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CAN FINANCIAL SERVICES COMPANIES BE LIABLE FOR THIRD-PARTY FRAUD?

The United States Court of Appeals for the Fifth Circuit Says...Maybe

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Financial services companies, such as investment companies, banks, and brokers, must be alert to potential red flags arising from their customers' transactions or risk being potentially liable for fraud committed by third parties. The United States Court of Appeals for the Fifth Circuit ruled that New York law confers a duty on investment companies, banks, and brokers to ensure that the customer transactions they process are properly authorized.[1] In a matter of first impression, the court held that subaccount holders are entitled to the protections afforded to traditional bank customers under New York tort law. If financial services companies fail to investigate suspicious activity, they are potentially liable for fraud committed by third parties.

Receivers for several insurance companies, which had been looted and rendered insolvent, initiated the case. The insurance companies were victims of a fraud perpetrated by former financier Martin Frankel, who is serving a 17-year sentence in federal prison for his wrongdoing. Frankel funneled the insurance companies' money into his own Swiss bank accounts via investment accounts at Dreyfus Service Corporation.

Frankel initiated his scheme by purchasing a registered broker-dealer firm called Liberty National Securities, Inc., in which he positioned his co-conspirators in key management positions. He persuaded the insurance companies to use Liberty as their broker. Using the alias "Eric Stevens," Frankel opened one master account and twelve subaccounts with Dreyfus between 1994 and 1999. Each account listed "LNS, Inc." as the registered shareholder.[2] Frankel did not identify Liberty as a broker-dealer to Dreyfus. On five of the subaccounts, Frankel listed the insurance companies as subaccount holders, identifying each insurance company by its initials, tax payer identification number, and address.[3] Shares purchased in these subaccounts were registered in the name of the subaccount holder, and the wire redemption instructions appeared to direct final credit back to the subaccount holder.

Thereafter, Frankel began a pattern of large purchases made with the insurance companies' money in the accounts at Dreyfus and rapid redemptions to his own Swiss bank accounts. Specifically, Frankel transferred money from the insurance companies' bank accounts to Dreyfus, purchased a large number of shares in the subaccounts, and, almost immediately after the shares were purchased, redeemed them and transferred the money to offshore accounts via standing wire instructions. Altogether, Frankel channeled $480 million of the insurance companies' funds through Dreyfus to his own accounts.[4]

The receivers sued Dreyfus, alleging that Dreyfus failed to properly discharge its duties and was liable to the insurance companies in tort, and under civil RICO, for effectively joining in Frankel's conspiracy. The district court granted summary judgment to Dreyfus on all claims. On appeal, the Fifth Circuit affirmed in part and reversed in part. The Fifth Circuit agreed with the district court that the receivers' federal RICO claim was without merit, and that Dreyfus did not owe a duty to the insurance companies for any accounts that were not opened in the insurance companies' names. But the Fifth Circuit held that Dreyfus could potentially be liable for those accounts in which the insurance companies were identified as the "customer."

The Fifth Circuit concluded that the insurance companies were Dreyfus' customers with respect to the subaccounts in their names. The Fifth Circuit declared that it was "abundantly clear" that the insurance companies were distinct entities from Liberty.[5] The court also found it significant that the accounts were opened using the companies' real taxpayer identification numbers and addresses and that Dreyfus contacted the companies directly via mailed monthly statements. The court concluded that these facts indicated that Dreyfus realized the insurance companies were separate and distinct legal entities from Liberty. The Fifth Circuit determined further that, under these circumstances, it did not

1. *Chaney v. Dreyfus Service Corp.*, No. 08-60555, 2010 U.S. App. LEXIS 1572 (5th Cir. Jan. 25, 2010) (applying New York law).
2. *Id. at *8.*
3. *Id. at *9.*
4. *Id.*
5. *Id. at *32.*

matter that the insurance companies did not open the accounts themselves or have a direct personal relationship with Dreyfus.

Having concluded that the insurance companies were customers of Dreyfus, the Fifth Circuit proceeded to analyze Dreyfus' obligations to protect them and their subaccounts. Under New York law, investment companies, banks, and brokers owe a duty of care to their customers. The insurance companies' subaccounts with Dreyfus were nondiscretionary, which the Fifth Circuit held conferred on Dreyfus a duty to exercise diligence in the execution of trade orders and "some duty to ensure that an individual purporting to trade on the customer's behalf is actually authorized to do so."[6] The Fifth Circuit concluded that there was a triable issue of fact as to whether Dreyfus breached that duty, because Dreyfus took no steps to verify that Liberty was authorized to make the redemptions, relying instead on Frankel's representations. The court described Dreyfus' efforts to identify the origin, legitimacy, or ultimate destination of the funds passing through its accounts as "non-existent."[7] A cursory investigation, the court surmised, would have "debunked" the accuracy of Frankel's account applications.[8] Similarly, Dreyfus made no effort to determine if the subaccounts were subsidiaries of Liberty or if Liberty was a broker-dealer investing on behalf of other entities. Even though the pattern of Frankel's transactions was "suggestive of money laundering," Dreyfus did not notice the red flags.[9] The plaintiffs, claiming negligence, argued that Dreyfus' failure to monitor for suspicious activity or verify redemption authority breached duties of care that it owed to the insurance companies, and caused their losses. Although the court noted that a jury could find Dreyfus' reliance on the authorizations to be reasonable, it found that a jury could also conclude that Dreyfus' personnel should have recognized the transactions as suspicious, which would in turn necessitate "more than turning a blind eye" to the "extraordinary" transactions.[10]

The court also concluded that the issue of causation was one for the jury. Dreyfus had argued that its conduct could not have caused the insurance companies' loss, because, had it contacted Liberty, it would have been told the same lies Liberty told when it opened the accounts. The Fifth Circuit disagreed, concluding that had Dreyfus made any inquiries of Liberty its inquiries may have gone directly to one of the many individuals at Liberty unaware of the fraud, which could have thwarted Frankel's diversion of the funds to his personal accounts. Therefore, it was possible that such an inquiry would have prevented some of the insurance companies' losses.

Investment companies, banks, and brokers should take note of this decision. Although decided under New York law, the principle that financial services companies can be potentially liable for losses that they arguably could have prevented with a modicum of due diligence will likely have broad appeal. Financial services companies should ensure the accuracy of authorizations related to subaccount holders, even those who do not open the account themselves or correspond directly with the financial services companies. If the subaccount holder can be identified as a distinct and separate legal entity, it may be deemed a customer. In addition, courts may now start finding a greater duty on the part of investment companies, banks, and brokers to investigate red flags that arise with large transactions and redemptions. In light of this decision, financial services companies should consider taking the following steps to protect themselves:

- Review "know your customer" policies to ensure that they are appropriate and sufficiently address potential issues;
- Review training programs to ensure that officers and employees are conducting the appropriate due diligence in a timely fashion, know how to recognize potential red flags, and take appropriate action if they discover suspicious activity; and
- Periodically confirm that the above policies are sufficient in scope and are being implemented.

In this era of highly publicized cases of Ponzi schemes and financial fraud, financial services companies should take affirmative steps to detect and prevent such wrongdoing, lest they find themselves facing substantial potential liability after the fact.

6. *Id. at *32.*
7. *Id. at *10.*
8. *Id.*
9 *Id. at *11.*
10. *Id. at *37.*