

What To Do When A Ponzi Scheme Is Uncovered: A Roadmap for Compliance and In-House Counsel

By Joshua Horn and Peter C. Buckley

Your phone rings. You receive word that a client ran a Ponzi scheme through your company. After you get over the initial shock and the inevitable anger from learning that someone used your business to perpetrate a fraud, you have a job to do. Regulators will want to assess your compliance department to determine whether there were any regulatory violations. Law enforcement will need information for the criminal prosecution. A receiver will be appointed and start looking for someone to blame – preferably someone with “deep pockets.” “What did we know ... how much is involved ... did we miss red flags ... what is our exposure ... how should we proceed?” Your executive team will want answers.

There is no precise roadmap for what to do next; every situation is different. What you do will largely depend on your responses to the executive team’s questions. But there are a number of things you should do in every case, and a number of decision points worth considering no matter what the circumstances.

Investigating a Ponzi Scheme

It is mission critical to determine the nature of the Ponzi scheme, how it

connected to your business, and what, if anything, your employees knew or should have known about the fraud. An internal investigation involves, among other things, gathering and reviewing documents and electronic information, interviewing employees, and interfacing with your regulators. To run the investigation, consider retaining outside counsel. They provide a helpful buffer between you and your firm’s employees, and their presence make it more likely that aspects of the investigation will be protected by the attorney-client privilege and the work product doctrine. In addition, employees may be more candid with someone outside the company. Using outside counsel also lends a degree of objectivity to the investigation and creates an orderly flow of information from your company to the outside world. Allowing them to run the investigation will allow you to see the big picture and facilitate liaison with your corporate client.

In gathering documents and electronic information, the details are key. As soon as you receive word of the fraud, suspend the loss of documents and data through ordinary retention policies. Document the “hold” and communicate the preservation notice to those who might have access to all relevant information, including those responsible for information technology. Consider retaining a reputable vendor to assist with the collection, review and production of your electronic data. Involve outside counsel in the process to ensure

compliance with the law and industry standards because courts will impose severe sanctions for the failure to preserve such data. Keep a record of your methodology to defend your process. And, when you produce documents to third-parties, specially mark them for each receiving party and keep copies of what you provide.

The results of your investigation will shape every decision throughout the rest of the process. If you find evidence of the Ponzi schemer’s fraud inside your company, you have a serious problem that may lead to regulatory fines and sanctions. Fraud also allows a receiver to connect you to the harm and exposes your “deep pockets” to compensate the victims.

Even if you determined that no one at the company participated in the fraud, you are not out of the woods – you must convince others to reach the same conclusion. It is important to fully cooperate with your regulators. After all, when the investigation is over, you still have to work with them on a daily basis. Through counsel, point them to the key pieces of information and demonstrate why your company had no participation in or reason to know of the scheme. If there are helpful documents, produce them even if not technically requested. For example, often the terms and conditions of your customer agreement define the scope of your duties to the schemer and permit you to rely upon your customer’s representations in conducting your affairs. Remember, you can advocate as you cooperate.

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Convincing your regulator that you are an ally in its pursuit of the fraud, rather than a target, is a significant victory. But, you are not done yet. After the regulator obtains injunctive relief against the schemer, including an asset freeze, a court will be designated as the exclusive jurisdiction for actions relating to the Ponzi scheme – as an aside, that designation will typically overcome any forum selection provisions in your contracts with the schemer. Usually, the same judge handling the injunctive proceedings is assigned to oversee the civil litigation. At the request of the regulator, that judge will appoint a receiver to assume control of the artifice of the scheme to recover assets for distribution to the victims.

Unfortunately, this process can work against you. The judge presiding over the appointment of the receiver hears all about the schemer's fraud and the harm caused. He/she will, understandably, feel sympathy for those victims and want to see justice served. Almost always, the assets of the schemer and those who participate in the fraud will not be sufficient to compensate the victims. The receiver turns to litigation against potential pockets. The same judge who appointed the receiver will be assigned to this litigation after implicitly or explicitly endorsing the receiver's pursuit of the case.

The receiver is also wearing multiple hats. On the one hand, he/she has a duty to maximize recovery for victims and a personal financial incentive to bring assets into the estate by any means. On the other hand, the receiver has a responsibility not to waste resources pursuing fruitless lawsuits. And, though the court usually authorizes the receiver to be paid during the pendency of the receivership, compensation can be reduced if he/she fails to provide an adequate return to the victims on the

investment of their resources.

Until your case reaches a jury, the judge and receiver are the decision-makers that will determine your company's fate. Understanding their motivation and perspective should inform your approach to extricating your company from further involvement in the fallout from the Ponzi scheme.

Avoiding Litigation

Before the receiver institutes litigation against you, consider an aggressive approach designed to discourage the receiver from filing suit. There are many legal defenses that present significant hurdles to recovery in the absence of fraud. Without fraud, the receiver will be looking to show that your company negligently failed to discover the Ponzi scheme. To combat this theory, consider the following:

1. **Educate the receiver about the duties, if any, owed by your company to the schemer.** If you had no duty to inquire, or if you were allowed to rely on the representations of your client, prove it to the receiver. Share the relevant case law. Explain the applicable regulations. The receiver may not be well-versed in your industry, and may be relying upon false assumptions as to what you should have done under the circumstances.
2. **Attack causation.** Undoubtedly, much has already been written about the bad acts of the Ponzi schemer and any accomplices. Ask the receiver how your company caused victim harm, when everyone agrees that it was the Ponzi schemer that inflicted the damage. Position yourself behind others such as the schemer's colleagues, professional advisors, accountants, attorneys, investors, and regulators – all of whom were in a better position to uncover the fraud but did not.
3. **Question damages.** Pin the receiver down on damages. In a negligence case, the economic loss doctrine presents a significant bar to

recovery in most jurisdictions. If the receiver argues deepening insolvency or loss of asset value, point to the Third Circuit decision of *In re CitX* and the line of decisions rejecting application of those damage theories to negligence actions.

In the end, your goal should be to convince the receiver that you will be a better ally than opponent. Let the receiver know that you have done your homework and are prepared for a long fight. Depending on the size of the receivership, expensive discovery and protracted litigation may present a significant disincentive to litigation. If the receiver believes that it is in the best interest of the estate (and in the receiver's own financial interest) not to tangle with you, he/she will focus receivership resources elsewhere.

When Litigation is Inevitable

Of course, you may not be successful and the receiver may decide to pursue litigation anyway. Remembering the tension inherent in the roles of the judge and the receiver may inform your litigation strategy. Consider these tools:

1. **Consider consenting to a magistrate judge.** In federal court, the parties can consent to proceed before a magistrate judge instead of the district judge assigned to the case. By obtaining this agreement, you may be able to avoid some of the pitfalls of proceeding before the same judge who presided over the injunctive proceedings and authorized the receiver to file the suit against you.
2. **Consider whether to seek a jury trial.** Of course, the receiver may insist upon one, but if the receiver neglects to ask for a jury or is agreeable, consider proceeding non-jury. Nothing is for certain, but the judge may perceive his or her role differently if asked to sit as the fact-finder.
3. **Review all of the receiver's filings in cases against third-parties.** The receiver also has to submit status reports and fee petitions that provide insight into the financial viability

of the receivership. The receiver's submissions may contain concessions that can be used against the receiver on liability and causation. Often, the victims have personal counsel. If the receiver is wasting resources pursuing litigation against you, consider letting them know.

4. Use legal arguments to your advantage. Assert your legal arguments through motions to dismiss or for judgment on the pleadings, but recognize that, in addition, the judge may need to be persuaded that allowing the litigation to continue is not in the best interest of the victims. Explain the scope of anticipated discovery, and demonstrate your willingness to take an appeal by insisting upon a decision on the merits of your legal arguments.

5. Consider consolidation. Discuss whether to consolidate your action with others brought by the receiver

against those with whom you might benefit from comparison. If there are other actions involving those who were in a better position to discover the fraud or with greater connection to the scheme, you may gain from consolidation.

Notwithstanding your best effort, the case may go to a jury. Certainly, there are many things to consider for a jury trial, but one that should be at the top of your list is potential testimony of the Ponzi schemer. It is a strategic decision with no real answer, but one that merits extensive consideration. To aid in your decision-making, you should strongly consider deposing the person at the heart of the scheme. You may fear what the schemer might say about your company and its knowledge of the fraud, but, if you did a thorough investigation, you should feel confident in your knowledge of the facts. If the fraudster points

the finger at your company, you are in a better position to learn this at an earlier stage of the proceedings because it can influence your strategy going forward. If faced with the prospect of a jury trial, and depending upon the potential exposure, you should consider the use of a jury consultant to obtain an understanding of how a jury may perceive the company and its role in the scheme.

Although there is no precise roadmap when confronted with a Ponzi scheme perpetrated under your watch, you are not without options. There are many ways to avoid litigation altogether or, if a suit is instituted against you, to position yourself for a successful defense. By understanding those defenses available to you and the decision points in the process, you can minimize the impact of the Ponzi scheme on your company.

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