A Comment on Professor Buell’s Paper

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Let me start by saying how much I enjoyed reading Professor Buell’s article.\(^1\) It provoked the same reaction I get with many other pieces I find powerful and thought provoking. It caused me to ask: “Why don’t I agree with this piece?” A lot of what Professor Buell says seems to me cogent, clear, and eminently correct, but at other times it strikes me as, if not wrong, at least difficult to fully endorse. My problem is that I am not entirely clear how strong a claim Professor Buell is making with regard to his “badges of fraud.” He could be saying that these “badges of fraud” are simply a way of explicating the complex process of exercising prosecutorial discretion, and that these “badges of fraud” are just one important factor that prosecutors analyze in their multi-faceted decision as to whether or not to prosecute any given fraud claim. If Professor Buell is only making this relatively modest assertion, he and I have little to disagree over.

But it seems to me that Professor Buell frequently makes a much stronger assertion, that the “badges of fraud” represent either a necessary or a sufficient condition for the exercise of prosecutorial discretion to bring a criminal fraud claim. Either of these claims strikes me as problematic. It clearly cannot be a sufficient condition just to see one of these badges of fraud in an investigation. Take concealment. Obviously there is lots of concealment by corporate managers that does not give rise to actionable fraud. CEOs can conceal adulterous affairs. They can conceal deals that have not quite reached fruition. There is, in short, a lot of information which they might be subjectively surreptitious about, maybe even subjectively feel quite guilty about, and which shareholders would find extremely interesting, but we would not say that every instance of such concealment, surreptitious conduct or subjective guilt, without more, constitutes actionable criminal fraud.

To say that the badges of fraud represent a necessary condition for any criminal fraud prosecution also raises difficulties. Professor Buell himself alluded to the major such problem when he observed that, as a

\(^{1}\) The paper to which this piece is a commentary is Samuel W. Buell, Novel Criminal Fraud, 81 N.Y.U. L. Rev. 1971 (2006). A panel of the Cardozo symposium was devoted to consideration of this paper. Professor Buell was also a participant in this panel.
matter of actual practice, when the fraud is of a well-established variety, the courts will frequently presume mens rea or similar cognitive badges of fraud.

So it would seem that Professor Buell’s badges of fraud are neither a necessary nor a sufficient condition, but maybe at most, a necessary condition for a criminal fraud prosecution when the fraud is of a novel or unusual type. That may well be Professor Buell’s thesis. But note that, if so, it comes close to being simply an assertion about one factor in a multi-factor test. It says that when other factors favoring a criminal fraud prosecution are weak, the presence of “badges of fraud” may well be the deciding factor in favor of prosecution. As a descriptive account of how prosecutors think about these matters, Professor Buell is very likely correct and surely has more insight into these matters than I can claim. But Professor Buell is making not just a descriptive but a normative claim about these badges of fraud. He is saying that these factors not only are, but should be, the deciding factor in at least some important category of criminal fraud prosecutions.

As to this normative argument that badges of fraud should be, in effect, the test for determining whether or not to bring a novel or unusual fraud claim, I must confess that I have my doubts. It seems to me there is enough flexibility in the fraud rules already, particularly given the open texture of the very concept of materiality, and the flexibility created by the fact that not only false statements, but omissions are actionable, that adding an additional potentially dispositive requirement of “badges of fraud” might well result in either over or under prosecution of corporate fraud cases.

For an example of under-inclusion, take a quintessential case like Enron. It is not inconceivable that, had the Enron management been a little more careful and a little better advised, they might have shown no badges of fraud whatsoever. They could have set up their Special Purpose Entities perfectly and conformed with every single bit of GAAP, showing no surreptitious behavior or evidence of subjective guilt. Yet given the flexibility of the concept of materiality under the federal securities laws, I believe they could still have been properly prosecuted for failing to fully disclose the underlying economic reality of those deals.

Finally, I think that the badges of fraud concept is a powerful idea that will often work well in considering whether CEOs and other top corporate executives should be prosecuted for fraud, but there are two other important categories of potential defendants for whom the concept is less useful. One is criminal wrongdoing by people at the middle or low level of the corporate hierarchy, rather than by CEOs or other top management. That is, you may have criminal activity that was not run from the top of the hierarchy, but passively tolerated by that hierarchy,
with various levels of knowledge. It seems to me that the badges of fraud concept may not be the most useful way of framing the prosecutorial decision in that context.

The other important category is the criminal prosecution of corporate entities. It seems to me that the function of criminal law with regard to corporate entities is quite different than that for human beings and that the badges of fraud concept is less helpful in dealing with non-human defendants. Rather, the focus of prosecutorial discretion in such cases should be on prospects of general deterrence, as well as avoiding unnecessary injury to relatively innocent third parties like employees and public shareholders. Given these concerns, the prosecutor’s choice between criminal prosecution and civil penalties may be quite different with regard to corporations than it is with CEOs, who may be fully indemnified and have much shorter time horizons than investor or employee groups.