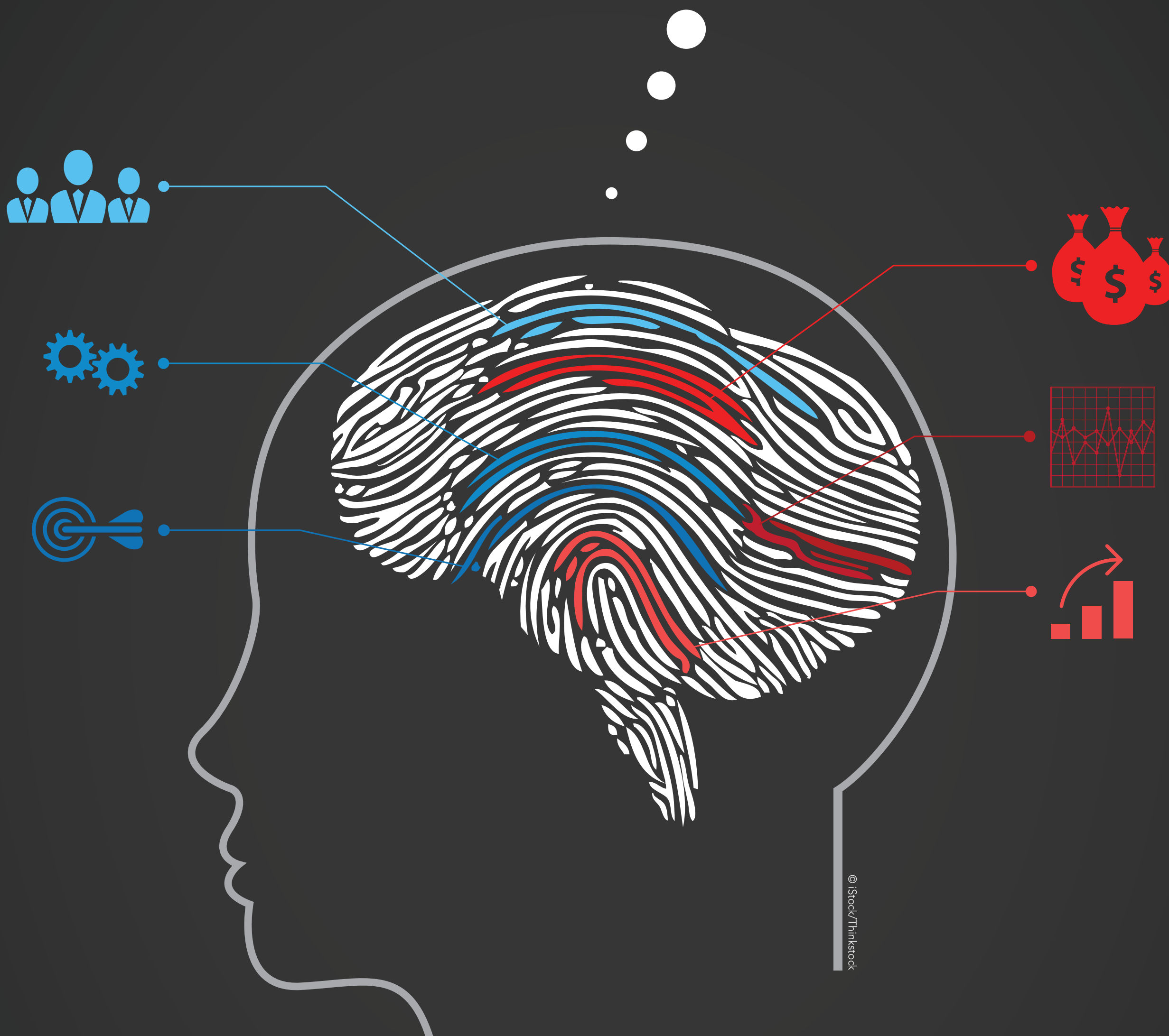
‘I didn’t intend to deceive anyone’



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FRAUD RATIONALIZATIONS AND THE GUILTY MIND

Fraud perpetrators often use a variety of excuses to alleviate the culpability of their mental states because they know they can’t be convicted unless prosecutors can prove their criminal acts were accompanied by a guilty state of mind known as *mens rea.*

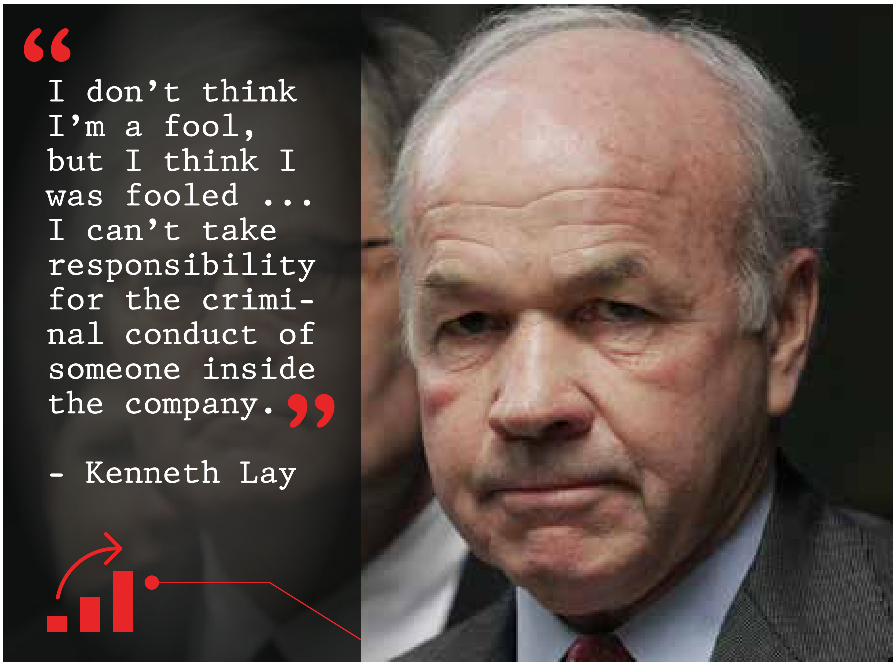
By Frank S. Perri, J.D., CFE, CPA; and Edyta M. Mieczkowska, CFE, CAMS

At the end of a five-year investigation, the FBI discovered that Enron Corporation — an American energy, commodities and services company based in Houston, Texas — used a variety of deceptive and fraudulent accounting practices to cover its financial reporting fraud. Corporate officers created the illusion that Enron was making profits in the billions, and its stock soared. Between 1996 and 2000, Enron reported an increase in revenue from $13.3 billion to $100.8 billion. However, the company was actually losing money.

Enron executives, who used insider information to trade millions of dollars in Enron stock, knew the company was hiding losses in offshore accounts. Investors were oblivious. CFO Andrew Fastow and some subordinates created off-book companies to manipulate transactions that provided himself with hundreds of millions of dollars in guaranteed revenue — all at the expense of the corporation and its stockholders. As Enron stock climbed, and as Wall Street continued to promote it, a group of 29 Enron executives and directors began to sell their shares. These insiders received $1.1 billion by selling 17.3 million shares from 1999 through mid-2001.

Enron founder, Kenneth Lay, and CEO Jeffrey Skilling also financially benefited from Fastow's fraudulent schemes in the millions of dollars of stock they sold prior to Enron's collapse.

When Lay was indicted for fraud, he conveniently blamed Skilling, Fastow and COO Richard Causey for Enron's demise and denied he'd known anything about the accounting fraud. Before his trial, he insisted he was a victim in an interview with "60 Minutes," stating: "I don't think I'm a fool, but I think I was fooled … I can't take responsibility for the criminal conduct of someone inside the company." (See "Enron's Ken Lay: I Was Fooled," by Rebecca Leung, "60 Minutes," March 11, 2005, at http://tinyurl.com/oyxm2rq.) (Lay died of a heart attack on July 5, 2006, after he was convicted but before he was sentenced.)



Houston, April 4: Former Enron chairman Kenneth Lay during the midday break of his fraud and conspiracy trial April 4, 2006, in Houston, Texas. (Photo by Dave Einsel/ Getty Images News/Thinkstock)

Skilling also insisted he was a victim and claimed he didn't know enough about accounting to detect fraud at the company. "I had no idea the company was in anything but excellent shape," he said in "Enron's Many Strands: The Former CEO: Darth Vader. Machiavelli. Skilling Set Intense Pace," by John Schwartz, *The New York Times*, Feb. 7, 2002, http://tinyurl.com/qzstldv.

'GOOD' INTENTIONS AND MENS REA

Fraudsters, like Lay and Skilling, commonly proclaim their innocence by denying a guilty mental state. In a securities fraud case, for example, management will artificially inflate an organization's stock price and then claim it was only a temporary measure to get through a difficult period and not an attempt to deceive anyone. Or in an embezzlement case, the perpetrator will say he never *intended* to fraudulently take the money because it was only a temporary loan.

High-level executives and CEOs might try to distance themselves from fraudulent behavior by claiming ignorance to demonstrate they didn't know of any organizational fraud to minimize the chances of possible indictment. They'll argue that subordinates who orchestrated the fraud scheme kept them in the dark.

In most criminal trials, prosecutors seeking a conviction must prove that the defendants showed a "guilty or culpable state of mind" — the legal concept of *mens rea*. Unfortunately for Lay and Skilling, Fastow testified at trial that his superiors encouraged him to make the financial health of the company look as positive as possible and to avoid public disclosure. So, the jury found that Lay and Skilling knew exactly what they were doing.

In this article, we attempt to show how misconceptions about mens rea can affect our professional skepticism in fraud cases. We'll use examples of the different

Houston, May 1: Former Enron CEO Jeff Skilling leaves the courthouse after proceedings in his fraud and conspiracy trial May 1, 2006, in Houston, Texas. (Photo by Dave Einsel/Getty Images News/Thinkstock)

types of a criminal state of mind to show when a fraudster most likely has given thought to his or her scheme.

(Some criminal laws, called *strict liability laws*, don't require the identification of any guilty state of mind. These laws say that regardless of an offender's state of mind, the act — such as the sale of alcohol to minors — constitutes a crime and deserves criminal punishment.)

SHADES OF CRIMINAL CULPABILITY

Diverging classifications of criminal mens rea accommodate different factual scenarios so that individuals who commit criminal acts *don't avoid accountability,* and they also impact the severity of punishment an offender faces.

What types of state of mind are necessary to demonstrate guilt? The various classifications of criminal mens rea, and their meanings, vary among jurisdictions and laws, which can cause some confusion. No single state of mind applies to all fraud offenders. Nevertheless, most fraud schemes require proof of one of the following classifications of mens rea: 1) intent 2) knowledge and 3) reckless conduct. We define and apply these three classifications of mental culpability because anti-fraud professionals can encounter them in white-collar crime prosecutions.

Anti-fraud professionals who aren't thoroughly acquainted with criminal law might think "intent" to commit a specific, criminal act is the only necessary type of state of mind that will hold fraud offenders accountable. They might believe that if the prosecutors can't prove intent to commit a crime then an offender can't be criminally liable. However, this perspective isn't entirely correct. Also, some anti-fraud professionals believe direct evidence (i.e., evidence that establishes a disputed fact without any inference) is the only type of evidence that proves intent such as an offender's statements that disclose the plan and the desire to engage in fraud. If this was true, prosecution would have to prove intent using direct evidence (i.e., an admission from the accused), and all a fraudster would need to say to avoid liability is that he or she never intended to commit the crime. Given the number of rationalizations that are readily available, few offenders realistically would admit that they were in *any* guilty state of mind. However, litigants can prove intent by inference through circumstantial evidence.

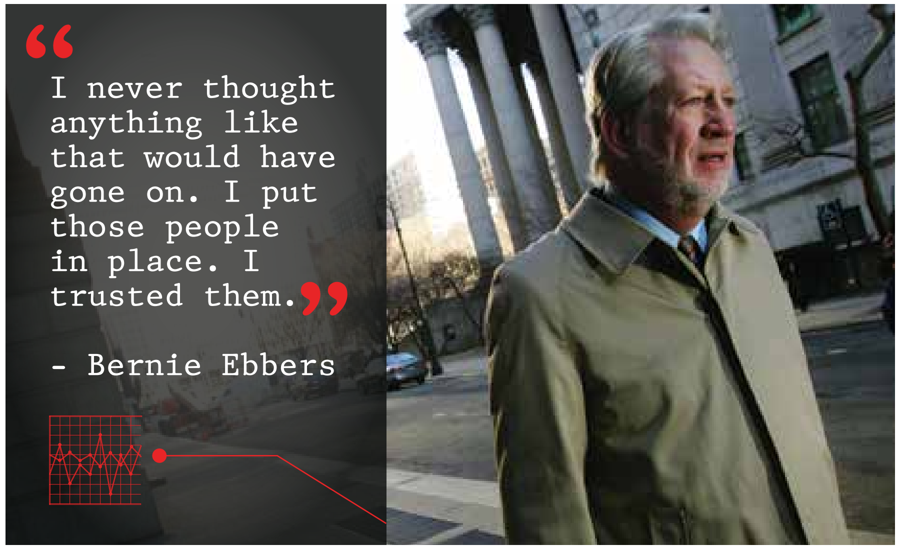
Now, let's delve into the three main classifications of mens rea.

INTENT

Someone who has intent to commit a crime acts with a deliberate, purposeful resolve — a desire to bring about a particular result. The amount of planning that went into committing a criminal act, offender statements or a combination of both could indicate a particular resolve. For example, an individual charged with murder might admit that he or she wanted to commit murder, which reveals his or her thoughts or even a motive. However, don't confuse motive as being synonymous with the different types of mens rea outlined in this article.

In the Enron scheme, the Securities and Exchange Commission's (SEC) complaint against Fastow speaks of intent by referring to it as *scienter* (in legal circles, intent is sometimes referred to by this Latin name): "Fastow engaged in conduct … in connection with the offer or sale of securities, by the use of the means or instruments of transportation … use of mails with *scienter* to defraud … by means of untrue statements of material facts." (*SEC v. Andrew Fastow,* 2002, http://tinyurl.com/oggn57b)

Yet, interestingly, Fastow — speaking at the *24th Annual ACFE Global Fraud Conference* in 2013 — still attempted to minimize his mens rea by referring to what he did as a mistake and not a criminal act. "I knew that what I was doing was



New York, March 15: Former WorldCom Inc. Chief Executive Bernard Ebbers outside federal court. (Photo by Chris Hondros/Getty Images News/Thinkstock)

misleading. But I didn't think it was illegal. I thought that's how the game was played. You had a complex set of rules, and the objective is to use the rules to your advantage. And that was the mistake I made.” (See “Debunking the Myth of the Out of Character Offense,” by Frank S. Perri, Richard G. Brody, Justin M. Paperny, originally published in the *Journal of Forensic & Investigative Accounting*, Vol. 6, Issue 2, 2014, at http://tinyurl.com/ndjrosw.)

To determine if intent to commit fraud exists, fact finders — such as juries or judges — are allowed to consider all circumstances to establish knowledge of wrongdoing and its extent because fraud offenders rarely state the intentions behind their actions. Consider how few fraud offenders would be investigated, held criminally liable or prosecuted if mens rea only could be proven through direct evidence.

Circumstantial evidence tends to prove a fact by producing other events or circumstances that offer a basis for a reasonable inference to draw conclusion(s). For example, if an employee takes a vacation and a fraud examiner found that fraud was perpetrated at the time the employee was present but no evidence of fraud was found during the period that the employee was on vacation, such evidence could be used to support an inference of the employee's involvement of the fraud.

KNOWLEDGE

Knowledge refers to a fraudster's deliberate indifference to his or her behavior that almost certainly creates a risk that results in a criminal outcome. The offender is aware of the nature of his conduct and didn't act through ignorance, mistake or accident. The focus is on the consequences of the fraudster's act to determine if the necessary state of mind exists for someone to be held criminally liable for crimes with a “knowing” mens rea.

For example, a person who fires a gun into a crowd acts knowingly because there is a practical certainty that others will be put at risk of great bodily harm or death. The offender might not have wanted to kill anyone, but the risk of such behavior can't be excused simply because the offender didn't want someone to die. Whether that person had the intent to murder becomes less relevant. The law recognizes that an offender's behavior can create outcomes that are harmful regardless if the offender had the desire for a particular outcome.

A fraudster who commits occupational fraud might claim that even though he committed the crime, he lacked the mens rea to commit fraud because of his personal belief that he'd eventually put the money back. However the focus isn't on how a fraudster interprets his behavior but rather on the consequences of his behavior — to take property from an organization without the authority to do so. Even though he perceived it as a loan — which is a non-criminal matter in his mind — the fraudster acted with knowledge that, for example, exploiting weak internal controls for financial gain could cause financial harm to the organization. It's the consequence of a fraudster's behavior that's questioned here — not his own personal motivations.

Consider the case of WorldCom, which began in 1999. WorldCom commenced making large offsetting accounting entries after the quarterly close to achieve the aggressive revenue targets established by the company and the financial community. The SEC Report (2003, http://tinyurl.com/mmh5n3a) found handwritten documentation at WorldCom that recalculated the difference between the actual results, found on the monthly revenue (internally referred to as the *MonRev* report), and the target or needed numbers. Once the variance was calculated, accounting entries were made to cover the shortfall so that financial targets would be met.

CEO Bernie Ebbers maintained that his CFO Scott Sullivan and his subordinates kept him in the dark about their financial reporting fraud. Ebbers stated he was, “Shocked ... I couldn't believe it. I never thought anything like that would have gone on. I put those people in place. I trusted them.” (See “Visionaries or False Prophets” by Frank S. Perri, 2013, from the *Journal of Contemporary Criminal Justice*, at http://tinyurl.com/lsurlng.) In turn, Sullivan testified that Ebbers knew of the fraud and that Ebbers told Sullivan not to issue an earnings warning to Wall Street which gave Sullivan the green light to create false profits.

The SEC investigation also uncovered a voicemail message from Sullivan to Ebbers that contradicted Ebbers' claims:

> *Hey Bernie, it's Scott. This MonRev just keeps getting worse and worse. The copy, um the latest copy that you and I have already has accounting fluff in it ... all one time stuff or junk that's already in the numbers. With the numbers being, you know, off as far as they were, I didn't think that this stuff was already in there. ... We are going to dig ourselves into a huge hole because year to date it's disguising what is going on.*

(See "Report of Investigation," Special Investigative Committee of the Board of Directors of WorldCom, Inc., by Dennis R. Beresford, Nicholas deB. Katzenhach, C.B. Rogers, Jr., March 31, 2003, at http://tinyurl.com/mmh5n3a.)

RECKLESS CONDUCT

Reckless conduct is when someone acts with a conscious disregard and exposes others to unjustifiable risk. It represents a gross deviation from a standard of care a reasonable person would take in a given situation. For example, states attach criminal liability to deaths that are a result of someone driving under the influence of alcohol. These acts might be classified as reckless homicides. (See "Man Pleads Guilty in Death of Illinois Officer," WGIL, Aug. 27, 2014, http://tinyurl.com/nogc5pt.)

The recklessness condition of mens rea suffices to establish criminal culpability under laws that prohibit fraudulent activities in securities trading, especially if a fraudster goes beyond carelessness and shows a pattern of poor decision making that could cause harm to others.

To establish a securities fraud claim, the U.S. government has options to phrase their complaints against offenders using the different mens rea available. (See "What Were They Thinking? Insider Trading and the Scienter Requirement," by Donald Langevoort, the Georgetown University Law Center, 2012, at http://tinyurl.com/lycn7kz.)

For example, they could show that the fraudster who made statements involving the sale of securities had the intent or engaged in reckless conduct that resulted in deceiving, manipulating or defrauding investors. (http://tinyurl.com/lycn7kz)

A government investigation also will focus on any and all facts that would suggest a fraudster's motive to mislead investors or that suggest fraudulent red flags existed about facts the organization knew and didn't pursue. (See "Red Flags for Fraud," by Steven J. Hancox, State of New York Office of the State Comptroller, at http://tinyurl.com/75lksbu.)

For example, the SEC's complaint against Ebbers reflects the alternative methods of using mens rea when it stated that, "Ebbers knew, or was reckless in not knowing, that WorldCom's true method of accounting for line costs was not disclosed to WorldCom's auditors." (http://tinyurl.com/nnk2noj)

A CEO who continues to use a standard investor presentation but doesn't get regular updates to ensure information accuracy could be subject to a claim of recklessness if prosecutors later allege the presentation contained material inaccuracies. Despite the fact the offender didn't intend to deliberately deceive a potential investor, the CEO's inaction exposed others to risks, and thus he committed reckless conduct. A fraud examiner could gather statements made by a potential fraudster to show a pattern of making material misstatements that were more than just being negligent. For example, Ebbers on multiple occasions during his tenure would state publicly that WorldCom was in good financial health, when in fact it was the fictitious revenue that was making the company look good. (http://tinyurl.com/nnk2noj)

UNDERSTANDING RATIONALIZATIONS

Fraud offenders, like all offenders, have their own rationalizations to morally distance themselves from their criminal acts. If a person lacks the mens rea required for conviction, then that person isn't guilty of fraud. Familiarize yourself with the classifications of mens rea to improve your skills and try to understand how fraudsters create legal rationalizations to neutralize their criminal culpability.

The authors emphasize that participants in the U.S. legal system might interpret various legal distinctions on the different states of mind in this article when applied to federal and state cases. Consider that not just one type of state of mind can apply to fraud offenders regardless of legal nuances.

None of the material in this article can be considered legal advice. Please consult with your counsel.

Frank S. Perri, J.D., CFE, CPA, is an attorney at the County of Winnebago. His email address is: frankperri@hotmail.com.

Edyta M. Mieczkowska, CFE, CAMS, is a financial crime risk management advisory officer at MB Financial Bank. Her email address is: emieczkowska@yahoo.com.

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