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Red Flags of Fraud Part II: A Due-Diligence Checklist

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In the last issue of the *ABI Journal*,¹ we explored case law denying a good-faith defense when defendants in Ponzi scheme fraudulent-transfer lawsuits had knowledge of a “red flag” putting them on inquiry notice that there was a potential problem in the investment requiring further investigation. In reviewing scores of cases on Ponzi schemes for previous *Journal* submissions,² as well as many of the recently filed clawback lawsuits, we were repeatedly asking what could be done to prevent future investor losses. The goal of this article is to report the experiences of yesterday for a guide for tomorrow. This article is an attempt to condense, in a checklist format, various court findings on so-called red flags, as well as theories that trustees throughout the nation are pursuing in clawback actions, to determine what red flags should cause investors to beware.³



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The checklist is broken into three categories: (1) operational red flags, meaning red flags that originate from the way that an investment is operated; (2) reporting red flags, meaning red flags that show up in financial

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statements, trading documents and other paperwork related to the investment; and (3) investment red flags, or red flags surrounding the performance of an investment. Most of the red flags discussed below are observable before an investor makes an investment decision. Others are only visible after investment.

Operational Red Flags The Investment's Auditor(s)

Is the auditor for the investment truly independent? Is there any sign that the auditor is tied to the invest-

ment, the principals that run the investment or vice versa? In the *Bayou* Ponzi scheme, the registered agent for the investment's accounting firm was a principal of the hedge funding being audited.⁴ The district court noted with favor the one broker-dealer that, as part of its due diligence, searched the New York Department of state records and found that *Bayou's* principal, Daniel Marino, was also the registered agent for *Bayou's* auditor.⁵

Does the size of the audit shop appropriately match the size of the investment? In *Madoff*, the trustee alleged that a red flag existed because

despite *Madoff's* multi-billion dollar operation, his auditor was a one-man firm operating in a strip mall.⁶

Transparency and Access to Investment Principals/Key Personnel



Brendan McPherson

When due diligence questions arise, are investors able to approach principals of the investment and receive reasonable answers to questions? In *Madoff*, trustee Irving Picard believed that the lack of access⁷ or

limited access to *Madoff's*⁸ was a red flag. One keen observer of *Madoff* (prior to the demise of BLMIS) noted that “[i]t's almost a cult [*Madoff*] seems to have

fostered...[t]hey seem[ed] unwilling to ask him difficult questions and seem[ed] to be considering his ‘interests’ before those of the investors.”⁹ In the *Drier*¹⁰ Ponzi scheme, the trustee alleged that provisions in loan documents were designed to ensure that investors did not have access to the investment.¹¹ Tom Petters allegedly “barred any communications by investors with retailers who Petters represented would be purchasing fictitious electronics, and was furious

Feature

¹ Paul Sinclair and Brendan McPherson, “Red Flags of Fraud: Background for Due Diligence,” *XXX ABI Journal* 4, 34-35, 69-70, May 2011.

² Paul Sinclair, “The Sad Tale of Fraudulent Transfers,” *XXVIII ABI Journal* 3, 16, 78-79, April 2009 (“Part I”); Paul Sinclair, “The Sad Tale of Fraudulent Transfers: Part II,” *XXVIII ABI Journal* 4, 44-45, 66-67, May 2009 (“Part II”); Paul Sinclair and Brendan McPherson, “The Sad Tale of Fraudulent Transfers: Part III,” *XXIX ABI Journal* 3, 1, 42-46, April 2010; Paul Sinclair and Brendan McPherson, “The Sad Tale of Multiple Overlapping Fraudulent Transfers: Part IV,” *XXIX ABI Journal* 4, 18, 68-71, May 2010 (“Sad Tale IV”).

³ The checklist should not be deemed to constitute an entire due-diligence checklist when making an investment or in helping a client make an investment, nor shall it constitute legal advice. These are merely the authors' observations from recorded cases and existing adversary proceedings. The authors speculate that the so-called “knew or should have known standard” will continue to evolve in the future.

⁴ *In re Bayou Group LLC*, 396 B.R. 810, 870 (Bankr. S.D.N.Y. 2008) (*aff'd in part, rev'd in part, In re Bayou Group LLC*, 493 B.R. 284 (S.D.N.Y. 2010) (“*Bayou*”).

⁵ *Id.*

⁶ See, e.g., *Picard v. Fairfield Sentry Ltd. et al.*, adversary proceeding number 09-01239 pending in Bankr. S.D.N.Y., Amended Complaint [Docket No. 23] (the “Fairfield Complaint”) at 99-104; and *Picard v. JPMorgan Chase & Co., et al.*, adversary proceeding number 10-4932 pending in Bankr. S.D.N.Y., Second Redacted Version of the Complaint [Docket No. 18] (the “JPMC Complaint in *Madoff*”) at 38.

⁷ The JPMC Complaint in *Madoff* at 45 (alleging that due-diligence team was not allowed to meet *Madoff*).

⁸ See, e.g., the Fairfield Complaint at 87.

⁹ The JPMC Complaint in *Madoff* at 38-39.

¹⁰ *In re Dreier LLP*, Case No. 08-15051 (Bankr. S.D.N.Y., filed Dec. 16, 2008), and *In re Dreier*, Case No. 09-10371 (Bankr. S.D.N.Y., filed Jan. 26, 2009).

¹¹ See, e.g., *Gowan v. The Patriot Group LLC, et al.*, adversary proceeding No. 10-3524, pending in Bankr. S.D.N.Y., Amended Complaint [Docket No. 12] (the “Patriot Group Complaint”), at 6, 8.

when” an investor made direct contact.¹²

Are investors taking—or being asked to take—a “trust me” approach? As indicative from many schemes, most recently Madoff and Petters,¹³ reputation of a fund or principals of a fund does not take the place of objective and thorough due diligence.¹⁴

Are investors relying on third-party due diligence so they are not able to independently gauge transparency? The primary investors in Madoff’s scheme were feeder funds.¹⁵ The trustee in Madoff pointed to investors in those feeder funds merely trusting the due diligence performed by the feeder funds and stated that this was not sufficient.¹⁶

Are there audited financial statements and tax returns? One of Petters’ entities, Petters Company Inc., lacked audited financial statements for most years and had not filed tax returns since 2002.¹⁷

Market Perception and News Coverage

Does the investment have a market reputation? If so, does that reputation support investment? In Madoff, it was a common perception among industry analysts that Madoff’s perfect timing of the market was based on illegal front-running.¹⁸ Additionally, industry experts were often warned of potential fraud.¹⁹

Is there negative news coverage surrounding the investment? News searches are generally part of out-sourced due diligence.²⁰ Reviewing news coverage is common sense and supported by Bayou.²¹

Is there evidence that principals of the investment have committed crimes involving dishonesty and theft? The trustee in Petters alleged a red flag because Petters had multiple felony convictions for crimes involving fraud and dishonesty, including forgery, larceny, theft by

check, frauds and numerous court judgments in civil matters.²²

Unusual Terms, Conditions and Provisions Required to Invest

Does investing with the investment require entering into unusual legal provisions? See various allegations being made by the trustee in Drier.²³

Lawsuits Filed against the Investment

Has a nationwide litigation search been performed? In Bayou, the district court noted with favor that an investor hired a due-diligence outsource firm, which, as part of its service, performed a litigation search.²⁴ Depending on the investment, a nationwide litigation search is most prudent.

Does a nationwide litigation search reveal any allegations made against the investment that bring any aspect of the investment into question? If so, has the investment been questioned about the substance of the lawsuit(s)? Also in Bayou, a litigation search would have revealed that a former partner had filed suit against the investment alleging, among other things, that the primary Ponzi scheme operators denied the partner access to firm books and financials. Though the allegations on their face were not indicative of fraud, the district court found that the complaint alone “was a clarion call for a Bayou investor to ask questions and get answers.”²⁵

The Common-Sense Catch-All: Does the Investment Pass the Smell Test?

Does the investment really need investor funds? In Drier, the trustee made an interesting allegation—that the fake financials provided to prospective investors indicated “hundreds of millions of dollars in cash and liquid assets on hand” and therefore, it made no sense that the investment would pay above-market interest rates required under the notes that it was peddling.²⁶ Similarly, in Petters, trustee Doug Kelley alleged that certain “defendant[s] never questioned why Petters accepted their investments in lieu of other available and less expensive financing alternatives, including commercial loans at lower fees, which would have been more lucrative” for Petters’ companies.²⁷

Is the investment, from an outsiders’ perspective, sustainable? The trustee in Petters alleged that JPMorgan “knew or

should have known that a business that relied on selling to legendary margin-cutters like Wal-Mart, Costco and Sam’s Club could not possibly operate a sustainable business if it had to pay interest rates from 15-24 [percent] or higher to finance its inventory.”²⁸

Is the investment’s strategy consistent? The trustee in Madoff asserted that Madoff’s investment strategy (the split-strike strategy) often changed according to circumstances, a red flag that investors should have noticed.²⁹

Are there any other inconsistencies or discrepancies that have arisen during the due-diligence process and have not been thoroughly explained? In Drier, the trustee alleged that the Ponzi scheme operator created a fake email account for his client contact, and that some investors should have been aware of this discrepancy because they received an email from the actual client contact at his actual email address that contained a different email address and a different signature block “with different telephone and fax numbers than the signature block on the dummy email address.”³⁰

Reporting Red Flags Method and Format of Reports

Is the investment’s reporting customary and industry-standard? In Madoff, it has been noted many times that customers received only paper trade confirmations and account statements, and not electronic real-time access to their accounts, something that became an industry standard by 2000. Hon. Burton R. Lifland already considered this a red flag.³¹ In Petters, Kelley alleged a red flag because Petters did not provide investors with online access to their accounts, “which was and is generally customary in the industry for purchase-order financing with large retailers.”³²

Does investment reporting comply with applicable authority or industry standards? In Madoff, the trustee stated that options trade confirmations that investors received did not comply with industry standards. For instance, none of Madoff’s options trade confirmations properly identified a counterparty.³³

Irregularities in Financial Statements

Are financial statements provided by the investment complete, and showing no signs on their faces of inaccuracy? In

¹² Kelley v. General Electric Corp., adversary proceeding number 10-04418, pending in Bankr. D. Minn., Complaint [Docket No. 1] (the “GE Complaint”) at 18.

¹³ In re Petters Co., et al., Case No. 08-45257 (Bankr. D. Minn., filed October 2008).

¹⁴ See discussion in the JPMC Complaint in Madoff at 47 and discussion in the GE Complaint at 14-15. See also Kelley v. JPMorgan Chase & Co., et al., adversary proceeding number 10-04443, pending in Bankr. D. Minn., Complaint [Docket No. 1] (the “JPMC Complaint in Petters”) at 31-32.

¹⁵ For a brief explanation of the role of feeder funds in Madoff, see Brendan McPherson, “An Update: Madoff Proceedings and Trustee’s Suit against Fairfield Defendants,” ABI Commercial Fraud Committee News, Vol. 7, No. 4, November 2010.

¹⁶ See, e.g., the JPMC Complaint in Madoff at 47.

¹⁷ JPMC Complaint in Petters at 31.

¹⁸ The Fairfield Complaint at 129.

¹⁹ See, e.g., the JPMC Complaint in Madoff at 31, which quotes a JPMC employee: “For whatever its worth, I am sitting at lunch with [JPMC Employee 1], who just told me that there is a well-known cloud over the head of Madoff and that his returns are speculated to be part of a [P]onzi scheme—he said if we [G]oogle the guy we can see the articles for ourselves[—Please] do that and let us know what you find.” (a less redacted version is available as Docket No. 18). The email was dated June 15, 2007, approximately 18 months before Madoff was arrested. See also The Fairfield Complaint at 146-54.

²⁰ See, e.g., www.backtrackreports.com/our_process.php.

²¹ Bayou, supra, n. 4.

²² JPMC Complaint in Petters at 13.

²³ See, e.g., Patriot Group Complaint at 6, 8.

²⁴ Bayou, supra, n. 4.

²⁵ Id. at 869.

²⁶ See, e.g., the Patriot Group Complaint at 5-6, Docket No. 1.

²⁷ See, e.g., GE Complaint at 18.

²⁸ Id.

²⁹ The Fairfield Group Complaint at 124.

³⁰ The Patriot Group Complaint at 10.

³¹ In re Bernard L. Madoff v. Securities LLC, 424 B.R. 122, 131-32 (Bankr. S.D.N.Y. 2010) (Lifland’s decision regarding SIPC customer claims, which is primary discussion in “Sad Tale IV”).

³² The GE Complaint at 17-18.

³³ See, e.g., Fairfield Complaint at 123.

Drier, the trustee alleged that a red flag existed because financial statements purported to be consolidated did not disclose what entities were being consolidated into the financial statements.³⁴

Irregularities in Reporting Statements, Trade Confirmations, etc.

Is the performance of the investment, as reported by the investment, in conformance with actual market performance? In *Madoff*, Picard alleged that investors received trade confirmations that indicated that certain stocks were trading at prices outside of the daily range for those stocks. In other words, Madoff, on several occasions, made the mistake of documenting the sale or purchase of securities at less or more than what was possible in the market.³⁵ Similarly, in *Petters*, the trustee argued that defendant General Electric Capital learned that amounts paid to the Petters companies “did not match the amounts that were represented by Petters to be the amounts of checks.”³⁶

Are there any other indications that reporting is inconsistent? In the *Manhattan Investment Fund* Ponzi scheme, the district court noted that as a warning sign, investors made certain inquiries after hearing at a cocktail party that the investment’s annual return was different than what they believed to be true.³⁷

Investment Red Flags

The Investment’s Historical Returns

Does a statistical analysis indicate that the investment’s returns are improbable or highly improbable? According to the trustee in *Madoff*, quantitative analysis that is standard in the hedge fund industry revealed that Madoff’s positive, consistent returns were statistically, highly improbable.³⁸

Does common sense dictate that returns are not plausible? In *Madoff*, an investor employee noted that “BLMIS’s volatility was only 2.5% over the preceding seventeen years, a period which included some of the most volatile capital markets in history; and...Madoff’s fund lost money in only 2 of 214 rolling quarterly periods since 1990.”³⁹

The Investment’s Impact on the Market

Based on the investment’s theory, should the volume of the investment

impact the market, and can this impact be independently verified? Madoff told investors that his success was based on his split-strike conversion strategy,⁴⁰ which involved investing in a basket of securities in the S&P 100 at opportunistic times and liquidating the securities and rolling the money into treasure notes several times a year. This sale of tens of billions of dollars in U.S. securities over just a few days would have had a clear impact on the market price of the securities bought and sold. In various clawback complaints, Picard alleged that sophisticated investors should have known that without evidence of such a market footprint, the trades were not occurring.⁴¹

Conclusion

Although all of the red flags above arise in the context of “objective” factors attributing “knew or should have known” constructive knowledge to a defendant to negate bad faith, should courts follow the historic approach—as some circuits do—that “good faith” means honesty?⁴² In fact, many of these same factors could be deemed to be a subjective tip-off that the defendant should have known it was “too good to be true,” such as unsustainable or overly consistent profits.⁴³ ■

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³⁴ See, e.g., Patriot Group Complaint at 5.

³⁵ See, e.g., Fairfield Complaint at 126-27.

³⁶ GE Complaint at 15.

³⁷ *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1 (S.D.N.Y. 2007).

³⁸ See, e.g., Fairfield Complaint at 128. See also Greg N. Gregoriou and Francois-Serge Lhabitant, “Madoff: A Riot of Red Flags,” EDHEC Risk and Asset Management Research Center (January 2009) at 12-13.

³⁹ JPMC Complaint at 45. See also *Picard v. Katz, et al.*, adversary proceeding number 10-05287 pending in the Bankr. S.D.N.Y., Complaint at 193-96.

⁴⁰ See “Sad Tale IV” for background and authorities with respect to Madoff’s split-strike conversion strategy.

⁴¹ See, e.g., Fairfield Complaint at 111.

⁴² See Parts I and II for a thorough discussion of this issue.

⁴³ See, e.g., *Jobin v. McKay (In re M&L Business Machine Company Inc.)*, 84 F.3d 1330, 1338 (10th Cir. 1996) (objective good faith rejected was investors’ knowledge of 120 percent and 468 percent returns per year).