver for increased attention, both by the authorities and the public, is the increasing use of e-mail and the Internet in fraud attempts. There is almost no e-mail user who is free form e-mail spam, including various fraudulent scheme offers of an increasingly various nature. The well known [insert small African country] money extraction scam, the stock purchase scam, and the 'please re-register your details with the bank' phising scam are just three examples of how potential for fraud is brought into everyday people's e-mail inboxes on a daily, if not hourly, basis. In some instances the scams have been at the heart of actual prosecutions in the New Zealand courts, such as the recent case of *SFO v Walsh*. In that case public and media attention was largely driven out of the fact that the subject matter of the allegations was the implementation of a so-called *Nigerian e-mail scam;* a scam which most people have been exposed to.

So instances of white-collar crime, including fraud, is on the rise, and is attracting increasing attention. As will be discussed later in the paper, it is possible to identify two main streams of fraud in an organisation: first, fraud perpetuated by an individual against an organisation; and secondly, fraud that implicates the organisation. The legal analysis and options available vary depending on what type of fraud is suspected, but in first instance, when fraud is suspected, it is important not to bury your head in the sand. The first thing to ensure is that proper and effective steps are taken.

Dealing with Suspected Fraud

Investigate, analyse, action

It is critical that corporations move quickly to deal with suspected instances of white-collar crime such as fraud. An essential part of this is the need for the corporation to seek independent legal advice governing its potential liabilities and options moving forward. The

reasons that inform this course of action are many, but two in particular are the desirability for corporations to clearly identify potential liabilities going forward from a commercial or financial sense, and the desirability of obtaining independent advice to minimise the risk of corporations, and their senior officers, from being accused of continued wrong doing.

How a corporation will deal with suspected fraud will largely depend upon whether it is conduct committed against the corporation, or whether it is conduct for which the corporation might be liable. In either case, a good model to follow is a three step process of *investigate*, *analyse* and *action*.

An initial *investigation* is essential to enable the corporation to identify the true nature and scope of the suspicious conduct. This investigation can be undertaken by in-house legal counsel in the first instance; however it will often be best to have outside counsel briefed to ensure that the matter is investigated in an independent fashion – both in substance and in form. Either way, it is essential that lawyers acting for the corporation undertake, or at least direct, the investigation to maintain privilege over the investigation and anything that arises from it.

Once an investigation is complete, it is important that the findings are thoroughly *analysed*. The analysis should include consideration of whether or not the conduct is of a kind targeted against the corporation, or whether it is conduct that implicates the corporation. An analysis of legal liability, both in terms of damages to third parties, and in terms of any mandatory obligations to report or advise of the conduct should also be undertaken. In circumstances where it is found that the conduct is of a kind that potentially binds the corporation then an analysis of potential criminal liability, or quasi-criminal liability, needs to be undertaken also.

Lastly, options for *action* should be identified, and implemented. In this regard a good place to start considering actions from is by looking at how the fraud affects the corporation or company the alleged fraudster is involved with.

Crimes against a corporation

Three issues of significance arise in circumstances where white-collar crime is perpetrated against a corporation by an employee. First, there may arise the question of the appropriate disciplinary response from an employment perspective. Secondly, there is a question of whether or not suspicions should be reported to the authorities. Thirdly, the issue of recovery of losses arises.

In the 2004 case of *Wackrow v Fonterra Co-operative Group Ltd* [2004] 1 ERNZ 350 the Employment Court had to consider to what extent an employees right to silence in criminal proceedings should limit the actions his employer could take with respect to a disciplinary enquiry. The upshot of Judge Shaw's decision in *Wackrow* was that an employee could exercise their right to silence in the face of an employer's attempt to inquire into matters at issue in a criminal investigation, when the answers to those questions could potentially incriminate the employee. Judge Shaw found that the existence of a criminal investigation into an employee's alleged misconduct not only gave rise to the possible exercise of the right to silence, but in fact meant that employers were barred from asking such questions.

The decision in *Wackrow* raises a number of interesting, and perplexing, issues for employers faced with suspicions of criminal conduct by employees, including:

- should the conduct be reported to the authorities?
- should the conduct be reported to any third party, including clients, that might be affected?
- what employment disciplinary action can be taken against the employee?
- what steps can be taken to recover any losses suffered?

Generally speaking there is no legal obligation upon a corporation to report suspected criminal conduct to the authorities. However, there may be instances where a corporation does

have mandatory obligations to report suspected conduct. In some instances such obligations might arise as a matter of law, depending on the profession or vocation in which the corporation operates. For example, receivers and liquidators have certain mandatory reporting obligations set out in the legislation governing their operation. Similarly, persons or organisations involved in the education sector have mandatory obligations regarding certain suspected criminal conduct of employees. Financial institutions also have mandatory reporting obligations that arise, *inter alia*, under statutes such as the Financial Transactions Reporting Act 1996. In addition to legislative requirements to report, industry bodies may also impose ethical or contractual obligations to report suspected conduct, and other obligations, such as the obligation to make certain disclosures under Stock Exchange listing rules, might also arise.

In situations where there is no mandatory reporting obligation to any authority, then there may nevertheless be other factors that might influence a decision to report. There may, most likely through operation of contract, be an obligation to report suspected misconduct to a third party, such as a customer. Equally significant might be concerns that the corporation might have regarding the potential for public criticism, and perhaps a consequent effect on company reputation or stock values, if it was later discovered that suspicions had been held, but were not acted upon. Public sector organisation also have certain obligations that arise under their code of conduct. Similarly, many private companies have now put in place voluntary codes of conduct, which include positive commitments to reporting criminal conduct in the course of business.

However, in the end, it may well be open to a corporation to elect not to report suspicious conduct. If a corporation elects to follow this path, then it is highly recommended that they seek independent legal advice to confirm that doing so is a legitimate and legal option open to them. Seeking such advice not only provides the corporation with some degree of certainty over its potential liability in this regard, but it also goes a long way to rebut any criticism that the decision not to report was in some way an attempt by the company to sweep the matter under the carpet, or worse, an action in aiding or abetting any criminal conduct that might have occurred.

In circumstances where the corporation determines that it is required to report the offending to the authorities, then it is important to identify precisely when that should be done. In some situations it will be possible, and indeed appropriate, to refrain from reporting suspicious conduct until such time as the company has had an opportunity to take employment action against the employee in question. The benefit of doing this is that the restrictions placed upon employers by *Wackrow* may be able to be avoided if employment disciplinary action is commenced prior to any complaint being laid. However, in some situations this will not be possible, especially where the obligation to report arises with an element of urgency attached to it. There is also an argument (yet to be tested in New Zealand courts) that a deliberate decision to refrain from making a complaint to the authorities, when one is clearly intended at some time, might be an act of bad faith by an employer in breach of obligations under the Employment Relations Act 2000. This decision, of whether to wait before reporting suspected conduct will often be crucial given the limits *Wackrow* places on employers' rights to conduct a disciplinary inquiry. In many instances, the inability to conduct a full inquiry prior to a criminal investigation has seen employer's having to carry employees at great financial cost for long periods of time while criminal investigations are carried out, and the criminal process allowed to run its course.

A related issue to the dilemma created by *Wackrow* is the similar effect a defendant's right to silence has upon civil legal action to recover losses. In many instances of employee fraud, the employer will want to look at civil legal action to recover the losses they suffer, either directly or consequentially, from the employee's conduct. As with the employment scenario, there are few, if any, hurdles to employers taking civil action to recover losses suffered by an employee's fraudulent conduct when the conduct at issue is not being investigated by the authorities. However, once a criminal investigation is underway the employee/defendant will be able to exercise their right to silence to resist the discovery of certain evidence that would normally be compellable. In a number of cases, the action may still be able to be pursued civilly,

however, as with the *Wackrow* scenario, this would usually require the criminal matter to be resolved first. An alternative to waiting for this to occur might be to liaise with the authorities investigating and prosecuting an employee for their misconduct, to see if use of reparation orders under the Sentencing Act 2000 can be made to compensate the employer for losses suffered as part of the criminal process itself.

Crimes implicating a corporation

In some cases where fraud is perpetrated by an employee, the company employing that person will be vicariously liable for their actions (that is, liable to third party's due to the fraud being committed in the ordinary course of the perpetrator's employment). The classic example is that of the rogue trader, who defrauds clients of their employers by trading on their accounts without their knowledge.

In such circumstances, even though the fraud isn't committed by the corporation itself (or in its name), the corporation can nevertheless be liable to any third parties who suffer loss. In the rogue trader's case, his or her company will often be liable to the clients for any losses incurred. When this happens it is likely that a company will look to discipline its employee in much the same way as if the fraud was against the company itself. The issue of potential civil recovery of losses also arises in much the same way, although the question of precisely how much the company has lost may be considerably more difficult to ascertain where the company is implicated in the fraud, given the likelihood of third party claimants against the company. , and the potential for civil or criminal penalties to be imposed on the company if the authorities decide to take action against it. Where a third party is involved, it does make it more likely that the company will be obligated to disclose the fraud in some way. In the rogue trader cases it is almost always the case that customers affected by the trader's actions are required to be advised. That inevitably leads to complaints to the regulator and/or the authorities. In many instances trading companies in that position prefer to front-foot such complaints.

In other cases fraud, or similar white-collar conduct, can be perpetrated by an employee or officer in such a way as to directly implicate the company itself. That is, the conduct is such that it is essentially done in the name of the company. This most often occurs where the Board of the company, or a number of its senior management, perpetrate the conduct. It is often times accompanies by a company culture permissive, or perhaps even encouraging, of the conduct.

One example of fraudulent conduct that implicates a company is anti-competitive cartel conduct, where senior management of a company collude with the senior management of competing companies in the market to reach illegal agreement on matters such as price fixing, production levels, market share and customer allocation. When this occurs, the company, as well as the individuals involved, is often implicated.

When conduct like this occurs, it is more likely that employment action will not be deemed appropriate. This is generally for one of two reasons. First, it may not be in the companies interests to cut an employee loose, and risk the potential damage they might do to the organisation. Secondly, it may be felt that the employees are only of secondary blame, in that they were only acting under the guidance, or perhaps even the expectation, of market and/or company practice. Where an employee is to be disciplined, then the same considerations already discussed, including *Wackrow* apply.

Civil recovery generally follows employment action. That is, if an employee or officer is disciplined then they may also be looked to for recovery of loss. Again, similar considerations arise as before.

Where things differ significantly for a company implicated in the offending, is often in the reporting of alleged fraudulent activity. Put simply, a company is much less likely to want to report fraud that it is implicated in, than where it is not. As noted before, there will often be a number of circumstances where reporting of suspected conduct is not necessary as a matter of

legal obligation, however, if a company does choose to adopt that course of action, it is essential that independent legal advice is obtained to ensure that the course of action is valid, and to minimise any implication of a simple cover-up.

There is one situation where a company may be more inclined to report suspected conduct it is implicated in however, and that is where there exists an opportunity for leniency, or amnesty, in regards to prosecution if they come forward. If such an opportunity exists, then that may well motivate a company to report conduct. For example, in many jurisdictions of the world there exists an amnesty programme of some kind in relation to cartel conduct. Cartels are notoriously difficult to detect, and accordingly, many jurisdictions offer amnesty from prosecution for the first member of a cartel to report illegal conduct to the agency responsible for prosecuting such conduct, in return for full cooperation. Amnesty in this context may be incredibly valuable, as it may ensure a company escapes prosecution in circumstances where prosecution could have significant consequences, in terms of fines and convictions. Even where no formal amnesty programme exists, it is important to consider whether a strategy of approaching authorities with an offer to cooperate is worth doing, especially in circumstances where it appears that the risk of detection and prosecution of the company is significant.

Working with law enforcement

As an aside, it is perhaps important to touch further upon a matter noted in passing before; the possibility of using the criminal process to recover moneys lost due to fraud. Generally speaking corporations who wish to pursue losses attributable to fraud will sue the individuals, or individuals, responsible for breach of contract, breach of trust, or in negligence. Such action is taken through the civil courts, and will be at the companies expense and will be determined on the balance of probabilities. However, an alternative is to seek to ride on the coat tails of a criminal prosecution, and see if reparation can be ordered under the provisions of the Sentencing Act 2000. This will almost certainly be in respect of a state prosecution, rather than a private prosecution however, because private prosecutions are expensive and onerous to operate, and, like all criminal prosecutions, operate on a ‘beyond reasonable doubt’ standard of proof. The higher level of proof, and the expense involved, will generally mean that organisations considering legal options to pursue fraudsters will opt for the civil courts.

Rather than implement a private prosecution, a company may choose to assist law enforcement take state criminal action however, as a sort of middle ground. This is often necessary in order to have the state authorities investigate and prosecute an alleged fraud in the modern environment, because although funding for white-collar crime detection has increased over recent years, it is still the case that much more white-collar crime occurs that the SFO and police are resourced to investigate. If a company chooses this course of action, then the best approach is for them to undertake their investigation in the same manner, style and form as a state authority would. This means ensuring that the investigation file is maintained in such a way as can ultimately be disclosed to the defendant without compromising the prosecution. Put simply, different rules of disclosure apply in the criminal context, than those of discovery in the civil context, and in order to best advance the prosecution once it is in the hands of the authorities, it is best practice to ensure that the company’s investigation is carried out in such a way as to enable the prosecuting agency to rely on the investigation as if it had been conducted itself. If a company chooses to go down this path, then often the best approach will be for it to instruct its lawyers to commence the investigation, aided perhaps by forensic investigation professionals, to investigate the matters at issue, interview and brief potential witnesses (and the potential defendants), preserve and document exhibits, and report the same to the authorities in a complete package ready to prosecute.

Conclusion

The potential for corporations to become involved in white-collar crime, either directly, or vicariously through rogue employee actions, is increasing. Law changes in New Zealand have added a number of new white-collar offences to the commercial environment, and additionally, a

number of regulatory authorities have increased their attention on pursuing white-collar conduct. Not withstanding this broadening in focus however, fraud, and in particular employee fraud and theft, remains a significant threat to the well-being of corporations in New Zealand.

The complexities of white-collar offending, and in particular the broad range of responses open to corporations who suspect white-collar conduct, suggest that a process of investigating and analysing suspected conduct, followed by taking appropriate action, is critical to minimising the harm to corporations, and to senior business executives. Furthermore, obtaining independent legal advice as to liabilities and potential courses of action provides those involved with a certain degree of protection form allegations of continued misconduct, or of aiding and abetting misconduct that has already occurred. It also arms the corporations involved to be able to take employment action against employees suspected of committing fraud, and to consider the best action available to try and recover losses the corporation suffers.

The use of legal privilege to enable corporations to fully investigate and analyse potential liability arising from suspected white-collar conduct is very important in enabling corporations to fully examine suspected conduct, and to identify steps moving forward that minimise the potential harm to the corporation and its officers, or to take action against the employee or recover losses.

Unlike the United States, New Zealand does not have a strong tradition of white-collar crime expertise. It is a unique area of law, located at the confluence of commercial business conduct and the criminal law, and as such requires a unique set of skills to properly understand and advise upon. It is essential to the well being of corporations that they ensure that when white-collar conduct is suspected, prompt and effective legal advice is obtained. In some instances, such as an application for amnesty, failure to act promptly or effectively may remove potential courses of action that would be highly beneficial to the corporation concerned. In other situations, a failure to properly investigate and analyse the conduct may prevent the best course of action for a corporation from being identified.

White-collar crime can have potentially consequences on the well-being of a corporation. In an age where there is an increasing public, media and governmental focus on corporate behaviour and governance, in addition to any direct financial losses a corporation might suffer, it is clearly time to ensure that we are taking the potential consequences of white-collar conduct, including fraud and theft, seriously.

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