News & Events

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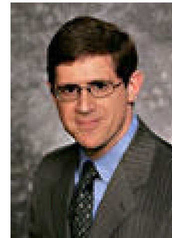
When Fraud Happens to You: Evaluating Your Options & Best Chances for Recovery

Jeffrey G. Weil and *Aaron Krauss*


Aaron Krauss

Recently, the scariest part of each day is opening the morning newspaper and seeing what new fraud has made the headlines. Bernard Madoff and his hedge fund. Joseph Forte and his investment fund. Jack Bennett and New Era Philanthropy. John Rigas and Adelphia. Hopefully, the article under the headline won't mention you or your clients. But sometimes it does.

We all try to protect ourselves and our clients from fraud. We maintain internal controls. We employ checks and balances. We check references and do background research. We hire auditors. We buy insurance. Sometimes, despite all of our efforts, we still become victims. What then? [1]

Jeff Weil

The first thing to do is quantify your damages and determine how the fraud took place. Quantifying your damages can be as easy as reviewing bank statements or digging out records of an investment's purchase price. In other cases, it can require a forensic accountant to review records, match transactions, calculate lost profits, and determine tax implications. Quantifying your damages is critical not only because you will need to perform a cost-benefit analysis before you try to recover your losses (the only thing worse than being the victim of fraud is throwing the proverbial good money after bad through ineffective or inefficient attempts to recover), but because you can often deduct your losses on your tax return. While this is certainly not the type of deduction you want, what could amount to an immediate, cost-free, 33% recovery is certainly better than no recovery at all. Determining how the fraud took place, at least in a general sense, is necessary to determine the likely targets for recovery and the potential theories to recover against those targets. Understanding the way the fraud took place is also likely to lead to an understanding of whether there are other victims. If there are many victims of a fraud, it may be beneficial to pool recovery efforts, either through a formal class action, or the joint retention of counsel. At the very least, you have to balance the risk of duplicating recovery efforts against the very real risk that there will be insufficient assets to recover. Absent a bankruptcy filing, [2] first in time is first in right. This is why fraud headlines often provoke a race to the courthouse.

I. Likely Targets For The Recovery Of Fraud Losses, And Potential Claims Against Those Targets.

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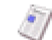 SIGN UP FOR FORENSIC INSIGHT, OUR NEWSLETTER.

Frauds can generally be divided into three types. First, there are outright thefts. Someone (such as a trusted bookkeeper or assistant) either steals outright or uses his or her position (as a trustee or power of attorney) to steal. Second, there are misrepresentations. Someone lies about the value or potential return of an investment. Third, there are Ponzi schemes. Someone recruits new investors and uses their money to pay old investors. These different types of frauds present different targets for recovery.

A. Likely Targets And Potential Claims When The Fraud Is A Theft.

Likely targets for the recovery of theft losses include insurers, guarantee funds, and the wrongdoer. It may also be possible to recover against banks, if the fraud involved checks or credit cards, or against "watchdogs that didn't bark," if there were any.

1. Potential Claims Against Insurers.

Theft is a classic insurable loss. All insurance polices, however, have both limits and exclusions. A $1 million policy is of only marginal comfort when facing a $10 million loss. That comfort may be reduced even further if the policy has an applicable sub-limit or exclusion. For example, many homeowner's policies limit coverage for the theft of cash, securities or "valuable articles" that are not specifically listed on the policy. They also often disclaim coverage for business losses. As a result, while an insurance policy is often the first place to look for a recovery, it is rarely the last. If an insurance policy pays all or part of a loss, the insurance company will be subrogated to any claims the insured has arising out of the loss. This right of subrogation allows the insurance company to "stand in the shoes" of the insured and attempt to recover the payments it made. If the insurance company only paid part of the loss (if, for example, the loss was subject to a deductible or exceeded the coverage limits), state law usually specifies the way in which the insured and the insurer will share any recovery. [3]

2. Potential Claims Against Guarantee Funds.

Some investment advisors are bonded, or are covered by the Securities Investor Protection Corporation. The SIPC provides up to $500,000 in coverage to investors whose brokers steal securities from them. [4] This coverage is only available to direct investors; it will not aid someone who invested through a broker who in turn placed investment funds with someone who turned out to be a thief. Coverage is also restricted to investments that are registered with the SEC. Investments in limited partnerships, commodities futures, and currency options are not covered. Finally, the SIPC imposes strict deadlines on when claims can be brought, and late claims are disallowed even if they have merit.

3. Potential Claims Against The Wrongdoer.

The wrongdoer is the obvious recovery target. Unfortunately, thieves and con artists rarely hold on to their ill-gotten gains. Instead, those gains are often used for "lifestyle enhancement," or are used to feed a drug or gambling addiction. Whatever assets remain are often held in joint name, [5] or are impossible to locate. [6] As a result, it is often extremely difficult to recover substantial sums from the wrongdoer.

4. Potential Claims Against Banks.

If a fraud involves either checks or credit cards, it may be possible

to shift most, if not all, of the loss to a bank. The longer the fraud persists without discovery, the less likely a bank is to be liable. As a general rule, if a bank is not notified of a fraud before the next statement cycle, the bank will have powerful defenses against any claim. Many forged check claims are subject to a one-year statute of repose. Speedy discovery of a fraud is therefore essential to any attempt to shift the loss to a bank.

5. Potential Claims Against Watchdogs.

If there were any literal (i.e., security guards or alarm companies) or metaphorical (i.e., accountants, trustees or lawyers) watchdogs, they may be subject to claims. Most security companies, however, include strict limitation of liability clauses in their contracts. Accountants' audit opinions (if there was an audit) explicitly disclaim the ability to detect fraud. While trustees and lawyers can be liable for giving bad advice, there has to have been a reason for them to think that the advice was faulty when it was given. As a result, it is difficult to recover substantial sums from watchdogs that did not prevent a theft. Watchdogs may, however, have substantial sums from which a recovery could be made, so potential claims must be carefully analyzed.

B. Likely Targets And Potential Claims When The Fraud Involves Misrepresentations.

While misrepresentation claims often present the same potential targets of recovery as theft claims, the claims against those targets, and more importantly the strength of those claims, change dramatically. It is often more difficult to recover against insurers, guarantee funds and banks. It may be at least marginally easier to recover against watchdogs, and there may be the possibility to recover against aiders and abettors. Although claims against the wrongdoer may be the same, the likelihood of recovery may increase.

1. Potential Claims Against Insurers.

While it is possible that a misrepresentation will trigger insurance coverage, it is much less likely to do so than an outright theft. Not only are misrepresentations likely to be "soft" or "indefinite," they are often related to contracts or business opportunities. Insurance generally protects property, not profits. Insurance policies are therefore an unlikely target for recovery of misrepresentation losses.

2. Potential Claims Against Guarantee Funds.

Guarantee funds and bonds, in contrast, may respond to misrepresentation claims. The SIPC, for example, will provide coverage for "pump and dump" claims. The likelihood of success in recovering from a guarantee fund will therefore depend on the exact nature of the misrepresentation. A careful investigation may reveal facts that will allow a covered claim to be presented. Because guarantee funds exist to pay claims, this is one of the most likely avenues of recovery to be both productive and cost-justified.

3. Potential Claims Against The Wrongdoer.

A wrongdoer who has made misrepresentations is at least marginally more likely to have assets than one who has resorted to outright thefts. This is because misrepresentations often start "around the edges," and only over time change from "puffing" to outright lies. It is also possible that a wrongdoer who resorts to misrepresentations in one area will have successful businesses in

another area. [7] Even if the wrongdoer has assets, however, those assets are often held in joint name, or are subject to bankruptcy "homestead" exceptions. As a result, one must guard against spending more pursuing claims against the wrongdoer than one is likely to recover.

4. Potential Claims Against Banks.

A misrepresentation claim is unlikely to give rise to claims against banks because banks generally do not inquire into the reason for any given transaction. One notable exception is that banks can be liable for a fiduciary's withdrawal and misappropriation of trust assets.

5. Potential Claims Against Watchdogs.

Accountants are often the major targets for recovery in the wake of a major misrepresentation. The purpose of an audit, after all, is to give reasonable assurance that the financial statements represent the financial condition of the company in all material respects. A defrauded party, however, was rarely the person to hire the accountant. Most states severely restrict claims against accountants by those lacking privity. If privity is not a precondition for bringing suit, the accountants' main defenses [8] on the merits usually revolve around their "reasonable" efforts and whether the error they did not detect was "material." Accountants can also defend against claims by arguing that the company being audited knew of the wrongdoing, was "in pari delicto" with the wrongdoer, or that the actions of the wrongdoer should be imputed to the company. The advantage of pursuing accountants is that they usually have assets to satisfy a judgment. Even so, a judgment against an accountant is difficult to obtain. Additionally, because accountants are often the only "deep pocket" within reach when a major fraud is discovered, they are experienced in defending against claims, and they do so vigorously. As a result, claims against accountants may not be cost-justified.

6. Potential Claims Against Aiders And Abettors.

The larger the fraud, the less likely that it was to have been accomplished by one person. Although the Supreme Court has severely limited "aiding and abetting" claims under the securities laws, [9] the laws of some states impose aiding and abetting liability on people who substantially contribute to a fraud or a breach of fiduciary duty. The RICO and conspiracy laws also impose liability on those who assist in committing a fraud. The advantage of claims against aiders and abettors is that they can reach potential deep pockets – or at least more pockets who collectively may have sufficient resources to pay the claim. If nothing else, additional parties are likely to have additional insurance policies, all of which might respond to a claim. The downside, however, is that the further one goes from the "core" of the fraud, the less likely one is to recover. Claims against aiders and abettors must therefore be brought carefully. If the "circle" is drawn too narrowly, there will be insufficient assets to respond to the claim. If, on the other hand, the circle is drawn too broadly, the claim becomes unwieldy, and the likelihood of success diminishes. It is therefore important to resist the temptation to sue everyone under the theory that they will all "pass the hat" and contribute to a settlement. In reality, the additional "contribution" from suing such defendants is often outweighed by the increased costs of pursuing the claim.

C. Likely Targets And Potential Claims When The Fraud Is A Ponzi Scheme.

A Ponzi scheme is essentially a series of misrepresentations. The

schemer falsely promises a return to "investors." Rather than actually making money for the investors, the schemer uses a portion of the "investment money" to pay "returns" to investors. If the schemer only "doled out" the initial investment to the initial investors as a false return, the only damages would be lost opportunity cost. The investor would have recovered his "investment," albeit with no return. In reality, Ponzi schemes gather steam. The initial investors tell their friends and family about the great returns they are getting, and others clamor to invest. The schemer encourages new investments, and touts past returns. Early investors may even serve as unwitting references to later investors. Early investors often make a large profit, because their "returns" are being paid by large numbers of later investors, many of whom are investing larger and larger sums. As in legitimate investments, it is best to get in on the ground floor. Eventually, all Ponzi schemes collapse. They do so for two reasons. First, mathematically, ever increasing numbers of investors are required to continue to pay the promised returns to early investors. When there are not enough new investors to pay returns, the scheme collapses. Second, not all of the new investment money is used to pay returns to prior investors. Invariably, some of the money is skimmed off by the schemer. This hastens the collapse of the scheme. Because a Ponzi scheme is nothing more than a series of misrepresentations, the potential targets for recovery are the same as for any other misrepresentation scheme. There is, however, one additional source of potential recovery – the early investors. A bankruptcy trustee can recover "preferences" paid to anyone who did not give "new value" within the 90 days prior to bankruptcy. A trustee can pursue preferences paid to "insiders" [10] within a year prior to bankruptcy. These preference avoidance powers allow a bankruptcy trustee to redistribute the moneys paid out by the schemer. Importantly, there is no need for a bankruptcy trustee to show that either the person making, or the person receiving, the preference payment had any ill intent. All that is necessary is to show that the payment was made, and that it was not made in exchange for "new value." [11] If a bankruptcy trustee – or more importantly any other creditor – can show that the transfers were either made with the intent to defraud other creditors or were made at a time when the schemer was insolvent, [12] they can bring a fraudulent transfer claim. The time for bringing fraudulent transfer claims varies, and can range from two years under the Bankruptcy Code to six years in states such as New York. [13] It may, therefore, be possible to recover many of the payments made to early investors. Early investors may, however, be able to use a "received in good faith" defense if they had no reason to suspect that the monies they received were anything other than legitimate investment returns. If, however, the returns were "too good to be true," a subsequent investor may be able to compel an early investor to disgorge any "profits."

II. At The Very Least, Deduct It.

Fraud losses are usually deductible from federal taxes. Whether the loss is an ordinary income deduction or a capital loss depends on the facts of the case. Both types of losses are subject to limits. Ordinary losses are usually deductible up to the amount of gross income. Capital losses can usually be deducted up to the amount of capital gains, plus $3,000. Deductions are also limited by the potential for recovery, even if the potential for recovery is uncertain. Losses that cannot be fully deducted in one year can often be carried forward into future years. It may also be possible to amend returns in prior years to deduct losses that are now known to have occurred in that year. [14]

III. Conclusion.

No one wants to be a victim of fraud. Sometimes, despite all of our best efforts, we are. While it is extremely difficult to recover all of a fraud loss, it is often possible, with diligence, to recover some of it.

About the Authors

Jeffrey G. Weil is the chair of, and Aaron Krauss is a member of, Cozen O'Connor's Commercial Litigation Department. Both practice in Cozen O'Connor's Philadelphia office and handle a wide range of commercial trials. Cozen O'Connor is a law firm, with more than 500 lawyers practicing in more than 22 offices in the U.S., U. K. and Canada. It is ranked as one of the largest firms in the United States.

[1] We cannot (and are not trying to) give legal or tax advice in this article. In order to do so, we would have to meet with you and discuss the particular facts and circumstances of your case, which may result in your particular case having a different probable outcome than most other cases. Naturally, we would be happy to meet with you and give you legal advice. After all, we are lawyers. Although every case is unique, we have tried in this article to discuss some of the events and outcomes that are likely to come up in many different cases. While we doubt that many cases will include all of these issues, we believe that many will include some combination of these issues.

[2] The bankruptcy code divides creditors into different classes, and establishes the order in which different classes of creditors recover. A class of creditors cannot recover anything from a bankruptcy estate until all of the claims of creditors with higher priority have been paid in full. All members of a particular class of creditors recover pro rata – often the proverbial ten cents on the dollar. While ten cents on the dollar may not seem like much of a recovery, under the bankruptcy code all members of the class would recover ten cents on the dollar. Absent a bankruptcy filing, some members of a class of creditors might recover 100%, while others might recover nothing.

[3] These laws vary from state to state. Generally, however, the laws fall into three categories. In some states the insured must be "made whole" before the insurer can recover anything. In others, the insured recovers its payment first. Lastly, in some states the insured and insurer share any recovery pro-rata.

[4]Some brokers have purchased excess coverage through the Customer Asset Protection Company. Obviously, a thief will not buy excess coverage. An otherwise reputable firm who innocently employs a thief might.

[5] Jointly held assets – such as a house – must be partitioned before being used to pay the debts of one of the owners. Many states will not force a non-debtor spouse to relinquish their interest in a jointly owned home. Creditors must therefore content themselves with a judgment that will be paid when and if the home is ever sold. Additionally some states – notably Texas and Florida – shield large amounts of assets (especially homes) from creditors.

[6] Although Swiss banking laws are not as protective of their depositors as they once were, it is difficult to trace or recover offshore assets, or assets that have literally been buried in someone's backyard.

[7]Someone with successful businesses in any area is unlikely to steal from third parties. They are instead likely to shift assets from one enterprise to another in order to prop up failing ventures.

[8] This assumes that there was an audit. Accountants often provide services, such as reviews, compilations and agreed upon procedures, that involve less investigation and testing than an audit. It is extremely difficult to show that an accountant who did not perform an audit breached a duty to discover misrepresentations.

[9] See Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768 (2008).

[10] "Insiders" can be loosely thought of as "friends and family."

[11] An example of "new value" is when a supplier gets "cash on delivery" for new merchandise. Such payments are not avoidable. Similarly, payments in the ordinary course of business – for example invoices paid within thirty days – do not give rise to preferences. A preference exists (for example) when the bankrupt pays off old invoices to favored suppliers shortly before bankruptcy.

[12] Fraudulent transfers can occur when the transferor is (or becomes as a result of the transfer) insolvent, when the transferor is (or believes it is) incurring debts that it will not be able to pay when they become due, or when the transfer leaves the transferor with unreasonably small capital to engage in its business.

[13] It may also be possible to toll the applicable statute of limitations, especially if the fraud was concealed.

[14] As with so many other things, you need to consult your own tax advisor to determine what is deductible, and when you can take the deduction.

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