

State of New York
Office of the Inspector General



An Investigation into the Petroleum, Alcohol,
and Tobacco Bureau of the New York State
Department of Taxation and Finance

May 2013

Catherine Leahy Scott
Inspector General

STAFF FOR THIS INVESTIGATION AND REPORT

LEONARD A. COHEN

Chief Counsel

SPENCER FREEDMAN

Executive Deputy Inspector General

MICHAEL C. CLARKE

Chief of Staff and Counselor

PHILIP FOGLIA

Special Deputy Inspector General

KENNETH MICHAELS

Investigative Counsel

BERNARD COSENZA

Deputy Inspector General for Investigations

ROBERT WERNER

Chief Investigator

LESLIE ARP

Deputy Chief and Confidential Investigator

WILLIAM GLEESON

Investigator

DENNIS GRAVES

Supervising Auditor

VAL DOUGLAS

Supervising Auditor

PETER AMOROSA

Investigative Auditor

ILENE GATES

Investigative Auditor

ALLA KORSUNSKIY

Forensic Accountant

FELISA HOCHHEISER

Director of Investigative Reporting (New York City)

Special Counsel

STEPHEN DEL GIACCO

Director of Investigative Reporting (Albany)

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EXECUTIVE SUMMARY

In September 2010, the Inspector General received allegations regarding systemic problems at New York State Department of Taxation and Finance (Tax and Finance) Petroleum, Alcohol and Tobacco Bureau (PATB). The then Deputy Inspector General for the Department of Taxation and Finance¹ reported to the New York State Inspector General regarding questionable PATB operations. In addition, a person requesting anonymity alleged numerous improprieties regarding PATB's operations. Both presented allegations that PATB's then Director, Thomas Stanton, among other things, had been running a multi-million dollar cigarette interdiction operation absent basic investigative protocols. Both allegations also cited flaws in Operation Keystone, a cigarette interdiction operation spanning from late 2008 to the fall of 2009 that began and ended in Westchester County, but was based mostly in Pennsylvania.

Upon learning of these allegations, the Inspector General commenced an investigation into PATB's operations, focusing on operations involving covert sales of cigarettes. This investigation examined PATB's tactics, and the policies and procedures associated with those operations, including internal audits. In so doing, the Inspector General substantiated that from 2002 until mid-2010, PATB, under former Director Thomas Stanton, ran a multi-million dollar cigarette interdiction operation that was devoid of appropriate investigative procedures and controls. These deficiencies included inadequate policies and procedures for handling millions of dollars of cash as evidence;

¹ Until 2011, the Office of the Deputy Inspector General for Taxation and Finance operated within the Department of Taxation and Finance, with reporting responsibilities to both the Department's Commissioner and the New York State Inspector General. Effective June 1, 2011, the functions of the Deputy Inspector General for Taxation and Finance were consolidated within the Office of the State Inspector General.

cash shortages; unregistered confidential informants who were paid hundreds of thousands of dollars; failure to track inventory; and PATB investigators operating out-of-state without proper authority. PATB's neglect of basic investigative protocols eventually led to dismissed prosecutions and the halting of sting operations in the summer of 2010.

In September 2010, Tax and Finance's Bureau of Internal Audit and Quality Control (Internal Audit) reported finding a deficit of approximately \$160,000 in cash proceeds from covert sales during Operation Keystone (PATB's largest cigarette sting operation). In addition, during the pendency of this investigation, the Inspector General learned through a federal law enforcement source that a confidential informant had alleged that a PATB Senior Investigator assigned to lead Operation Keystone had stolen money from the proceeds of cigarette transactions. Accordingly, the Inspector General obtained records of personal bank accounts used by the Senior Investigator to determine if cash had been deposited into the accounts. These records reflect that the Senior Investigator deposited approximately \$25,000 in cash into an joint account over an 11-month period in 2009; the majority of the deposits took place within two weeks following cigarette sale transactions in which cash was found to be missing; and, this pattern of deposits was not consistent with the previous and subsequent years' bank records, which reveal only minimal cash deposits, if any.

Based on this investigation, the Inspector General referred this matter to the Westchester County District Attorney. The District Attorney's Office made a determination not to prosecute. The Senior Investigator resigned from Tax and Finance.

Throughout this investigation, the Inspector General has communicated with Tax and Finance regarding the findings and recommendations herein, and Tax and Finance has already implemented – and continues to implement – corrective action. Specifically, by both interim oral and written reports during the investigation and its response to this investigative report, Tax and Finance has presented a detailed restructuring plan that includes updated internal controls and extensive training to prevent recurrence of the issues presented herein. These remedial measures are essential because, although Tax and Finance terminated PATB’s proactive cigarette interdiction operations in the summer of 2010, the agency continues to engage in other criminal investigations. The Inspector General notes Tax and Finance’s responsiveness to the recommendations that the agency formulate rigorous law enforcement protocols, train its investigators in those protocols, and ensure adherence to them. As to the recommendation that Tax and Finance review the conduct of those Tax and Finance employees who were either engaged in the PATB sting operations or charged with supervising that bureau and take appropriate action, Tax and Finance has reported that management level employees from the time period addressed in this report have either left the agency voluntarily or have been relieved of their duties. Tax and Finance has also stated that it will continue to pursue disciplinary action against current staff implicated in the report, where appropriate.

INVESTIGATION

A. Background

The New York State Department of Taxation and Finance collects and enforces the collection of New York State taxes including personal income taxes, corporate income taxes, and excise taxes on certain products including petroleum, alcohol, and tobacco. Tax and Finance employs criminal investigators who hold dual roles: as peace officers with authority to carry and use firearms within New York State, and as police officers with limited authority to execute warrants in criminal tax cases within New York State.² Some criminal investigators employed in the Revenue Crimes Bureau were assigned to investigate revenue tax crimes relating to personal income tax, sales tax, withholding tax and corporate tax laws; other criminal investigators employed in the Petroleum, Alcohol and Tobacco Bureau (PATB) were assigned to investigate crimes relating to failure to pay tax on certain products including, relevant to the instant investigation, cigarettes. New York State law requires that cigarettes sold at retail establishments in the state be stamped to reflect payment of cigarette excise taxes.³ Cigarettes may not be sold in New York State with other states' tax stamps, fraudulent tax stamps, or no stamp at all.⁴

In May 2002, Thomas Stanton, who had been Director of Tax Enforcement for New York City's Department of Finance leading investigations involving cigarette tax evasion, became Director of PATB. With regard to untaxed cigarettes, prior to 2002,

² N.Y. Crim. Proc. Law §§ 2.10(4)(a-c) and 1.20(34)(q).

³ In New York City, an additional stamp reflecting payment of local taxes is also required.

⁴ New York State criminal penalties apply to the sale of contraband cigarettes, and federal criminal laws apply to interstate transportation of contraband cigarettes.

PATB conducted investigations by engaging in controlled purchases from those alleged to be selling contraband cigarettes throughout New York State. In contrast, Stanton sought to implement proactive methods to interdict trafficking in New York State by selling cigarettes to traffickers in New York State and elsewhere. By this method, which he had used in his previous position with New York City, Stanton hoped to identify higher-level traffickers directly by selling cigarettes to them in wholesale quantities. Stanton also believed that the higher criminal penalties for larger quantities of contraband would provide greater incentives for defendants to cooperate. To that end, Stanton sought the assistance of federal prosecutors whenever possible to maximize potential sentences for interstate trafficking of contraband cigarettes.

During the period 2002 through 2010, PATB criminal investigators, led by Stanton,⁵ ran proactive cigarette sting operations with law enforcement agencies within and outside New York State. PATB set up undercover operations in various locations in which criminal investigators and confidential informants posed as sellers of contraband cigarettes, often from clandestine locations such as storage facilities and warehouses. Tens of millions of dollars worth of these cigarettes, which were purchased by PATB from cigarette wholesalers or directly from manufacturers, were sold in these operations.⁶ Given the magnitude of cigarette sales into the illegal, untaxed market, PATB and Stanton gave surprisingly little thought to any potential lost tax revenue to New York

⁵ Director Stanton reported to the Deputy Commissioner for the Office of Tax Enforcement.

⁶ PATB also requisitioned authentic-looking tax stamps from Tax and Finance's actual producer of legitimate stamps to affix on the cigarettes sold in the sting operations.

State – an apparent omission given Tax and Finance’s mandate to collect and enforce the collection of New York State taxes.⁷

PATB also recovered funds by engaging in a practice known informally as “rips,” which recouped cigarettes sold during the operation and allowed PATB to retain the cash proceeds from the sale of the same cigarettes. While an operation was ongoing, a member of the PATB undercover team would contact a member of a police department on the route expected to be taken by a purchaser, to coordinate a pretextual car stop of a targeted purchaser. The local police would pull the driver over for a traffic violation, and ask to search the vehicle. When the contraband cigarettes were found, they would be returned to a PATB investigator. The rips also enabled the local police to obtain identification from the driver that could then be provided to the PATB team.

B. PATB Major Operations Preceding Operation Keystone

From 2002 until 2008, in addition to standard regulatory activities and small sting operations within New York State, PATB ran a number of major cigarette sting operations both within and outside New York State. Each of these operations was initiated by Stanton.

⁷ This investigation represents the second time that the Inspector General has investigated activities of Stanton in particular and PATB in general. In May 2006, the Inspector General issued a report which found that Stanton and PATB Assistant Deputy Director Paul Rossi had threatened a business owner with arrest and the closure of his business if he did not voluntarily close his business. For these actions, Tax and Finance suspended Stanton for ten days and Rossi for five days. *See Report at* <http://www.ig.ny.gov/pdfs/Investigation%20of%20a%20Complaint%20of%20Abuse%20of%20Authority.pdf>

i. Operation Phoenix

In 2002, after arriving at Tax and Finance, Stanton proposed his idea to conduct cigarette sale operations, which he called “reverse-buys,” to then Deputy Commissioner Peter Farrell and then Commissioner Arthur Roth, both of whom approved Stanton’s plan. However, when Stanton sought cash from Tax and Finance with which to purchase cigarettes to commence his undercover operation, he learned that money was not available. Stanton therefore, with the consent of his supervisors in Tax and Finance, sought the assistance of a tobacco wholesaler who gave him a \$40,000 line of credit. PATB bought and immediately sold \$40,000 worth of cigarettes in a number of deals for a profit. PATB paid the wholesaler back and, as Stanton described, “just started churning.”

PATB’s first major operation, “Phoenix,” was commenced after the September 11 terrorist attacks. Stanton and then Deputy Commissioner Farrell maintained that there was a mandate after the attacks to prevent possible funding of terrorists through the sale of untaxed cigarettes. Operation Phoenix involved federal and local state agencies, including the federal Bureau of Alcohol, Tobacco, and Firearms (ATF), the federal Internal Revenue Service, the Virginia Department of Alcoholic and Beverage Control,⁸ and the United States Attorney’s Office for the Eastern District of Virginia. The storage facility where undercover sales took place was located near the Maryland-Virginia border to enable federal jurisdiction as investigators could observe targets crossing state lines. Operation Phoenix’s sale activities ended in 2003 with multiple arrests and convictions⁹

⁸ Virginia ABC participates in investigations involving cigarette smuggling and other criminal activity not apparent from its name.

⁹ An August 2004 internal report indicates that 25 people had been arrested and 19 had been convicted as of that time.

for charges of interstate trafficking in contraband cigarettes in Virginia federal court. New York State court-ordered restitution totaled over \$6.7 million. However, to date, Tax and Finance has received only approximately \$197,000.¹⁰

ii. Operations Genesis and G-2

In March 2003, PATB commenced a joint operation¹¹ named “Genesis” to procure intelligence on contraband cigarette sale activity in retail stores within New York State’s Capital district – Albany, Schenectady, and Troy – with a corollary operation, “G-2,” in Utica. The operation initially used a Tax and Finance confidential informant to traffic cigarettes to retail stores known from prior investigative work to sell counterfeit or otherwise contraband cigarettes. Of note, Operation Genesis was the first operation to use personnel other than Tax and Finance investigators to sell cigarettes to traffickers. Tax and Finance, however, in contravention of basic investigative protocols and its own policy, failed to register the confidential informant, a method used to formalize the agency-informant relationship. Instead, Tax and Finance relied on the New York State Police, who, as per its own policy, registered the confidential informant.

Investigators from the State Police were involved in the operation to seize any drugs and guns which might be found. The New York State Attorney General’s Organized Crime Task Force (OCTF) was responsible for prosecuting the cases. Tax and Finance and OCTF records reflect the execution of numerous search warrants in October 2005, 31 arrests, and convictions by guilty plea to charges of tax evasion. Although over

¹⁰ Some of the defendants were placed on payment plans with minimal monthly payments.

¹¹ According to PATB reports, the federal immigration service was initially involved, as was the Joint Terrorist Task Force.

\$376,000 in restitution was ordered, to date, Tax and Finance has received only approximately \$85,000.¹²

iii. Operation KG

“KG,” the next major cigarette operation, commenced in late 2006. It was named after King George County, Virginia, where most of the contraband cigarette sales took place. The operation was once again run by PATB with assistance from federal and local law enforcement agencies, and was again prosecuted by the United States Attorney for the Eastern District of Virginia.

PATB solicited the assistance of a target of Operation Phoenix to act as a salesperson for the new, Virginia-based operation. Over the subsequent months, additional confidential informants were used to lure interested purchasers of contraband cigarettes to the Virginia site through telephone calls, resulting in sales of thousands of cases¹³ of cigarettes worth millions of dollars. Some purchasers offered to, and on occasion did, engage in other criminal transactions, such as selling confidential informants or undercover investigators fraudulently obtained driver licenses, counterfeit tax stamps, and guns.

In May 2008, members of the operation team – PATB, ATF, Internal Revenue Service, and other federal law enforcement agencies – executed 24 arrest warrants in the Metropolitan New York area and in King George County, Virginia, for transportation of contraband cigarettes. Of those indicted, 18 defendants pleaded guilty to criminal charges including the sale of contraband cigarettes and money laundering, and received

¹² The court also ordered \$195,000 to be forfeited from defendants, of which Tax and Finance receives a statutorily allotted percentage.

sentences ranging from probation to up to four years imprisonment, with restitution to New York State of over \$4.2 million.¹⁴ To date, Tax and Finance has received only approximately \$17,000.

C. Operation Keystone

i. Parameters of the Operation

Operation Keystone was the largest undercover cigarette sale sting operation during Stanton's tenure as Director of PATB. According to Tax and Finance accounting data, Operation Keystone involved more than 650 undercover sales of over 470,000 cartons of cigarettes and generated proceeds totaling nearly \$17 million.

While the operation was ultimately named "Keystone" for the nickname of the state in which most of the PATB activities took place, Pennsylvania, the operation actually originated and concluded in Westchester County, New York. In August 2008, PATB members approached the Westchester County District Attorney's Office to gain cooperation with an undercover sting operation they wished to commence in Yonkers, New York. Following a meeting with Stanton in September 2008 during which Stanton assured the District Attorney's Office that all transactions would be audio- and video-recorded and that a highly experienced confidential informant would be used, the District Attorney's Office agreed to work with PATB on the operation.

PATB rented a small garage next to a house near a main road in Yonkers. Prior to commencing any transactions, the District Attorney's Office, in conjunction with PATB, constructed a partition in the garage to create an area where a PATB investigator could

¹³ One case is comprised of 60 cartons of cigarettes.

observe all transactions undetected by the targets of the operation. In addition, covert recording equipment and cameras provided by the District Attorney were installed to record the undercover cigarette transactions. Nevertheless, unbeknownst to the District Attorney, following the first day's transactions, PATB did not position an investigator behind the partition to witness the transactions.

According to PATB members, the confidential informants would call their contacts and arrange to sell them cigarettes. They would meet a mile away from the garage, and then direct the purchasers to the garage. Several team members in cars performed surveillance. The transactions were audio- and video-recorded, but no PATB members were present with the informants during the transactions, which involved tens of thousands of dollars in cash paid to the confidential informants in exchange for cigarettes. Because the sale site lacked a viable location for counting the money and the PATB team did not place a money counter in the garage, the informants were directed to take the cash proceeds, drive to a specified meeting point, and turn over the proceeds to a PATB Supervising Investigator. Of note, in the time between the transaction and meeting with the Supervising Investigator, the informants were not video-recorded or otherwise searched or surveilled.¹⁵ The Supervising Investigator was responsible for placing the money in evidence bags, which were transported to PATB's midtown Manhattan offices for counting.

A member of the PATB team in Yonkers testified to the Inspector General that PATB had no specific policies or procedures governing informants' handling of money.

¹⁴ The court also ordered over \$4.2 million in restitution to New York City.

¹⁵ The Inspector General learned that the Westchester County District Attorney's Office was not aware during the pendency of the investigation that the confidential informants were left alone with the cigarettes and cash proceeds for extended periods of time.

That member further testified that he was aware of two occasions in which the amount of money counted was less than it should have been, based on the price and quantity of the cigarettes involved in the transactions. His recollection was that the shortages ranged from a few hundred to less than two thousand dollars. He noted that the PATB investigator assigned to monitor the cash and the accounts was aware of the shortage, but it was assumed that the purchaser had “shorted” the informant conducting the transaction.

Soon after the Yonkers operation began, circumstances arose which caused it to be terminated. Prior to commencing the Yonkers operation, certain upper-level members of the Yonkers Police Department were advised of the PATB operation; however, this information would not have been shared with patrol-level officers. Shortly thereafter, a member of the Yonkers Police Department pulled over a purchaser in a vehicle, and the purchaser informed the police officer of the location of the sales operation, thereby compromising the operation. As a result, PATB was forced to cease operations at that location. Westchester County customers were directed to a warehouse in Pennsylvania that PATB established in the fall of 2008.

In October 2008, Stanton and PATB investigators met with representatives of the United States Attorney’s Office for the Middle District of Pennsylvania and ATF to discuss establishing a covert cigarette sale operation from a warehouse in Marshall’s Creek, Pennsylvania. The location was chosen for its proximity to the Pennsylvania-New Jersey border to facilitate interstate traffic necessary for federal jurisdiction.

In coordination with the United States Attorney’s Office in Pennsylvania, covert operations commenced in November 2008 from a Pennsylvania warehouse off Interstate Route 80 near the New Jersey border. Members of the PATB team and other law

enforcement agencies working on the operation were assigned to different physical areas and tasks. As in previous operations, team members conducted surveillance of the perimeter of the warehouse, and others were assigned to watch the routes leading to the warehouse to monitor the purchasers' whereabouts before the cigarette transactions and to witness their interstate travel afterwards. Transactions took place at a desk in the main garage area. In a loft above the ground floor, PATB staff had installed digital audio-visual recording equipment and other computer equipment belonging to Tax and Finance. Of note, although the transactions were recorded, many of the purchasers and confidential informants spoke languages that PATB team members and other members of law enforcement agencies assisting in the operation did not understand.

In Pennsylvania, up to six cameras captured video during sales. Three cameras were installed that captured activity in the desk area, and another captured activity outside the garage; one camera focused on the loading area; and another camera focused on the cigarette storage area. However, no camera was directed towards the loft, where cash-handling activities occurred.¹⁶

Indeed, although Director Stanton and Assistant Director Paul Rossi testified that they assumed – without basis – that cameras captured all activity within the warehouse, many areas were not captured on the video recordings.¹⁷ Both also testified that only a small number of videoed transactions were reviewed by members of the PATB team. Thus, other than routine review by Tax and Finance's Internal Audit unit as part of the

¹⁶ At a certain point during Operation KG, PATB members ceased counting the cash at the transaction site, and instead placed the cash in evidence bags to be transported to New York City for counting.

¹⁷ The recordings were transferred to compact disks for permanent storage, and were stored by PATB in Tax and Finance's Albany office.

audit process, the video footage went essentially unwatched, and, as such, any anomalies were neither identified nor addressed.

As part of the instant investigation, the Inspector General reviewed numerous digital recordings and found significant problems with the recording procedures. A number of recordings started after the beginning of a transaction, some stopped before the end of transactions, and all ended before the proceeds were placed in evidence bags and sealed, thereby precluding review of the complete transaction. In a number of instances, the Inspector General found no recording whatsoever though investigative reports indicate that a recording was made. In other instances, investigative reports reflected that recordings were missing due to technical difficulties. It was anticipated that these investigative reports would be used in potential prosecutions.

In Pennsylvania, sales were arranged by a small number of confidential informants. The informants directed purchasers from the Westchester operation to Pennsylvania. As is common with confidential informants, one of the informants recruited for Operation Keystone had himself been engaged in the sale of contraband cigarettes. However, the Inspector General determined that on days when he was not engaged in PATB activities, the confidential informant continued to work at his own retail market. Of note, PATB sold him cigarettes tax-free from its inventory to sell in his market. Stanton testified that this arrangement helped maintain the appearance to PATB targets that the informant was engaged in illegal sales, and not assisting law enforcement. Stanton acknowledged in his sworn interview, however, that not only did the confidential informant receive the cigarettes tax-free, but also he was not required to return his profit

from selling the government-supplied contraband. Asked in his sworn interview why PATB did not recoup such profits, Stanton testified, “We didn’t even think of that.”

One or more PATB investigators acting in an undercover capacity were assigned to work as laborers for the confidential informants, and helped purchasers load cigarettes into their vehicles.¹⁸ PATB investigators involved in Operation Keystone testified that they maintained their service weapons within the bay area of the warehouse in a hidden location where they would be accessible if needed.

According to PATB undercover investigators and based upon the Inspector General’s review of video recordings, typical transactions involved a purchaser who would arrive with grocery bags or garbage bags filled with cash, most in small denominations. The confidential informant sometimes either performed a cursory review to ascertain that the cash presented roughly approximated the agreed upon amount, or counted the money in full, using a bill counter. However, PATB members reported that the bill counter often jammed making precise cash counting during the transaction difficult. After a purchaser left the warehouse, the garage door was closed.

A PATB Senior Investigator sat in the loft area during sales, usually unaccompanied. Later in the operation, an ATF agent also stationed himself in the loft during sales. While a ladder could be lowered to access the loft, during sales the ladder would be pulled up so that purchasers would think the loft was unoccupied. When the transaction was completed, either a confidential informant, or occasionally the undercover agents, handed the money to the Senior Investigator in the loft, who was

¹⁸ The Inspector General learned that PATB investigators acting in an undercover capacity as laborers often received cash tips from the cigarette traffickers for loading the cigarette into the vehicles. While Tax and Finance documents reflected the receipt of cash tips, it could not be verified that all tips received were documented.

responsible for taking the money out of the original bags and placing it in clear evidence bags that were then marked. From the time that the targets left the warehouse until the money was handed to the Senior Investigator in the loft, the audio-video recordings were turned off and the confidential informants and the undercover agents were left alone with the money. The Senior Investigator was also primarily responsible for completing an EN-651 – a form to document the types of cigarettes sold, the amounts of each type sold, and the total cost. He also documented sales data in separate investigative reports. However, the Senior Investigator related to the Inspector General that the data he inputted on the form – the number of cases sold and the total cost – was based wholly on information provided to him by the confidential informants.

Operations in Pennsylvania ended after a robbery incident in June 2009 (discussed below), after which PATB returned to Westchester County to continue sting operations, this time from a Yonkers warehouse. The Westchester County operation, which continued until September 17, 2009, ultimately resulted in the successful prosecution of more than 20 cigarette traffickers, notwithstanding the issues raised in this report.

In the summer of 2010, Tax and Finance ended PATB covert cigarette operations after, among other actions, a review of a newly opened PATB covert bank account sparked a broader examination of PATB, which identified systemic inadequate policies and procedures within those operations. Stanton, upset by the cessation of the cigarette sting operations he had initiated, divulged the information to the media, and was terminated by Tax and Finance as a result.¹⁹

¹⁹ John Crudele, “They’re butting heads in Albany over cig sting,” *NY Post*, July 8, 2010.

Subsequently, in September 2010, Tax and Finance's Internal Audit unit reported a deficit of over \$160,000 in cash proceeds from covert sale operations during Operation Keystone. The response from the Office of Tax Enforcement accompanying that Internal Audit report noted that these cash shortages created "a condition that too easily permits someone involved in the undercover operation to be the person engaging in the theft. . . . [P]ermitting ourselves to be shortchanged makes it difficult if not impossible to conclusively demonstrate otherwise."

Upon commencing this investigation, the Inspector General advised all prosecutorial agencies with cases pending based on undercover purchases from Operation Keystone about the allegations. Thereafter, related pending indictments in the United States District Court for the Eastern District of Pennsylvania for trafficking in contraband cigarettes that had been obtained as a result of PATB's sting operations were dismissed "in the interests of justice." The Westchester County District Attorney's Office conducted its own investigation regarding its pending cases.²⁰

ii. Cash Shortages in Operation Keystone

On September 20, 2010, Tax and Finance Internal Audit provided its findings and recommendations to the Office of Tax Enforcement regarding its review of covert operations documentation for the period that covered Operation Keystone which discovered approximately \$160,000 in missing cash. While the audit covered the

²⁰ Prior to the Inspector General's investigation, numerous defendants prosecuted by the Westchester County District Attorney's Office for the illegal purchase of cigarettes as depicted on audio-video recordings were convicted pursuant to guilty pleas. The District Attorney's Office advised the Inspector General that, upon learning of the investigation, the District Attorney's Office informed defense counsel of the Inspector General's ongoing investigation, but noted that the investigation did not impact the integrity of the recordings depicting the crimes for which their clients were charged. The District Attorney's Office

beginning of 2010, an examination of PATB's accounting records for the \$160,000 revealed the missing cash spanned from the end of October 2008 until mid-2010. Then Deputy Inspector General for Tax and Finance reported this information to the Inspector General.

The Inspector General's Office performed its own analysis of transactions in Operation Keystone to attempt to ascertain the reasons for the shortage of more than \$160,000 detected by Tax and Finance's Audit Unit, and to determine whether the audit had actually uncovered all discrepancies. Specifically, the Inspector General sought to determine whether the shortages were due to purchasers providing less than the stated amount or to pilfering by the members of the operation – either the confidential informants or the PATB investigators, or both. Relevant to this issue, during the pendency of this investigation, the Inspector General learned through a federal law enforcement source that an Operation Keystone confidential informant had alleged that the PATB Senior Investigator assigned to lead Keystone, had stolen money from the proceeds of cigarette transactions.

Accordingly, the Inspector General obtained records of bank accounts identified as the personal bank accounts used by the Senior Investigator to determine if cash was being deposited into the accounts. These records reflect that the Senior Investigator deposited approximately \$25,000 in cash into an account in a pattern of varying increments over an 11-month period during 2009; the majority of the deposits took place within two weeks following cigarette sale transactions in which cash was found to be missing; and, this pattern was not consistent with the previous and subsequent years'

has informed the Inspector General that defense counsel will be notified of the findings set forth in this report.

bank records, which reveal only minimal cash deposits, if any. The Inspector General then selected 184 undercover cigarette transactions that took place within approximately 14 days prior to certain cash deposits made by the Senior Investigator in his personal bank account. Nine additional sales were selected and examined based on other factors. In total, the Inspector General reviewed 193, or nearly 29 percent, of the sales.²¹ This analysis entailed a review of the audio-video recordings and PATB documentation of the aforementioned 193 transactions. As noted earlier, the Senior Investigator was responsible for preparing EN-651 forms – essentially a receipt for the cigarette products sold and their cost – and other PATB investigative reports that also included such sales data.

The Inspector General first reviewed approximately 250 hours of audio-video recordings and determined from the video, to the extent possible, the number of cases sold and the amount of money tendered for each transaction. The Inspector General then compared data from the EN-651 forms to sales data gleaned from audio-video recordings of Keystone transactions, which revealed several instances in which cash shortages did not appear to be the result of a customer tendering less than the required amount.

Significantly, of the nearly 200 sales transactions reviewed, the Inspector General identified 15 transactions in which the data from audio-video recording is inconsistent with the information on the EN-651 records created by the Senior Investigator in terms of the quantity of cigarettes sold and/or the amount paid for those cigarettes. In particular, in each of these instances, both the EN-651 and investigative forms report the number of

²¹ According to PATB's accounting data, Operation Keystone involved 671 undercover sales of approximately 471,928 cartons of cigarettes for \$16,975,578. During these sales, which took place on 18 different dates, over 143,000 cartons of cigarettes were sold for \$5,342,625 – both figures representing approximately 30 percent of Operation Keystone totals.

cases sold and/or the amount of cash paid as less than what the video of the transaction actually depicts.

For these 15 questionable transactions, PATB internal audit records reflect shortages of \$6,405 where the dollar amount of the bank deposit was less than the amount from the sales recorded on the EN-651. However, as Internal Audit reviewed video recordings of only eight transactions, it is unlikely that Internal Audit's examination included review of the video recordings reviewed by the Inspector General.²² The Inspector General's thorough review of the videos, as described above, identified an additional \$37,260 in cash shortages not accounted for by PATB, as follows:

Sale date	Invoice	Video	EN-651 data As reported by Senior Investigator	Amount Deposited In Bank by PATB	Shortage As determined by Inspector General	Shortage As determined by Internal Audit
2/12/2009	37737	24 cases - \$45,600	23 cases - \$44,160	\$42,279	1 case - \$3,321	\$1,881
4/9/2009	37642	29 cases - \$66,420	27 cases - \$62,220	\$60,492	2 cases - \$5,928	\$1,728
4/16/2009	37623	20 cases - \$46,800	19 cases - \$44,460 ²³	\$43,000	1 case - \$3,800	\$1,460
4/16/2009	37635	29 cases - \$60,480	26 cases - \$58,140	\$56,894	3 cases - \$3,586	\$1,246
6/25/2009	43733	18 cases - \$41,640	16 cases - \$37,440	\$37,480	2 cases - \$4,160	\$0
6/25/2009	43734	9 cases - \$21,060	8 cases - \$18,720	\$18,720	1 case - \$2,340	\$0
6/25/2009	43737	16 cases - \$36,540	16 cases - \$31,860	\$31,860	0 cases - \$4,680	\$0
6/25/2009	43742	11 cases - \$27,840	11 cases - \$25,500	\$25,500	0 cases - \$2,340	\$0
7/30/2009	43017	15.5 cases - \$33,720	14.5 cases - \$31,680	\$31,670	1 case - \$2,050	\$10
7/30/2009	43021	36 cases - \$73,440	34 cases - \$69,360	\$69,290	2 cases - \$4,150	\$70
7/30/2009	43022	3 cases - \$7,020	3.5 cases - \$6,780	\$6,770	0 cases - \$250	\$10
8/6/2009	43035	23 cases - \$51,880	22 cases - \$50,880	\$50,900	1 case - \$980	\$0
8/13/2009	43073	16 cases - \$37,140	15 cases - \$34,800	\$34,800	1 case - \$2,340	\$0
8/13/2009		1 case - \$2,340		\$0	1 case - \$2,340	\$0
8/27/2009	36027	7.5 cases - \$17,100	6.5 cases - \$14,760	\$15,700	1 case - \$1,400	\$0
Totals		258 cases - \$569,020	241.5 cases - \$530,760	\$525,355	17 cases - \$43,665	\$6,405

²² Internal Audit's September 20, 2010 report does not state the dates of the recordings it reviewed.

²³ The EN-651 completed by the Senior Investigator for this sale reflects 19 cases of cigarettes were sold for \$44,460. The Senior Investigator subsequently reported in an Investigative Report dated May 11, 2009, that 20 cases were sold for \$46,800, which matches the totals ascertained from the review of the sale video by the Inspector General.

As explained above, as compared with Internal Audit's review of video recordings of eight sales transactions, the Inspector General analyzed 193 transactions, or approximately 30 percent of the total transactions. This analysis revealed that in 15, or almost 8 percent, of the 193 transactions, there were what appeared to be deliberate inconsistencies between what was recorded by video and the information on the EN-651. Notably, these inconsistencies could not be detected by comparing the EN-651 paperwork to the deposits, the method employed by Tax and Finance Internal Audit. Rather, the significant shortages could only be identified by comparison to the video recordings.²⁴

Most of these shortages occurred in sales for which an EN-651 form was reported, and a transaction invoice number was generated. As the table above reflects, however, the Inspector General found a transaction on August 13, 2009, for which PATB assigned no invoice number. In reviewing transactions for August 13, 2009, and comparing them to documented sales, the Inspector General observed a customer purchase a case of cigarettes and tender payment in cash. However, PATB has no record of this sale and no corresponding deposit of cash.²⁵

The Inspector General also analyzed the personal bank accounts of 19 other PATB investigators and confidential informants involved in PATB undercover cigarette sting operations to determine whether others made personal cash deposits that coincided

²⁴ These inconsistencies were not divulged to the Westchester County District Attorney's Office until the Inspector General's investigation had been largely completed.

²⁵ Review of audio-video footage did not reveal the specific amount charged in this instance for the case of Newport cigarettes. PATB, however, typically charged customers \$2,340 per case. The Inspector General also found an additional eight sales in which the video footage is inconsistent with PATB records as to the amount of cigarettes being provided to a customer. However, for these sales, the Inspector General was unable to identify any potential cash shortages as it did for the above-referenced sales.

with the above-referenced cash shortages of between \$37,260 and \$43,665. Numerous such deposits were identified among this group which totaled more than \$26,000.

However, in the absence of any consistent correlation between these cash deposits and the cigarette transactions, it was difficult to link any of these deposits to the Operation Keystone cash shortages.

The Inspector General confronted the Senior Investigator about both the discrepancies in the amounts reported on the EN-651 forms and the amounts deposited in the bank, and the discrepancies between the cases sold as observed in the audio-video recordings and the amounts reported on the EN-651 forms. He claimed that the errors were due to the confidential informants misreporting the amounts to him and human error due to the speed with which these reports needed to be produced. When asked directly whether he ever misappropriated any cash from the covert sting operations, the Senior Investigator denied doing so. As to the significant cash deposits into bank accounts bearing his name, the Senior Investigator initially stated that he doesn't "have cash deposits. The [money] that [was alleged] I deposited in my bank account – I didn't. I don't have that kind of money. I never have. I never will." Upon being confronted with specific cash deposits and acknowledging his handwriting on the deposit slips, the Senior Investigator stated, "I couldn't begin to explain why – what else, you know, I had going on. I don't put a lot of cash in the bank. I would really be stretched [sic] to see \$20,000 in cash in the bank." The Senior Investigator then stated that he would check his bank statements. Although the Inspector General offered the Senior Investigator the opportunity to present any information about these cash deposits, he did not do so.

Based on the information reported herein, the Inspector General referred this matter to the Westchester County District Attorney. The Westchester County District Attorney's Office conducted its own investigation, which included, but was not limited to, reviewing audio-video recordings and financial records, and interviewing numerous witnesses. Among the witnesses interviewed were the two individuals who directly took possession of the cash in question: namely, the confidential informant and the Senior Investigator. The informant, who was a necessary witness to establishing the allegations against the Senior Investigator, told Westchester County District Attorney investigators that he took contemporaneous notes reflecting instances where a discrepancy existed between the amount of cigarette sales he transacted and the corresponding paperwork completed by the Senior Investigator. In an effort to assess the credibility and viability of the confidential informant as a witness, the District Attorney investigators questioned the informant as to whether he ever illegally took any money during this investigation; he denied doing so.²⁶ Notwithstanding that assertion, a review of certain audio-video recordings by a District Attorney investigator revealed that the informant appeared to have pocketed an undisclosed amount of cash. Armed with this information, the District Attorney investigator sought to confront the informant, only to learn that the informant had left the United States with his wife and children with one-way tickets overseas. The informant had also vacated his residence and business. Based on these circumstances, along with the inability to conclusively trace the cash deposits into the Senior Investigator's accounts to the undercover operation, the Westchester County District Attorney's Office closed the investigation due to insufficient evidence. It should also be

²⁶ The Westchester County District Attorney also raised concerns about the large sums of cash paid to the informants for their services and the effect such payments would have on their credibility at trial, a

noted that the Westchester County District Attorney's Office interviewed the Senior Investigator, who maintained that he did not steal any money from the operation. The Senior Investigator resigned from Tax and Finance.

iii. Unusual Incidents in Operation Keystone

In addition to the apparent thefts of the proceeds of cigarette transactions, other unusual incidents occurred during Operation Keystone.

a. Burglary of Warehouse During Operation Keystone

During the operation, transactions occurred on only one day per week. On those days, the general practice was to remove both the money and cigarettes immediately from the warehouse and transport them to New York. Contrary to this practice, at the end of a long day of undercover sales on March 26, 2009, the PATB team led by the Senior Investigator decided to leave two trucks loaded with approximately \$75,000 worth of cigarettes in the garage bay area overnight with the garage bay door locked. Surveillance cameras were not set to record any activity.

The next morning, the first PATB investigator to arrive at the warehouse found that the warehouse had been burglarized. The garage door had been pried open and padlocks on the trucks had been cut, apparently with bolt-cutters. An empty portable safe that had been stored in one of the rooms remained untouched in the main bay area.

Two PATB investigators took digital photos of the warehouse after the burglary, and a sketch was prepared of the location of the trucks and objects in the warehouse. Although both ATF and the Pennsylvania State Police, who were involved in the

deficiency of PATB operations that is discussed later in this report.

operation, were advised of the burglary, Stanton instructed one PATB supervisor not to report the burglary to the local police; the PATB supervisor surmised that PATB did not tell the local police about the operation in general and the burglary in particular because they “can’t stop talking.” In fact, no such report was made. This senior PATB member testified that this instance was the only time cigarettes were left in the Pennsylvania warehouse overnight.

b. Attempted Robbery of Purchasers

An incident that occurred during the summer of 2009 in Pennsylvania illustrates the potential danger of operations like Keystone, and the problem of PATB investigators engaging in such an operation without proper police or peace officer status. On June 25, 2009, during a day of sales, a regular customer alerted the PATB investigators acting in an undercover capacity in the Pennsylvania warehouse that a number of unidentified people in a car had been trying to rob, at gunpoint, purchasers waiting in the area of the warehouse.

The next day, June 26, 2009, the *Pocono Record* newspaper carried a front-page story with a photograph of the car stop initiated by PATB and members of the Pennsylvania State Police. The picture showed a PATB investigator near the car, with his gun out by his side, near the car carrying the alleged robbers.

The pictured investigator testified that he had been “backing up a Pennsylvania officer who was pulling over a female who was supposed to have a shotgun. You know, I’m backing him up. It’s a cop thing. I’m going to do it.” Though he lacked police officer status in Pennsylvania, he also acknowledged that, because others had their

weapons aimed at the alleged robbers, he “was the one who put cuffs on every single bad guy . . . There were four [bad guys].”

According to this investigator, once the PATB investigators were alerted to potentially dangerous criminal activity, “we jumped into the situation. We were being cops. We were trying to be cops. I mean, we were the ones who found the bad guys, but Pennsylvania [State Police] made the stops . . . We put them in custody with Pennsylvania State Police. Was it 100 percent right? No, but, I mean, I’m backing up an officer.”

Pointedly, this incident exemplifies the problems inherent in interstate interdiction of cigarette sales absent proper authority and cooperation from other state and federal agencies.

D. Deficiencies Regarding PATB Investigations

i. Lack of Supervision and Proper Chain of Command

In 2002, after arriving at the Department of Taxation and Finance, then Deputy Commissioner Peter Farrell and then Commissioner Arthur Roth both approved Stanton’s proposal to conduct proactive cigarette sale operations. Prior to Stanton, PATB had been led by Director Charles Mills, Jr., a career police officer and police chief who had worked in New York City and upstate New York before joining Tax and Finance. Mills created a policy and procedure manual for PATB based on an NYPD manual. During Stanton’s tenure, however, the controls instituted by Mills ceased to be followed. Deputy Director Paul Rossi, upon joining PATB in December 2003, tried to enforce the directives in the manual. According to Rossi, Stanton’s response was, “‘You gotta be kidding.’ – it just

wasn't happening.” Rossi related that he was thwarted in his attempts to address even the most basic administrative issues such as procedures for days off or gas receipts and more pressing fiscal issues such as overtime procedures and caps on overtime pay.

In addition, under Stanton, the chain of command typical of a law enforcement agency disappeared. Line investigators contacted Stanton directly with requests, bypassing supervisors who had otherwise declined such a request. For example, Operation Keystone was effectively directed by a Senior Investigator, even though two Supervising Investigators and a Chief Investigator were assigned. Moreover, for years, Tax and Finance executive management including Deputy Commissioner Farrell and Commissioner Roth relied on Stanton's reports of apparent investigative success and prosecutions, and failed to inquire sufficiently of Stanton as to the existence of professional law enforcement policies and procedures or, to the extent such policies existed, whether they were being followed.

Subsequent executive management, including Deputy Commissioner William Comiskey²⁷ and current Executive Deputy Commissioner Jamie Woodward²⁸ mistakenly also relied on historical information, and did not inquire of Stanton as to his investigative methods. For instance, Comiskey, who became Deputy Commissioner with responsibility for supervision over PATB in 2007, testified as to his perception of PATB's operations upon his arrival at Tax and Finance: “PATB had a string of success stories . . . and their investigators were, at least as far as I could tell, animated, focused, and directed.” By contrast, Comiskey explained, the Revenue Crimes Bureau, which investigated income tax and related crimes, lacked staff and training. Accordingly, he

²⁷ Comiskey retired from state service in September 2010.

focused his attentions on those issues and that bureau more than PATB. As a result of Comiskey's inattention, PATB continued to operate as an essentially independent bureau within Tax and Finance, subject to scant supervision and accountable only to itself.

In May 2008, Woodward became Executive Deputy Commissioner and oversaw Comiskey and other deputy commissioners; and, in June 2009, she assumed the position of Acting Commissioner of Tax and Finance. Nevertheless, she admitted to having little knowledge of PATB's covert sting operations. Woodward stated, however, that she assumed PATB's operations were being appropriately monitored by Deputy Commissioner Comiskey and that internal audits she knew to be occurring were a sufficient check on PATB's activities. Woodward acknowledged in her testimony that, at some point in or about 2009, she gained some understanding of issues regarding PATB "account reconciliation" raised by Internal Audit. Nevertheless, she admitted it was not until 2010, after a review of a newly opened PATB covert bank account sparked a broader examination of PATB, that she became aware of systemic inadequate policies and procedures within PATB's operations and terminated the operations. Woodward acknowledged responsibility for any issues arising from PATB operations, and testified, "[S]ome of the things that had gone on were unbeknownst to us at the time, I wish had not gone on."

ii. Improper Out-Of-State Use of Weapons

Tax and Finance criminal investigators are peace officers empowered with the authority to carry and use guns within New York State. As noted earlier in this report,

²⁸ Jamie Woodward has served as Executive Deputy Commissioner since 2008. From June 2009 to January 2011, she also served as Acting Commissioner of Tax and Finance.

however, many cigarette operations were conducted in other states. As such, PATB investigators who possess peace officer or police officer status within New York State were assigned to cigarette sting operations outside the state, where they had no authorized law enforcement status. Yet, in most instances, the investigators were not deputized by the federal agencies with whom they were working.²⁹ They therefore functioned as peace or police officers, absent the legal authority to do so.³⁰

Making matters worse, testimony revealed that some PATB investigators took it upon themselves to bring their own, personal semi-automatic rifles – for which they were not even formally trained or qualified to use in a New York operation – to the site of cigarette transactions out of state. Furthermore, the cigarette sting operations were conducted without sufficient regard for the safety of PATB staff or the potential for legal liability. Specifically, insufficient consideration was paid to the possibility of a violent confrontation with criminals. While some targets were armed with shotguns, PATB investigators were assigned only handguns which often were not on their person. As noted earlier, PATB investigators involved in Operation Keystone testified that they maintained their service weapons within the bay area of the warehouse in a hidden location where they would be accessible if needed. As such, the investigators placed themselves at risk.

When former Deputy Commissioner Comiskey, in his sworn interview before the Inspector General, was asked whether concerns arose about PATB peace officers

²⁹ Specifically, in Operation Keystone, none of the PATB investigators was deputized.

³⁰ The Tax and Finance Criminal Investigation Division manual provided to the Inspector General at the outset of this investigation did not address the issue of investigators carrying and/or using firearms out-of-state. A section in the manual entitled, “Code of Conduct,” only addressed the issue of carrying weapons generally: “No employee may carry a firearm or other deadly weapon (as defined in the New York State Penal Law, Section 10.00(12)) during the performance of departmental duties, or on departmental premises, except as specifically authorized by law and the Commissioner of Taxation and Finance.”

operating out-of-state, Comiskey responded that initially, little attention was paid to those concerns; however, the issue got a “fair degree of attention” when the sting operations were under review in 2010. He noted that “the thinking at the time” was that the operations were conducted in tandem with other federal and local law enforcement, and the U.S. Attorney was involved, and that was probably “good enough.” Comiskey admitted, however, that “in hindsight it [probably] wasn’t.”

Executive Deputy Commissioner Woodward acknowledged in her testimony before the Inspector General that there had been no discussion of PATB investigators working on potentially dangerous investigations out-of-state before Operation Keystone, the first major operation that took place after she became Executive Deputy Commissioner. She testified that she did not recall any such discussion until a wide-ranging review was conducted of PATB operations in 2010, when she was Acting Commissioner. Asked if she could recall any protocol regarding the status or powers of PATB investigators working out-of-state, Woodward testified, “I know I should know this, but I don’t.”

iii. **Improper Handling of Confidential Informants**

Confidential informants can be valuable for law enforcement operations as they permit infiltration of criminal enterprises through actual criminal connections. Law enforcement agencies use confidential informants and have protocols to register the informant and formalize the relationship. In fact, Tax and Finance policy required registration of informants by the agency. Notwithstanding this policy, from 2002 through 2010, PATB did not register its informants, but apparently instead relied on the

registration of informants by other agencies. This practice was known to and sanctioned by Tax and Finance executives. Indeed, when Stanton was asked in his sworn interview by the Inspector General whether informants were registered by PATB, he responded, “Not by us. They were all registered with somebody else.” Asked why they were not registered by PATB, Stanton replied, “We really didn’t have any procedure. And I looked at it as paperwork.”

Despite Stanton’s assertion, Tax and Finance criminal investigations policy and procedure manual did address “confidential informants,” defining them as individuals who “provide useful information concerning criminal activity with the expectation of confidentiality.” However, the manual did not cover many of the kinds of activities involved in PATB sting operations. To the extent the written procedures for informants did apply to those known as “confidential informants,” key procedures, in addition to the lack of registration of informants, were ignored.

For instance, one PATB confidential informant in Operation Keystone attended a family social event of the Senior Investigator, in contravention of Tax and Finance policy against “knowingly maintain[ing] a social relationship with a CI while off duty” In addition, the Senior Investigator admitted to accepting a gift of between 10 and 20 cases of baby formula that he testified normally cost between \$70.00 and \$80.00 per case from that same confidential informant.³¹ Under the ethical standards for state employees contained in the Public Officers Law, state employees are prohibited from accepting gifts of more than nominal value from those contracting with the state. Confidential

³¹ The Senior Investigator’s decision to accept this apparently improper gift raises an additional issue. As the Senior Investigator acknowledged in his testimony, at the time he offered to work with PATB, the informant had been questioned by law enforcement authorities about having trafficked in stolen baby formula, which is used to cut the concentration of powdered drugs such as cocaine by drug dealers.

informants are used to build criminal cases against targets, in the instant matter, criminal cases against cigarette traffickers. As such, throughout any criminal investigation, the confidential informant must be viewed as a key witness against the target or targets; and thus, maintaining the credibility of the confidential informant is essential. By violating both Tax and Finance policy and the Public Officers Law, the Senior Investigator compromised the credibility of a key confidential informant.

Moreover, in order to maintain the integrity of the investigation in anticipation of criminal charges, confidential informants are reimbursed for actual expenses but only rarely receive other payments. While paying informants for their services does occur, it is done sparingly because in a criminal prosecution such payments must be disclosed to the defense and can be used to undermine witness credibility. Nevertheless, Stanton chose to pay his confidential informants significant sums of money for their services in apparent disregard for the goal of the sting operations – criminal convictions. In fact, confidential informants involved in Operation Keystone and others were paid large sums of money for their cooperation. Indeed, while the use and payment of incentives to confidential informants was not unique to Operation Keystone, particularly large amounts were paid on this operation. Specifically, PATB informants were paid \$1.00 or \$2.00 per carton of cigarettes sold to traffickers, resulting in payments to individual informants of over \$500,000 in some cases. The two main informants of Operation Keystone were paid more than \$540,000 and more than \$140,000, respectively.³² The calculation of how much an informant was to be paid was based upon a PATB investigator – usually the Senior Investigator – tallying the number of cartons sold by the informant as memorialized on the EN-651 forms. As noted earlier, however, the Senior Investigator’s

sole source for the number of cartons sold were the confidential informants themselves. The auditor would then issue a check and provide it to the requesting investigator, who would in turn give the check to the informant signed by a Tax and Finance Deputy Commissioner.

While Stanton insisted that payment of these high commissions was “reasonable” for an informant who was potentially risking his life, he failed to recognize that PATB investigators were, themselves, potentially risking their lives but earning significantly less money.³³ Moreover, Stanton’s testimony reflects that he did not perform any sort of analysis as to whether considerably less money would have sufficed as incentive for these confidential informants.

Notably, confidential informants were paid with checks payable to “Cash.” Stanton claimed that paying informants in this manner was necessary in order to conceal their true identities; it is unclear why payment in the confidential informant’s name from one of PATB’s covert accounts would have jeopardized either the safety of the informant or the investigation itself. Ironically, the checks payable to cash from the Tax and Finance account created an opportunity for these informants to evade paying taxes.

iv. Inadequate Procedures for Handling Cash and Inventory
a. Poor Controls for Cash as Evidence

In the PATB undercover operations, most of the evidence obtained from the alleged traffickers was cash. In each PATB operation culminating in Operation

³² Another confidential informant was paid over \$400,000 for his activities in two operations.

³³ One PATB investigator described in his testimony an incident where a confidential informant, who had been paid hundreds of thousands of dollars, was bragging about his earnings and flaunting BMW pamphlets.

Keystone, cash shortages were found. Cash shortages were reported to Stanton, but he did not discuss the shortages with his supervisors. When Stanton's initial supervisor, Deputy Commissioner Peter Farrell, learned of the shortages, he assumed that any shortages were due to customers paying less than the bargained-for amount. Farrell, Stanton, and Deputy Director Paul Rossi all wrongly assumed that PATB investigators directly involved with the cigarette sales had confronted such customers when, in fact, the customers were allowed to continue to make purchases. In point of fact, testimony reveals that Stanton was not concerned with these cash shortages in particular nor with proper evidence handling protocol in general – controls intended to preserve integrity of the evidence.

Controls are essential to any law enforcement operation involving cash because any cash shortage that could not conclusively be shown to be connected to “shorting” by the purchaser would necessarily lead to suspicion as to anyone else involved in the process, namely the PATB confidential informants, PATB investigators, and other Tax and Finance staff who handled the cash during and after the sale. Rather than treat the cash – each individual bill – as evidence, PATB treated it as proceeds of a business transaction and deposited it in covert bank accounts.

One PATB investigator tasked with counting the cash testified that initially he did so using a counting machine when possible, watched by the purchaser. In Operation Phoenix, as in later operations, cash often came in denominations as small as one-dollar bills. One PATB investigator expressed concern about potential danger because “the bad guys were getting antsy because of all the time it took to count the money.” On occasion, the counting machine broke. For each purchase, a PATB investigator was responsible for

completing a report on an “EN-651” form that reflected the amount of cigarette product sold for each of a number of different varieties (e.g., menthol and regular, long and short), and the amount charged. Exemplifying PATB’s weak controls, only one investigator was required to complete and sign the form, without further review providing the opportunity for data entry mistakes or purposeful changes.

One PATB investigator was assigned to attend to the cash when PATB investigators brought it to New York, often late at night. That investigator, with assistance from others, would count the money in the New York City office and place it in bags for deposit. Daily proceeds totaled hundreds of thousands of dollars. The bagged cash was then placed in a large safe in the New York City office. A short time later, the investigator, accompanied by another armed PATB investigator, brought the cash to a bank where it was counted by a bank employee and deposited.

In addition, as noted earlier, on occasion, PATB recovered inventory and funds by engaging in “rips” in which PATB would contact the local police, who would then coordinate a pretextual car stop of a targeted purchaser, ask to search the vehicle, and seize the contraband cigarettes. These seized cigarettes were then returned to a PATB investigator; however, the recouped cigarettes, valued at tens of thousands of dollars, were at a minimum not properly accounted for, and even were vulnerable to theft.

b. Unaccounted-for Cash Turned in to Tax and Finance

On March 26, 2013, Tax and Finance informed the Inspector General that it had received a box in the mail that contained \$292.00 and a note stating that the money

belonged to the Criminal Investigation Division, was from the PATB covert bank account, and had been “used for ‘show buy money[.]’”

Video footage obtained from the post office where the package had been mailed revealed that a retired Tax and Finance employee had mailed the package. The retired employee held multiple responsibilities during his tenure with Tax and Finance, including attending to the receipt of the evidence bags of cash at the end of a day of sting operations, and storage of that cash in a safe.

When initially questioned by Inspector General’s investigators shortly after his identification was revealed, the retired employee claimed that some Tax and Finance employees had given him the money to return, and that he had agreed to do so. In his testimony before the Inspector General, however, the retired employee retracted that explanation. Instead, he testified that he had found the cash while cleaning his apartment. Specifically, he explained that he had found the cash in a pocket of a Tax and Finance “raid” jacket he had used and taken home as a souvenir when he retired.³⁴ The retired employee claimed to the Inspector General that he did not know why the cash was in the pocket of the jacket. He speculated, however, that although Tax and Finance procedure requires money from sting operations to be packaged in plastic bags before transportation, an investigator might have handed him the cash during the final day of a Bronx operation, though he had no recollection of that having actually happened. Tax

³⁴ “Raid” jackets are used during operations to assure proper identification of law enforcement and are generally emblazoned with the name of the law enforcement agency. The retired employee testified that he obtained the jacket after new jackets were ordered. Because the lettering had peeled off the old jackets of PATB staff who regularly wore them, the jackets were no longer used in raids. According to the retired employee, he never participated in any raids, but wore the jacket, albeit rarely, so he could stay warm and be easily identified when he would meet colleagues who were bringing evidence to the lobby of Tax and Finance’s building.

and Finance has not been able to attribute the funds to a particular transaction or operation.

v. **Inadequate Internal Audits**

Tax and Finance's Bureau of Internal Audit and Quality Control (Internal Audit) was responsible for auditing the covert accounts used by PATB and PATB's cigarette sting activities; this review process, however, was flawed. Audits took months, and the auditors analyzed transactions from an almost purely financial perspective, rather than a law enforcement operations perspective. Assigned auditors did not view unaccounted-for cash in the undercover cigarette deals as stolen or missing evidence; rather, the cash proceeds were analyzed as those of an ongoing business in which cash shortfalls were referred to as "accounts receivable."

Moreover, while Internal Audit had the opportunity to audit individual transactions to compare whether the amount of money received by PATB in a given transaction equaled the amount of cigarettes purchased at a certain price, it made only a limited attempt to do so, and did not raise significant concerns about the inability to perform a thorough audit. To the extent that analysis of eight audio-video recordings was attempted, Internal Audit's reports complained of multiple problems that hampered the ability to review the recordings. While some of these problems – background noise, accents and dialects, and camera angles – were real, and should have been addressed, Internal Audit provided no reason it did not compare the actual sale price from the audio-video (a primary source), to the form completed by PATB, (a secondary source) as the

Inspector General did. Instead, Internal Audit relied solely on data from the form completed by PATB.

Audit activities began in August 2002, at the outset of Operation Phoenix. Internal Audit provided its first review memorandum in September 2004. The report focused almost entirely on internal financial controls, not controls for evidence. A cautionary note in the memo should have raised concerns that law enforcement best practices were not being followed, and could not be followed:

[B]ecause of the nature of the covert operations, we cannot attest to the accuracy of the sales and purchases made with cash. The nature of covert transactions do not [sic] allow an auditor to confirm the amount of sales and purchases made with cash. However, no information has come to our attention that leads us to believe that the financial statements are not accurate and complete.

Nevertheless, the continuation of the “reverse buy” operations for several years reflects that no one in Tax and Finance recognized, let alone sought to remedy, the operations’ inherent flaws.

The memorandum noted a number of accounting deficiencies and made recommendations to address them: the accounting and cashiering functions be separated “as soon as qualified and available staff can be found”; canceled checks for all the covert bank accounts be obtained for review; and the expenses incurred for “buy and bust” operations not be paid from covert accounts.

Regarding Operations Genesis and G-2, in May 2005, Internal Audit issued a memorandum of its continued review of the PATB covert operations. While one of the main goals of the report was to “establish accountability for the covert account funds,” the memorandum again cautioned that Internal Audit’s

ability to establish accountability for cash transactions is limited. Our audit includes the review of documentation to corroborate the value of the sale or purchase. However, in most instances the corroborating documentation was created by the investigator who was directly involved in the transaction.

Indeed, Internal Audit provided relatively early warnings that more accountability was necessary. Accounts receivable were listed in financial statements as ranging from \$5,040 on December 23, 2003, to \$13,339 on June 30, 2004, to a negative receivable of \$409 on December 31, 2004.

Internal Audit issued another review memorandum in October 2006 covering the period from January 1, 2005, through August 18, 2006, including, but not limited to, Operations Genesis and G-2. In an e-mail to Office of Tax Enforcement Deputy Commissioner Peter Farrell accompanying that memorandum, the Internal Audit Director expressed serious concern about PATB's operations:

I am sorry to say that things are not well with this aspect of your operation. There are signs of significant deterioration in the controls over this operation; unaccounted for cash, unrecorded sales/revenues, acceptance of checks for payment and most of all the lack of [the covert account administrator's] time to attend to the administration of these funds.

The memorandum documented the expansion of sting operations into areas including cigars and alcohol and noted, without labeling them as such, methods that fell far below any standard of best law enforcement practices:

On some occasions OTE entrusted an intermediary who was not a Department employee and was a target in a previous investigation, to conduct business with the target individuals. Transactions were conducted without OTE investigators present, thereby depriving OTE investigators of first hand [sic] knowledge of the terms of the purchase/sale. Our concern is the intermediary could have

skimmed revenue and/or product off the sale or purchase without the knowledge of OTE.

Specifically, Internal Audit found that because the original auditor had been assigned to an investigation, his functions – already noted to be inappropriately combined as cashier and auditor – were being covered by other staff. As a result, multiple accounting issues arose, including funds that could not be accounted for, inadequate documentation, and basic bookkeeping errors.

As of August 18, 2006, financial statements noted accounts receivable of \$12,840, which included “underpayments” of \$25,099 and “overpayments” of \$12,259. No explanation was provided for this terminology. Similarly, an audit conducted regarding Operation KG noted an accounts receivable of \$4,265.

On September 20, 2010, Internal Audit provided its findings and recommendations to the Office of Tax Enforcement regarding its review of covert operations documentation for the period that included Operation Keystone.³⁵ The first issue discussed was Internal Audit’s review of a sample of video recordings of transactions. The report noted that the recordings provided “a general understanding of the sales process. However, they did not provide us with the exact quantity of the cigarettes sold or the exact amount of money exchanged during the sale.” Three reasons were provided: background noise, inability to hear sale details due to accents and low speaking volume, and camera angle. Internal Audit recommended that the confidential informant “re-cap on the recording” the sale details; however, the Office of Tax Enforcement responded that such an approach would be inappropriate, and that the

proper place for such data was on an investigative report. Both Internal Audit and the Office of Tax Enforcement, however, failed to recognize that such reports could themselves be manipulated to disguise a theft of cash from the proceeds of a transaction, and that the videos could provide a method to review any such misappropriation of funds.

The second major issue raised by Internal Audit was the discovery of approximately \$160,000 in “accounts receivable.” Internal Audit’s non-law enforcement approach to auditing was highlighted in its failure to recognize that this missing money represented a tremendous lapse in PATB’s ability to establish chain of custody of evidence. Internal Audit, using business accounting terminology, noted that most of the “accounts receivables” were “more than 90 days old.” Internal Audit then naively recommended that the Office of Tax Enforcement “make every effort to collect on its receivables. If it determines that certain customer accounts are uncollectible, it should have the Account Administrator write-off [sic] the receivable balance to bad debts.”

The Office of Tax Enforcement correctly recognized – albeit far too late – that “the problem is much more serious than portrayed in this report[,]” and noted, “This is not a case where credit is extended and the customer is expected to pay in the future.” The Office of Tax Enforcement urged verification of “all money received before parting with product” with a money counter or, if not feasible, to at least take corrective action as soon as possible after a shortage is found. The Office of Tax Enforcement also noted that a customer had underpaid on several transactions, and commented pointedly:

No rational business would permit that to happen more than once without demanding and obtaining recompense before engaging in further business. Failure to act as others would

³⁵ While this audit period (January-March 2010) was after the conclusion of Operation Keystone, Internal Audit’s reported accounts receivable balance for the audit period was actually a carryover balance primarily attributable to that operation.

threatens the credibility of the undercover operation. Moreover, the under-receipt of cash on a repeated basis . . . and the absence of attempts in transaction after transaction to rectify the situation costs the State a great deal of money and creates a condition that too easily permits someone involved in the undercover operation to be the person engaging in the theft. While . . . management has no reason to believe this to be the case, permitting ourselves to be shortchanged makes it difficult if not impossible to conclusively demonstrate otherwise.

By the time Internal Audit's findings and the Office of Tax Enforcement responses were reported, including the painful acknowledgement that PATB investigators could themselves be suspect, the sting operations had ended.

FINDINGS AND RECOMMENDATIONS

The Inspector General found that from 2002 until mid-2010, PATB former Director Thomas Stanton ran a multi-million dollar cigarette interdiction operation absent basic investigative protocols and controls. These deficiencies included inadequate policies and procedures for handling millions of dollars of cash as evidence; cash shortages; unregistered confidential informants who were paid hundreds of thousands of dollars; failure to track inventory; and PATB investigators operating out-of-state without proper authority. PATB's neglect of basic investigative protocols eventually led to dismissed prosecutions and the halting of the sting operations.

In addition, Tax and Finance management disregarded their mandate and permitted Stanton to operate absent rules and appropriate supervision. While Internal Audit was deficient in certain areas of the audits, since 2004, the reports highlighted problems regarding internal controls that should have been addressed at the time. It was

not until 2010 when PATB opened a bank account without appropriate internal approval that Tax and Finance began to scrutinize PATB's operations. Indeed, top Tax and Finance executives who purportedly supervised Stanton and oversaw PATB knew very little of the operations, were unaware that the investigators were operating out-of-state absent proper authority, and accepted Stanton's explanation that any cash shortages were wholly attributed to the targets.

Although Tax and Finance terminated PATB's proactive cigarette interdiction operations in the summer of 2010, the agency continues to engage in other criminal investigations. Internal Controls and rigorous investigative protocols are vital to criminal investigations because they not only protect the integrity of the investigation, but also the physical safety of the investigators, confidential informants, and the public at large. Accordingly, while acknowledging that Tax and Finance has already taken steps to address some of the issues raised in this report, the Inspector General recommends that Tax and Finance formulate rigorous law enforcement protocols, review and update its policy manual, train its investigators in those protocols, and insist on their adherence. The Inspector General further recommends that Tax and Finance establish appropriate protocols and procedures for out-of-state investigative activity consistent with applicable laws. In addition, the Inspector General recommends that Tax and Finance review the conduct of those former-PATB members still employed with the agency and take appropriate action. Consistent with standard practice, the Inspector General provided a preliminary copy of this report to Tax and Finance for review and response. The following summarizes Tax and Finance's response.

RESPONSE BY TAX AND FINANCE

Tax and Finance Commissioner Thomas H. Mattox responded to this report. As noted in the report, upon discovery of the issues detailed herein, Tax and Finance ceased all covert sting operations and closed all associated covert bank accounts. Tax and Finance then engaged law enforcement experts for counsel as to the necessary ameliorative measures to be taken. The measures include:

- Members of the management team employed during the period of the operations examined by the Inspector General either voluntarily left the agency or were relieved of their duties. Tax and Finance hired executive management to oversee operations, including a Deputy Commissioner for Criminal Enforcement and a Director of Investigations. Tax and Finance has stated that it will review the evidence against current personnel implicated in this report and determine the viability of pursuing disciplinary action, including termination.
- As early as January 2011, criminal investigators were instructed on standards of conduct, and the potential disciplinary actions if policies were violated. Investigators are now required to document their daily activities in diaries and in Tax and Finance's case tracking system; overtime is strictly monitored; the role of supervisor has been clearly defined; and the Director of Investigations has become more involved in case reviews and the execution of search warrants and arrests.
- In 2011, Tax and Finance instituted new policies and procedures regarding Confidential Informant registration, tracking, payment authorization, and

required acknowledgement of payment taxability as income payments as income.

- A new bar coding software system has been procured to improve the management of all evidence.
- On July 15, 2011, Tax and Finance and the New York State Police entered into a Memorandum of Understanding by which the two agencies agreed to coordinate their efforts to promote common goals concerning the enforcement of the New York State tobacco tax laws.
- In February 2012, the New York State Police facilitated a three-day training program for Tax and Finance criminal investigators on undercover operations, which included the management of confidential informants, operational planning and warrant execution, New York State trans-border issues, and the legal issues encountered in conducting undercover operations.
- In April 2013, Tax and Finance expanded its partnership with the New York State Police by utilizing senior police officers to further leverage joint resources as well as improve information sharing among federal, state and local law enforcement agencies.
- To date, Tax and Finance had consolidated regional criminal division offices, and plans to engage in further consolidation. Specifically, Tax and Finance has concluded that a reduced number of regional offices across the state will create a better alignment of its organizational structure, which should more efficiently deploy and leverage its most effective supervisors and personnel.

- Tax and Finance anticipates a redesign of the supervisory structure of the criminal division. Tax and Finance reiterated its commitment to ensuring that all employees act pursuant to the highest ethical standards.