Above the Law: A Short Story About Privilege and the Potato Chip Theory

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There is something especially distasteful, even sickening, about either a man of God or someone in law enforcement breaking the law. Perhaps because God and the law are about all that stands between us and savagery. So, maybe, Godly or law enforcement folks going bad makes us feel more vulnerable, and less protected in the world.

These were some of the thoughts Eddie Coello pondered as he drove through the sleet and slow-moving early morning traffic. He was en route to the Gravois State Bank (GSB) in Gravois, Illinois, which was a wealthy suburb on the North-West side of Chicago. Coello was facing, and trying to resist, one of the most basic risks that auditors face when starting an assignment—preconceived notions about what he may find. He knew that auditors were especially vulnerable to confirmation bias, a cognitive bias that may interfere with his and his team’s work.

A cognitive bias is a mistake in reasoning, evaluating, remembering or other cognitive processes, often resulting in holding onto one’s preferences and beliefs regardless of contrary information.¹ One of the primary biases for auditors is that, once they form some view on some part or even the audit client, they tend to embrace information that confirms that view while ignoring, undervaluing, or even rejecting information contrary to that preconceived view.²

The potential for impairing Cello’s or his team’s objective opinion was that GSB’s primary shareholder was a federal judge, Jerome Green, which should provoke a positive bias. Unfortunately, Judge Green was caught up in an FBI sting operation³ for taking bribes in exchange for courtroom decisions.

Unluckily (or not) for the elderly judge, he had passed away just days before indictment and trial where he would have faced a significant number of first-hand witness accusations about his guilt. Now, in addition to the usual difficulties on a large audit, Coello had to deal with a bias towards under-valuing positive data and over-valuing negative information. Worse, Coello had always believed and taught his teams about his “Potato Chip Theory.” That is, no one ever eats a single potato chip. “Especially the perfectly shaped and salted ones,” he would joke, “and similarly, no one ever does one bad thing”. So, ceteris paribus, he actually believed that there was an elevated risk of improprieties at an institution when separate criminal conduct had already been established.

“Well,” Coello sighed, taking the Gravois exit, “I guess we’ll test that theory.”

The first week of the bank audit seemed standard enough, with no significant difficulties in accessing information, scheduling appointments with appropriate staff and management, or workflow. Returning from lunch on Friday of the first week, though, Coello was surprised to find his audit team in an especially happy mood. The GSB President, Harvey Miller, had given the crew tickets to attend a Chicago Bears versus Green Bay Packers football game with him the following weekend. Traditionally, the only socializing between auditors and auditees was a luncheon following their wrap-up meetings. Even that much was not always the case. Although the game was technically scheduled after the audit fieldwork and exit meeting was scheduled to be completed, Coello knew that the tickets cost was substantially more than the price of lunch. He also was troubled by President Miller passing the tickets out at mid-audit and wondered if this was another “potato chip.”

¹ https://www.chegg.com/homework-help/definitions/cognitive-bias-13
² https://www.psychologytoday.com/blog/science-choice/201504/what-is-confirmation-bias
³ Operation Greylord (named after a local racehorse) was jointly conducted by the FBI, IRS, U.S. Postal Inspection Service, Chicago Police Department, and the I.A. Dept. of the Illinois State Police. The investigation lasted about forty-two months during the 1980s—although the protracted trials exceeded the end of field-work by more than ten years. A total of ninety-three were indicted, including: seventeen judges, forty-eight lawyers, ten deputy sheriffs, eight policemen, eight court officials, and a state legislator.

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“I’m sorry, team, but we’ll have to return them. I’ll take them back to President Miller and explain that his generosity exceeds what would be usual and suitable.” Amidst complaints that they could not be “bought” for the price of a professional football game ticket, they had known others who had accepted swag costing even more, and a chorus of general disappointed groans, everyone handed or tossed him their tickets.

“It’s not just the price,” explained Coello, “although it is a generous gift, and we have no control over what other auditors do. But we’re supposed to be ethical in fact and in appearance. C’mon, now, consider what you’d think about someone else taking a gift under similar circumstances. Wouldn’t you question, or be suspicious of, whether someone else might have been too soft on an estimate or any other discretionary decision?” The stares and attitudes from his team told him they were not in the mood for either logic or an impromptu ethics lesson.

“So much for the good mood,” he thought, collecting the tickets and heading toward President Miller’s office. The CEO was just finishing up an apparent meeting with a loan customer when Coello arrived. His usual enthusiastic greeting was followed by an invitation to join him at the upcoming Bears home game. Coello apologized that neither he nor anyone from his team could accept the president’s “generous offer,” but suggested a luncheon after the closing meeting instead. President Miller’s raised eyebrow seemed to convey that he could not believe he had been turned down, which, in turn, made Coello wonder how often his generosity had been accepted during previous audits. “Anyway,” said Coello, trying to segue from the discussion, “are we still on for loan discussion today at 4:00?”

“Sure, why not,” President Miller said, “Just don’t be as rough as your predecessor last year.” Coello walked away trying to remember who was in charge of the previous examination. He remembered it was Bob Kennedy.

He also recalled that Bob was not predisposed to conflict of any sort and, in general, was not exactly regarded as a “bulldog” type. Quite the opposite, in fact, so what could the banker have meant? More potato chips?

Loans collateralized by real estate that had fallen into default and had their collateral repossessed were referred to as Other Real Estate Owned (OREOs), because the real estate had become a bank asset and classified as an OREO asset category. Such was the case of a commercial real estate loan, originally to finance twenty-seven gasoline stations located around, but mostly north, of the city. Standard practice would be to sell the OREO as soon as possible at its fair market value in an arms-length transaction. Subsequent refinancing of the properties by the OREO bank would generally require fifteen to twenty-five percent cash up-front, enough cash flow sources to repay the loan in full, and all the other credit requirements of someone financing a similar loan at a non-related financial institution.

A usual task of the asset quality review by regulatory bank auditors was to review OREO properties from the previous and current examinations and determine if and how those properties were disposed. One of those properties was on Coello’s discussion list. Previously on the bank’s list of OREOs for $1.27 million, someone had apparently acquired the properties using GSB financing. Coello made it a point to contact Bob Kennedy to ask about the OREO during that examination. Kennedy recalled that he had discussed the commercial real estate with the bank president, and that President Miller was “super conservative” about the issue.

“I was inclined to classify the asset as ‘Substandard,’ in fact, and President Miller jumped up and said he didn’t want us to think he had any bad assets on his books, so he would classify it all as ‘Loss’ and effectively write it off completely.”

“What did you do?”

“Well, I figured that if he was that conservative about protecting the veracity of bank asset values I would trust him to manage the process, so I left it as a ‘Special Mention’ classification.”

Coello thanked Bob for the additional insight, and then went about examining the sale agreement made with the new buyer/borrower. The documentation was apparently complete and thorough, and supported by strong financial information. Still, the buyer had financed almost ninety-nine percent of the OREO value, although his financial statements suggested that he could have paid more, and he had purchased the properties for book value. Most auditors, whether internal, external,
or regulatory seldom, if ever, question the veracity of support documentation, but Coello made it a point to scrutinize this case more carefully. First, however, the loan review meeting.

Typically, on a bank audit, bank auditors have divided their loan review work amongst themselves and so will meet as a group with bank management to discuss problems or anomalies they recognize with individual loans. The process is usually uneventful and, frankly, the only time an auditor is surprised is when a banker does not know every loan in detail. An auditor will discuss one of the loans; inform the banker of his/her reasons and decision about classification (and recommended provisions to the reserve for bad debts), unless the banker has additional evidence that would change that decision.

When Coello discussed the former OREO, now loan, he summed up by recommending a ‘Doubtful’ classification of the loan based on the borrower’s lack of up-front cash payment for the property, lack of any pay down since inception of the loan, and that it was an “interest-only” loan for the first three of a ten-year term.

Miller exploded, jumping up and fairly shouting that he would never want a bad debt of any kind at his bank and, if Coello or anyone would check, they would see that, indeed, very few loans whatsoever were even classified as ‘Substandard’.

Coello eyed the president’s behavior coolly as the man continued to rant about how the bank had always been known as a “clean” shop and he would not tolerate this or any other asset to impugn that reputation.

“So,” he repeated again, “I’ll just charge off the whole (expletive) thing and be done with it.” Coello considered his options and words carefully, remembering that Mr. Miller had told Bob Kennedy essentially the same thing; perhaps in a ploy to get him to back down on the proposed classification.

“Ok.” said Coello, “Go ahead—and then give me a copy of the debit and credit tickets by the end of the day.”

“What?” The banker looked and sounded shocked. “I’m not gonna charge off that loan! It’s too good!”

“Well, then, President Miller...we have a difference of opinion. But if you cannot provide additional support for the loan’s quality, I expect you to classify the loan as ‘Doubtful’ and provide at least fifty percent of its value to the Allowance for Loan and Lease Losses (ALLL) either today or tomorrow—and then see that I get a copy of the debit and credit tickets afterwards.”

President Miller’s glare at Coello was intense, but he regained his composure and simply said “Fine. Let’s move on to the other loans.”

The banker was reticent for the next two days, and unusually unavailable for additional meetings. Coello and his team wrapped up their work and left the bank on Friday, but Coello still had a feeling he had missed something. Documentary records were unavailable when he tried to trace the history of either the former OREO or investigate the new borrower to satisfy his curiosity. When working in his Reserve Bank office that Sunday to piece together his report, he abruptly stopped. Something was wrong, his intuition told him, and he did not want to complete the report as scheduled. He felt he had to call his superior, who was the assistant vice president in charge of on-site bank supervision, at her home. Ordinarily, that would either never happen or at least be regarded as a bold move.

But his boss had a well-known and highly regarded open-door policy, and frankly Coello did not know how to proceed. She picked up the phone, surprised to hear his familiar voice on a weekend. “Hi, Joan. What’s happening?”

“Nothing much, just washing dishes and listening to Les Misérables. What’s going on with you?”

“Well,” he started, “I have a problem.”

“What sort of problems did you find?” she asked.

“Actually, not much. It’s a problem that I either haven’t found or didn’t have time to satisfy my curiosity about.”

Joan Benson was very direct, “What do you need?”

“More time,” said Coello, “and a little help.”

“Who and for how long?” she asked.

“I’d like another week, and I want to take Ed Kristopher and John Folts with me.”
Knowing that Foltz had a good technical reputation, she did not question that choice, but knowing that Kristopher did not, made her wonder, “Why him?”

“Kris has more street smarts than anyone you have working for you,” he said. “And I think that’s the kind of talent I need.”

“Ok.” his boss replied, “I’ll make sure no one questions your absence from the office for another week. Keep me informed and let me know if I can help.”

“Thanks, Joan, I will,” said Coello, and hung up the phone. Then, to his empty office, he said “Joan, you are the best boss a person could have,” and then made his calls to Ed Kristopher and John Foltz.

The next day the three were back at the bank, as Coello explained to President Miller, to tie up some lose ends about documentation. He then sent Foltz down to the loan department to trace the history of the OREO at the root of his concerns and send Kristopher to visit the sites of the OREO properties, along with his camera.

Coello went to visit the borrower/buyer of the OREO, but only after reading and analyzing everything he could get his hands on about him beforehand. After two days, they met at the bank workroom and found that each had discovered quite a bit. President Miller was either unavailable or even out of the bank for those days, and had notified his secretary that he would be gone at least another two days, “On business.”

Ed Kristopher discovered, and documented, that the former OREO properties were gasoline stations, and only two were currently functional. Conversations with other business people near those properties informed him that either they had been closed for years, or that they were surprised the functional ones were still in business. “You almost never see a customer,” said one business neighbor of one of the two operating stations.

Kristopher knew how gasoline stations operated, though, including the danger of gasoline leaking from underground storage tanks that rusted and decayed over time. He talked to a friend in the business who told him “It’s not a question of if the tanks will leak—but when.” His friend assured him that, based on the age of the properties, the tanks (whether in use or not) were almost certainly leaking fuel into the ground.

Kristopher then visited the state Environmental Protection Agency and discovered that the owner of the properties would be responsible for any environmental damage; including digging up the old tanks, cleaning the soil in and around the hole, and then filling the holes. All in all, likely a multi-million-dollar project.

John Foltz had traced the current loan back to its OREO status, then further back to another loan, then back to a stint in ‘Other Assets’ and another loan before that, and another OREO property before that, and so on—going back twenty-seven years to the original loan! It was clear that the bank had maneuvered the original loan, which was partially repaid, around the bank’s balance sheet to avoid bad debt expenses associated with a non-performing loan as well as both the write-down to fair market value and the environmental cleanup costs associated with property ownership.

Eddie Coello discovered that the current buyer/borrower was not a businessperson at all; but worked for another major borrower of the bank in a semi-skilled construction capacity. That large borrower, in fact, was the original borrower to finance the chain of gasoline stations three decades before that time. All subsequent buyer/borrowers, in fact, had been employees of the original borrower’s construction company. Their financial information was fabricated each time with no real expectation of debt repayment—but only to defer the eventual decision until the properties could be “Palmed off” onto other unsuspecting buyers. That strategy had reduced the overall debt by approximately fifty percent since default on the original master note.

Coello released his two assistants to other work by Wednesday and was contemplating his next move when an accidental discovery directed his efforts. While searching for President Miller, who was rumored to have been in the bank that day, Colello passed the desk of Miller’s secretary. “Hi,” he said in passing, “How’s it going?”

“Not good,” she replied, “thanks to you-know-who.”

Colello stopped to follow up, asking “What do you mean?”

“Look at my desk!” she said, “What do you see?”

“Just usual desk stuff,” replied Coello, “Why?”
“Because it’s my birthday!” she said, “And I should have flowers or something on it besides ‘usual desk stuff,’ especially after all I’ve done for him!”

“Like what sort of things,” he asked.

“Like staying after work while he types up the board of directors’ meeting minutes or covering for him when he’s off in some other state on business or reminding him to update his loan information! Just all kinds of stuff! And I don’t even get flowers on my birthday?”

“Why would President Miller be typing up board minutes? Wouldn’t that be the job of the board’s secretary?”

“No, he does them himself since he has a better idea about bank operations than the secretary. Anyway, he puts them off for a few months and then does them all at once. He’ll start after dinner, put a bottle of bourbon on his desk, and then drink and type until 9:00 p.m. or so at night. And I have to stay to fetch whatever information he may want to help his typing!”

Obviously, Coello’s team had been duped on other matters aside from the OREO, and things required much more investigation that he originally thought; although his findings were already sufficient for serious further investigation and enforcement action. Still, it was obvious that the bank needed a deep-dive into all its affairs.

The next morning at the bank, Coello was told that a Mr. George Steinberg wanted to see him. Steinberg was married to the only child of former bank owner and Judge Green. He was concerned about Coello’s findings, having missed the wrap-up meeting, and why Federal Reserve Bank auditors were still at his wife’s bank; since she had inherited Judge Green’s holdings.

He also informed Coello that he was a very well-regarded attorney at a very well-connected firm and knew banking law and GSB operations “As well as any man.”

Coello spoke carefully, but directly. “Then I suppose you are familiar with the history of the bank’s practices with OREO, Mr. Steinberg?” The attorney lowered his head and Coello heard him sigh, in sort of a resignedly way, then when he raised his head his face appeared somewhat ashen.

“My wife nor I had any knowledge of either my father-in-law’s or President Miller’s antics before Judge Green died,” he finally said, “Although proving that will be hell. What is likely to happen?”

“I can’t speak for the folks in our enforcement unit, but as you can imagine, it will all be counted as good if—now that you know—you come clean about accounting for the fair value of the property; including recognizing environmental clean-up costs. Further, you should investigate all persons responsible for this fraud and then hire an outside audit firm to investigate whether any other frauds exist in your loan portfolio; and make that known to the Federal Reserve and other shareholders.”

“I just want to be rid of this albatross! Could my wife and I sell the darned thing?”

“Just recently becoming aware of the problem, making all possible efforts to clean things up, and then wanting to sell the bank to a disinterested third party with sufficiently deep pockets to fill in all the holes—I would guess that that would be a good decision. Again, I can’t speak for enforcement, but I would feel comfortable recommending that sort of rehabilitative plan.”

“Then it’s decided,” he replied, “and good riddance. I’ll call the board to order today if I can, and we’ll move immediately to clean things up.”

Epilogue

Judge Green’s daughter and her husband did, indeed, proceed to develop and implement a bank-restructuring plan along the lines discussed with Eddie Coello. Using another audit firm, Big 5 at the time, the bank’s assets of any significance were scrutinized in detail. A law firm specializing in banking issues was hired to market GSB and received several reasonable offers. Eddie Coello met with the winning bid at their meeting in the bank to consummate the purchase. He learned that the new owners, while performing their own due diligence, had asked President Miller to disclose “Everything, no matter how insignificant it may seem.” Reportedly, he had disclosed only a few small matters, which the due diligence had already uncovered.

“So, what will you do?” asked Coello.

The purchaser replied, “Well, he’s out; finished as far as I’m concerned. We don’t work with people we can’t trust.” Their meeting ended with the purchaser thanking Coello for helping his holding company find “A diamond in the rough.”
Coello replying, “We were just doing our job.”

As he was leaving the room, the purchaser turned to Coello again, saying “If you ever want to leave the Federal Reserve, we could sure use you in our holding company.”

“Thanks,” Coello replied, “but I’ve got some of the most interesting work and the absolute best boss in the world.”

“That’s rare,” said the purchaser, “but good luck to you anyway.”

As he drove back to the office, Coello reflected on the events of the day and this last conversation. “Yes,” he said aloud, “that truly is rare.”

President Miller lost his job at the bank and, for a while, seemed destined to an early retirement. Coello later heard that the new owners were considering legal action against the ex-president, but never discovered what eventually happened to him. The bank prospered under good management and remains a strong part of the purchaser’s holding company. Joan Benson was eventually promoted to vice president in charge of all forms of bank supervision at her Federal Reserve Bank, where she remained until retirement.

Coello was talking to another Reserve Bank examiner preparing to audit the same bank, and was asked “Did you know there was a fraud in the bank about two years ago?” Coello marveled that not only do organizations fail to share information, but even people within the same organization (due to turnover, shifting responsibilities, etc.) sometimes fail to share information within their own organization.

Note: An instructor may assign this short story for students to read and have classroom discussion afterwards. Or an instructor could prepare a multiple-choice and true-false quiz for the class.
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