

## Fraud: alternate remedies for lenders and investors | BY RICHARD G. HADDAD

You've just discovered a substantial fraud by your borrower, or perhaps by your borrower's equity sponsor. You may have learned of the fraud in a number of different fashions: missing collateral or other reporting irregularities, confession by an insider, or media reports of a Securities and Exchange Commission investigation or criminal indictment. After the initial shock of realizing that your asset or investment is not worth what you had been led to believe, what steps should you take to begin to recover your loss?

One of the first things to consider, even before pursuing remedies against third parties, is reporting the fraud to appropriate law enforcement authorities. In fact, reporting can be mandatory in certain regulated industries, such as US banks. Following this initial step, lenders and investors who find themselves in the situation of being fraud victims have a number of legal options and remedies available to them. While the first instinct may be to pursue the fraudster and his or her conspirators, this course may not result in the best recovery or most cost-efficient use of resources. Often, the proceeds of the fraud have been dissipated, either spent on actual operating problems with the underlying business, or used to pay legitimate creditors in furtherance of perpetuating the scheme. In some cases, assets may be hidden in secret accounts or in foreign jurisdictions that make tracking difficult.

Most significantly, the fraudsters themselves are frequently subject to multiple investigations, including criminal prosecutions, and the fact or threat of criminal prosecution may delay victims' attempts at civil recovery. For example, an accused might assert his or her right against self-incrimination under the US Constitution and refuse to

provide details of the fraud or locations of assets. As a result, concurrent criminal prosecutions or agency enforcement actions can set back civil recovery against the fraudsters for months or years.

Victims should not unduly despair, however, because there may be other, potentially lucrative, sources of recovery. From a cost-benefit perspective, it is often better to concentrate recovery resources on 'deep pockets', that is, a person or entity who is able (through either assets or insurance) to pay a substantial judgment or settlement. These targets include outside directors of the fraud-infected company, accountants who may have issued certified financial statements, and recipients of proceeds of the fraud.

*Outside directors.* Outside directors are individuals who were supposed to be 'minding the store' and ensuring that management complied with its duties and responsibilities under law. Lenders or investors can recover from directors under several theories, although in many popular jurisdictions of incorporation (e.g., Delaware), the laws and certificates of incorporation are written to protect directors in the exercise of their business judgment. However, such protections may be insufficient to completely insulate directors from all legal liability. Public, and many private, corporations often carry some form of directors' and officers' insurance that may provide directors with coverage for settlements and judgments. Theories against the directors may include, among others, negligent misrepresentation in connection with misleading financial statements, and breach of fiduciary duty if the corporation was insolvent and owed a duty to its creditors.

*Accountants.* Investors and lenders generally review copies of a company's audited financial statement before deciding to invest, lend or authorise additional funding. In an attempt to limit liability, accounting firms commonly do not directly provide financial statements or certifications to the lender, but, instead, a certification is issued to the board of directors or shareholders of the borrower. In turn, the borrower presents the financial statements to the lender or investor. In the United States, the law often distinguishes between parties who are in privity with the accountant, such as the borrower itself, and those who do not have direct contractual privity or other communications with the accountant, such as lenders and third-party investors. State laws concerning accountants' liability vary, with certain states quite vigilant through legislation or legal precedent in protecting the interests of accounting firms. Yet many jurisdictions provide one or more theories under which lenders and investors can pursue remedies against accountants. For example, in New York, the law distinguishes between levels of culpability: claims of ordinary negligence can be brought only by the accountant's client (e.g., the borrower) while gross negligence amounting to fraud may be brought against the accountant by third parties. In general, New York law allows the third-party lender to assert claims if it can allege that an auditor knowingly or recklessly ►►

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issued a false or misleading opinion concerning a company's financial statements, or through allegations of conduct grossly departing from generally accepted auditing and accounting standards. Therefore, even if the lender or investor did not have direct communication with the borrower's auditor, recourse against the auditor is still possible if sufficient intent and serious defalcations can be alleged and then proven, such as a refusal to recognise the obvious or failure to investigate the doubtful.

*Recipients of tainted funds.* As we have seen in recent fraud scandals, including Madoff and others, it is quite common that seemingly innocent parties receive proceeds of the fraud, either in an effort to perpetrate the fraud itself, or in the case of charitable institutions, an effort to promote the social standing of the fraudster himself. Regardless of their status – whether unwitting participants or charitable transferees – even unknowing recipients are not immune from liability or 'claw-back' under fraudulent conveyance or bankruptcy preference laws. These recipients may be pursued either by a bankruptcy trustee or, in certain circumstances, the creditors themselves.

*Prior lenders.* Often if a lender or investor succeeded a prior financier, the natural inference is that perhaps the prior lender had knowledge of the fraud and remained mum in an effort to get paid out and

shift the problem onto another lender. Generally speaking, it can be difficult to successfully claim that a prior lender failed to disclose unfavourable information about a borrower because there is a body of law that provides that lenders have no duty to share information. Thus, unless the defrauded lender or investor has specific knowledge that the prior lender either was involved in the fraud, or made affirmative and knowing misrepresentations to the new lender or investor, the claim may be dismissed. Put simply, although an existing lender may have no duty to provide information to a prospective lender, once the prior lender offers information, it may not provide false information. Given such high legal hurdles, it may not be worthwhile to bring suit against a prior lender.

While the prospects for recovery may look grim upon discovering a fraud, all hope is not lost. After investigation by counsel and others, there may be available assets and viable avenues of recovery that can bring a substantial recovery and reduction of the loss resulting from the fraud. ■

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