

# McClatchy Washington Bureau

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## Justice Dept. drops massive fraud case

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WASHINGTON — Two years into a fraud investigation, veteran federal prosecutor David Maguire told colleagues he'd uncovered one of the biggest cases of his career.

Maguire described crimes "far worse" than those of Arthur Andersen, the accounting giant that collapsed in the wake of the Enron scandal. Among those in his sights: executives from a subsidiary of Berkshire Hathaway, the investment empire overseen by billionaire Warren Buffett.

In May 2006, he felt strongly enough about his case that he prepared a draft indictment accusing executives from a Virginia insurer, Reciprocal of America, of concocting a series of secret deals to hide its losses from regulators. Although he didn't name anyone from Berkshire Hathaway's subsidiary, he described the company as a participant in the scheme.

But Maguire never brought those charges.

Months after preparing the draft, he was removed as the lead prosecutor on the case and reassigned.

His replacement, a prosecutor who hadn't been involved in the case until then, soon announced that the Berkshire Hathaway subsidiary, General Reinsurance, wouldn't be indicted. By April of this year, the entire investigation, which the Justice Department once hailed as one of the largest insurance-fraud cases in the history of Virginia, had fizzled.

Former employees and policyholders of the Richmond-based insurer were astounded. Why had the Justice Department spent upward of \$2 million to investigate the case only to decline to prosecute? Maguire and his team of investigators had secured two related guilty pleas, interviewed dozens of witnesses and gathered 7,000 boxes of documents.

At the Justice Department, some whispered that Maguire and his team had overreached and had been knocked down. Others heard that the government needed resources for terrorism investigations.

Lawyers for the two companies had another explanation: Prosecutors realized they didn't have evidence of a crime.

"It was a black and white decision," said Stanley Twardy Jr., one of General Reinsurance's attorneys and a former U.S. attorney. "They just called it like they saw it."

But Tom Gober, a certified fraud examiner who worked on the case, thought investigators had gathered plenty of evidence.

Gober, a government-contracted investigator, concluded that the Justice Department had buckled under pressure from defense lawyers. Shortly before Maguire was removed, his supervisors were urging him to drop the case against General Reinsurance, Gober said.

Gober's suspicions were fanned by allegations of politicization in the Justice Department after nine U.S. attorneys were fired.

He took his complaints to the Office of Professional Responsibility, which investigates Justice Department misconduct.

"It just stinks," he said. "You don't come in out of nowhere and in no time kill three years of sophisticated effort."

Maguire and officials with the U.S. Attorney's Office and the FBI in Virginia declined to respond to questions about the decision.

Justice Department spokesman Bryan Sierra said he couldn't comment, either. "As with any investigation, circumstances change day to day, and in the end the decision was made not to charge certain defendants in this case," he said.

Internal documents that McClatchy Newspapers obtained show that Justice Department lawyers in Washington had become locked in an intense debate with Maguire over the case until he was removed from it.

The documents, together with court records and interviews, provide a rare look inside a corporate fraud case and the Justice Department's deliberations on whether to pursue an indictment.

Five years after Enron collapsed and tough measures aimed at white-collar crime were enacted, federal officials struggled with questions of corporate accountability:

Who should be held responsible when fraud leads to a company's demise? How far should federal prosecutors go in pursuing corporate suspects?

In the Reciprocal of America case, the fallout was clear. More than 80,000 lawyers, doctors and hospitals in 30 states lost their malpractice coverage. As they couldn't expect new insurers to cover them for past cases, some who were sued have claimed losses of hundreds of millions of dollars.

As doctors and lawyers faced bankruptcy, the victims of malpractice feared they'd never get their due.

Even so, prosecutors had to be certain that their evidence of wider wrongdoing justified the financial damage that an indictment could cause to General Reinsurance.

After the Enron scandal provoked an aggressive Justice Department crackdown on corporate fraud, federal courts made it clear that the department had overstepped its authority in several high-profile cases. The pendulum appeared to be swinging back in favor of corporations.

### **A COMPANY UNDER SIEGE**

A team of state insurance auditors arrived at Reciprocal of America's headquarters in January 2003 to launch their investigation. They shepherded the company's 300 employees into a conference room and locked the doors.

Suspicious accounting activity had been detected. The company and its subsidiaries were being shut down for the duration of the investigation.

As auditors carted away boxes of documents and computers, several employees burst into tears.

Federal agents soon expressed interest in joining the case. The auditors had found troubling numbers.

Insurance companies are supposed to avoid insolvency by socking away vast surpluses collected from policyholders' premiums and passing risk to giant reinsurance counterparts such as General Reinsurance.

The more risk the reinsurer carried, the higher the premium it would collect. When the arrangement worked, both companies prospered.

But Reciprocal hadn't accumulated the surplus required by law. Even worse, it was more than \$450 million in the hole, according to regulators.

Year after year, millions of dollars in losses somehow had been concealed from regulators.

The company wouldn't be delivering on its promises to policyholders anytime soon.

Dr. Joel Schroeder of Olathe, Kan., lost his coverage when he needed it the most.

The family of Bertha Walker, who'd died of a stroke at 71, had filed a medical malpractice lawsuit against him. The suit dragged on for five years, until a judge awarded her family \$750,000 in damages.

Schroeder said he could pay only about \$10,000. He's now suing his insurance broker for selling him the Reciprocal policy. The Walker family, however, may never collect.

The whole ordeal probably would have been avoided if he'd had coverage, said Schroeder, who's since signed up with a new insurer.

"There's a chance that a settlement could have been reached before trial," he said. "But I didn't have enough money to offer a settlement that the family would accept."

Greg Mitchell, an attorney for 25 Kentucky hospitals and former policyholders with Reciprocal, said the Justice Department's decision disappointed his clients because the loss of coverage had hurt many of them financially.

State insurance commissioners in Virginia and Tennessee are suing former and current executives from Reciprocal and General Reinsurance in an attempt to collect damages. The federal suit accuses the companies of participating in a fraudulent accounting scheme similar to the allegations that federal authorities investigated. The judge preliminarily dismissed many of the claims, but allowed the plaintiffs' attorneys to prepare a new complaint.

"It's been a very bad saga," Mitchell said of the Justice Department's decision. "We were advised it was worth the effort to cooperate. After all that cooperation, nothing happened."

Reciprocal's surplus began to erode in the late 1990s, when medical malpractice awards shot up. Desperate to pump up the surplus, the company's executives asked General Reinsurance to assume millions more in risk.

The Berkshire subsidiary agreed, according to documents from both companies. General Reinsurance, known as "Gen Re," treated the unusual transactions as "side" or "unenforceable" deals. Its executives referred to one deal as an "off balance sheet loan," according to internal documents.

Maguire included details of the deals in his draft indictment as part of the alleged accounting-fraud scheme designed to help Reciprocal falsely inflate its surplus and hide its losses from regulators.

As Reciprocal of America continued to lose money, executives from the company and General Reinsurance took trips together aboard a yacht, the Scottish Lass. They dubbed their outings on the Chesapeake Bay their "Chesapeake Audits," according to the pending lawsuit.

In pursuing suspects, regulators and FBI agents sifted through thousands of e-mails and memos. The trail led straight to Reciprocal President Kenneth Patterson and his executive vice president, Carolyn Hudgins.

Investigators found evidence that the pair had manipulated the company's accounting records to conceal losses, and urged the pair to admit their guilt.

In February 2005, Patterson and Hudgins pleaded guilty to felony fraud charges. They agreed to cooperate with investigators. But agents soon became frustrated with the pair because they didn't

appear to be divulging much detail. Corporate fraud cases were hard enough to prosecute because of their complexity. Without testimony from convincing cooperators, the case could be difficult to sell to a jury.

A federal judge sentenced Patterson to 12 years in prison and Hudgins to five years. Both declined requests for interviews.

That spring, Justice Department lawyers in Washington began to voice skepticism about proceeding against General Reinsurance. They pointed out that some of the evidence, which dated to the late 1990s, might be too old. They also warned that an indictment could hurt a major corporation unnecessarily.

"The bottom line has always been what do we want to do with Gen Re," Joshua Hochberg, the Justice Department's then chief of the fraud section, wrote to Maguire. "Indicting the company would have enormous collateral consequences."

Hochberg, who's no longer with the Justice Department, declined to comment.

Maguire pushed back, arguing that his team had plenty of evidence that demonstrated a pattern of fraud over more than 15 years.

"Gen Re has been a public menace for a long time," he wrote colleagues. "Their 'I'm not my brother's keeper' attitude has enabled them to make millions by 'aiding and abetting' bad guys."

At the very least, Maguire argued, the department should impose a fine of up to \$600 million. "If they balk, they should know that we are more than ready to indict Gen Re," he wrote.

## **SOME SETBACKS**

Two weeks later, the Supreme Court dealt the government a major setback in its pursuit of corporate fraud by throwing out the Justice Department's conviction of Arthur Andersen for shredding documents in connection with the Enron scandal.

The Justice Department decided not to retry the case. By then, Arthur Andersen had collapsed.

General Reinsurance's lawyers hired their own experts to counter Maguire's view of the case in briefings with Justice Department lawyers.

While they acknowledged that General Reinsurance might have entered into "handshake deals" with Reciprocal, they described them as harmless and the industry norm.

Ronald Olson, an attorney for General Reinsurance and a director on Berkshire Hathaway's board, argued that his client was a victim of Reciprocal's fraud. After Reciprocal collapsed, General Reinsurance lost millions from the deals, he said. It later banned "side" deals as a bad business practice.

"There was no knowledge at Gen Re that people at Reciprocal of America were hiding information from regulators or auditors," Olson said.

He now describes the criminal case as "maybe the longest investigation I remember being associated with. We were extremely frustrated."

FBI agents urged Maguire in May 2005 to proceed at least with an indictment against John William Crews, Reciprocal's general counsel, who'd co-founded the company in 1977, according to internal documents.

Maguire and the agents believed that Crews had participated in many of the meetings with General Reinsurance and had received memos and e-mails about the companies' relationship.

Crews and his law firm also had collected more than \$63 million in legal fees from Reciprocal of

America and its subsidiaries, according to allegations in the pending lawsuit.

Nonetheless, the threat of indictment remained very real to General Reinsurance.

Authorities had launched a separate investigation of General Reinsurance's relationship with American International Group, the largest U.S. insurer. The probe resulted in the ouster of Maurice "Hank" Greenberg, the chief executive officer and president of American International Group. The New York Attorney General's Office later sued Greenberg, accusing him of misleading investors. That suit is still pending.

Under pressure by the New York attorney general, the Justice Department and the Securities and Exchange Commission, Buffett agreed to talk to regulators, although investigators said he wasn't a target.

In February 2006, three former General Reinsurance executives and a former American International Group executive were indicted on charges of manipulating financial statements.

As Maguire considered indicting Crews in June 2006, a federal judge who was overseeing a massive tax case against accounting firm KPMG slammed the Justice Department as violating the Constitution "it is sworn to defend" by pressuring the firm to stop paying for defense lawyers for its employees.

"Those who commit crimes — regardless of whether they wear white or blue collars — must be brought to justice," U.S. District Judge Lewis Kaplan wrote. "The government, however, has let its zeal get in the way of its judgment."

The ruling reverberated throughout the legal community, prompting the Justice Department to soften its prosecution policies.

Within months, Maguire was removed from the Reciprocal of America case.

His replacement, Assistant U.S. Attorney Michael Gill, quickly set a new tone. In his first meeting with the team last fall, he called General Reinsurance's lawyers to tell them that no case would be brought against their clients in connection with Reciprocal.

Worried that Gill also might kill the investigation of Crews, FBI agents assigned to the case prepared a memo detailing their strongest evidence against him. Gill, however, decided this spring not to indict Crews either.

Crews' lawyer, J. Jonathan Schraub, said his client wasn't indicted because he never did anything illegal.

"There are many reams of allegations," Schraub said. "None of them are valid."

Gober, the certified fraud examiner, refused to let go. He wrote Deputy Attorney General Paul McNulty in February to ask for an explanation. McNulty, who'd overseen the case as U.S. attorney for the eastern district of Virginia until his promotion in November 2005, never replied. McNulty is due to leave the department soon.

*(Tish Wells contributed to this article.)*

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