

CHAPTER 1

Road to Recovery

*The law does not pretend to punish everything that is dishonest.
That would seriously interfere with business.*

Clarence Darrow (1857–1938), country lawyer
and civil libertarian

A SHARP STICK

From school playgrounds to Wall Street, on every continent, some individuals, without apparent provocation, want to poke you in the eye with a sharp stick. In the financial markets, the attack takes the form of investment misconduct and fraud. The perpetrators are bullies or sociopaths. Perhaps they are strangers, but often they are employees or trusted friends. Through greed, a sense of entitlement, or outright evil, they sharpen the stick, carefully plan the assault, and stalk their prey. Often without any remorse whatsoever, they are joyful in the disfigurement or destruction of innocent victims. This sordid set of facts is the reason I wrote this book.

We are constantly reminded that there is an abundant supply of financial miscreants ever-willing to apply acute focus to a singular purpose (*myoptical singularis*) and drive that sharp stick of financial misconduct solidly into the eye of their victim.¹ In a world where protective measures often fail and an innocent victim suffers monetary damages, recovery is often possible. The process begins with rejecting the status quo. Abandoning a belief in the inevitable is necessary. It is a tedious process and you will be tempted to waffle. Others count on that for their success. But keep in mind, justice can be incredibly satisfying, and monetary relief is a decent outcome as well.

Assuming that being the target of investment misconduct or fraud is distasteful, and an experience that you want to avoid, there are two options: avoid the bullies and sociopaths by staying off the playground, or adopt

defensive measures. On occasion, these proactive defensive tactics are effective, but they are not always foolproof. If counterterrorism strategies were altogether successful, then there would be little need for a guide to recovering from investment misconduct. Con artists and schemers are adept at finding a workaround. Financial terrorists are skilled in their craft; therefore, this book is necessary.

As recently as two years ago, recovering from investment misconduct would have been discussed in a very different manner. Even though our society finds value in issuing report cards to first-graders and auto manufacturers, somehow we never held the integrity of our financial markets to the same standard. If we had, the results would have been dismal with failing grades in nearly every area of oversight. However, through a combination of outrage and the recognition that the nation's financial survival was at stake, a benevolent guardian put our failing system on probation with an assignment of remedial work. The opportunity to bring order to consumer advocacy and our financial markets is reflected in part in recent demands for overall fairness. Two years ago, any project related to investment conduct would have focused on a severely flawed industry, under the influence of many individuals lacking any sign of an ethical compass, and regulated by laws and agencies with underwhelming insight and abilities.

DODD-FRANK: THE ENGINE THAT COULD

In the past 24 months, many things have changed, and the next two years, propelled by the engine of Dodd-Frank and uncompromising public sentiment, have the potential to be even more revolutionary. Highly visible individual cases such as Madoff Securities, Marc Drier, and R. Allen Stanford have introduced many consumers, otherwise uninformed, to the red flags related to investment misconduct. Federal and state investigations into product-related investments that were marketed through brokerage firms or agents have intensified and will likely lead to fines, sanctions, and possibly criminal prosecution. And the world of class action suits is no longer confined to medical products and firearms. Large settlements related to securities and investments, launched by experienced legal teams, have been effective.

Even with an undeniable shift in the visibility of investment misconduct, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection legislation is designed to usher in sweeping changes and have a long-lasting impact. The Dodd-Frank moniker, like most congressional efforts, will soon fade from the headlines, but it has the potential to be the catalyst for much-needed change. Along with analyzing the current options

for recovery from investment misconduct it is essential to review the impact, and in some cases the absence of impact, of Dodd-Frank.

Much like the benchmark securities acts of the 1930s, there are things in this legislation that financial institutions “can do,” “must do,” and “cannot do.” Through Dodd-Frank, new bureaus, agencies, task forces, advisory groups, and commissioner positions were crafted as watchdog custodians of the process. After a predictably controversial review period, Dodd-Frank has paved the way for much-needed reform.

Along with the new controls, compliance metrics, and consumer advocacy programs, Dodd-Frank has put in motion the mechanism to nullify the clauses in consumer account agreements that limit disputes to arbitration and bar them from civil adjudication. This aspect of Dodd-Frank will be discussed in detail throughout this book. But it must be noted now that this potential development, if ultimately adopted, will be nothing short of revolutionary. As history consistently reminds us, a revolution is often marked by unforeseen challenges. This leads to landmark decisions being made with limited background data, and that disturbs me. Relying on conventional wisdom trumpeted through limited data yields disastrous results.

It is nearly impossible to resist the temptation to jump to the bottom-line conclusion for recovering from investment misconduct. But that temptation, as much as it may abbreviate the process for some, is a disservice to many others. Unfortunately, I often find what I will refer to as the “Hawaiian Muu-Muu Syndrome,” where one size fits all. Just as in the investment advisory process, there is no common denominator that can be applied globally for a one-size-fits-all solution to victimization. Even though you will soon observe that I admittedly have a strong bias related to the best recovery strategy for the majority of victims, I am an avid proponent of full and fair disclosure of all possible options for monetary relief.

Metaphorically, think of recovering from victimization as a duel. You get to choose your weapon. I may have a preference, but I am not the person in the duel, so you need to make the choice. Granted, I know a lot about the weapons and have even employed several, but that does not necessarily mean that I have a monopoly on clarity. It is your neck on the line.

For informed decisions, complicated issues demand a robust examination. Even though the thrust of this book will focus on the most prevalent form of financial dispute resolution, in the spirit of building a firm foundation for all victims, other options will be briefly reviewed.

In approximately 10 hours you will have completed a journey through the odd kingdom of investment misconduct. If the plot unfolds as planned, you will be much better prepared to respond, recover, resist, or possibly retaliate. But first you must take a pledge, the *oath of non-acceptance*.

REJECTING ACCEPTANCE

Even though estimates are notoriously inexact, the monetary and emotional damages of securities fraud are massive. The aftermath of the deception is more than a minor nuisance. On even the smaller of monetary scales, investment misconduct can destroy businesses and families. And on the level of destruction that we have become all too familiar with, by any reasonable measure, there is a global pandemic of economic terrorism—bullying at its finest. It is a zero-sum game of losers and winners. Indeed for every gain through fraud, there is a realized loss. There is no so-called self-insurance. Every loss related to securities fraud is passed along to someone as a higher cost of goods or services, reduced benefits, or an attack on the financial markets. No individual, country, or community is spared. It is a widespread and costly disease.

As a defining premise, I refuse to accept the notion that anyone “had it coming,” or in some cases, “they should have known better.” During my career as a consulting and testifying expert, I have been engaged by both Claimants (typically investors or employees of brokerage firms) and Respondents (often a brokerage firm or employee).² I firmly believe that the only universal truth is that there are no universal conclusions inherently associated with all claims. I have had personal experience with frivolous and unreasonable allegations and responses from both sides of the dispute. Thankfully, most advisers, firms, and clients are sincere and honest participants in the all-important process of shared interests.

But in a financial system with tempting access to vast amounts of assets, things do get off track. And in a global society where hundreds of millions of individuals are only a phone call away from banks, securities exchanges, and the potential for unearned riches, for some, investment misconduct is an irresistible temptation. Often lacking any apparent reason other than an overwhelming sense of entitlement, companies and individuals victimize others.

Regardless of motives or naïveté, I have yet to meet someone who proclaims, “Take that sharp stick and poke me in the eye.” If you ignored the red flags associated with investment misconduct and mistakenly made an appointment with financial disaster, this book is the next step in shaking off the disorienting numbness and getting reorganized.³ This reorganization may include monetary damages and even much-deserved justice. Or perhaps it will define the recovery process in a manner that will help you forever avoid making the same investment mistakes again.

In a much more sinister scenario, if you were the unwitting target of blatant fraud and someone made that appointment with disaster for you, you have even more options. But passing time is an enemy of justice. In this circumstance of indecision, recovery is problematic. Memories become

less precise. Documents are misplaced. Costs rise as the litigation process drags on.

Without question, the emotional toll of a crisis has a cumulative effect. As a victim, it is critical to shake off the disorientation, reject the inevitability of “bad things happen to good people,” and commit to recovery.

Regardless of the catalyst, reorganization begins with a rejection of the inevitability of victimization. There is nothing fair or inevitable about loss by intentional theft or deception. Through investments connected with some form of security such as common stock, a bond, or a futures contract, if you feel that you have been deceived or manipulated, I hope to provide you with a blueprint for recovery. If there is a financial demon in the room, this book was written for those who are interested in an exorcism.

THE INCALCULABLE THRESHOLD

There is a monetary damages threshold for the practical application of this guide, but it is not altogether quantitative or rigid. In the Association of Certified Fraud Examiners 2010 report on global fraud, the fuzzy nature of fraud metrics is evident:

Measuring the cost of occupational fraud is an important yet incredibly challenging endeavor. Arguably, the true cost is incalculable. The inherently clandestine nature of fraud means that many cases will never be revealed. . . . Consequently, any measurement of occupational fraud costs will be, at best, an estimate.⁴

In terms of losses related to U.S. securities fraud, there is a range of estimates from respected organizations such as the North American Securities Administrators to university studies such as Stanford’s Class Action Clearinghouse. These sources suggest that annual damages from securities fraud are from \$40 billion to \$600 billion. But once again those are estimates based on a number of variables and assumptions.

Nevertheless, if a study conducted in 2007 by the Canadian Securities Administrators/*Auterité canadienne en valeurs mobilières* (CSA/ACVM) can be a surrogate for all of North America, the conclusion is very disturbing. The Canadian study concluded that 1 in 20 Canadians are victims of investment fraud, with only 17 percent reporting their victimization. In other words, approximately 5 percent of Canadian citizens are victims of some form of investment fraud.⁵

Extending that finding to the United States, the implication is that each year 15 million Americans (equivalent to the population of Los Angeles) are

victims of securities fraud. That breaks down to one serious financial crime occurring every 2.1 seconds. Think about it another way: if you complete this chapter in one hour, by the time you finish, more than 14,000 individuals (possibly including you, your business, or family) will have been victimized by serious investment misconduct.

Based on my experience, monetary losses from misconduct vary greatly. But using a conservative \$50,000 of damages per victim, the results equate to a staggering \$750 billion price tag—roughly the budget for U.S. forces in Iraq and Afghanistan.

Losses due to investment misconduct can conceivably be as low as \$5,000 or less and as steep as hundreds of millions or even billions. To the benefit of the victim, the recovery system is flexible. There are options at all levels of loss. An alternative to limiting our focus is to accept the following premise: If the assets you lost in an investment scheme were important to you, your family, or your business enterprise, then this book will help you understand and evaluate various methods for resolution and recovery.

DEALING WITH THE DEMONS

You will soon become familiar with criminal and civil procedures, class actions, mediation, settlement agreements, arbitration, and the often-overlooked gesture of cutting losses and the litigation version of throwing in the towel. Capitulation? That is correct. Litigation is not always the best solution.

It is fair to say that in dealing with financial misconduct you will experience an unpredictable blend of pleasure and pain. *One concept that is critical to accept: For all parties impacted by investment misconduct, without insight into the unique process and a strategic plan, tossing money and an uninformed effort at the problem is a costly and avoidable mistake.*

My goal is to have a meaningful dialogue with the thousands of individuals and organizations who refuse to accept the notion that the natural order of events permits breach of trust, gross negligence, deception, common theft, and fraud. As you move forward in the process of reorganization, you will discover unique resources and compelling securities litigation strategies. Expect a fusion of longstanding practical methods for victim reorganization and recovery with new options available only through the recently enacted Dodd-Frank legislation.

This book will offer limited value to anyone willing to accept victimization and the status quo. Between the covers of this book is a call to informed action. In that spirit, this book is dedicated to those who are convinced that professional conduct and integrity are not simply obscure theories. It is for those who are prepared to move beyond the numbing trauma of investment

misconduct and securities fraud and ask the questions, *What went wrong?* and *What can be done?*

Be forewarned: demons are best destroyed when they are first discovered. At that point, you are inspired and the demons have not had time to gauge your vulnerability. With neglect and time, they become even more menacing, resilient, and legendary in scope.

WHAT WENT WRONG?

What went wrong? Most likely, numerous things and many of them were preventable. Safeguards such as surprise audits, an effective system of checks and balances, clearly defined accountability, a thorough vetting of advisers, or carefully crafted deceptive devices are often cited. Even more prevalent is the tendency to trust individuals and systems until you have reason not to—and that is often the heart of the issue, the weakness in the cloth—misplaced trust, blind faith. Pablo Picasso agreed when he noted that being hated is more difficult than being loved.

Unlike undomesticated members of the animal kingdom that maintain a keen sense of survival and are spooked by the most minor change in their environment, modern humankind, and thus modern investors and organizations, to their detriment, are trusting rather than tentative and accepting instead of anxious.

I will make every attempt to reengineer the process with the exploration of recovery techniques. Through existing options, regulatory mandates, and new legislation, there are time-proven ways to reorganize, reclaim your assets, and eventually reject the notion of unchallenged trust.

Once the commitment is made to reject the status quo, a reversal of fortune begins.

WHAT CAN BE DONE?

What can be done? A lot—more than you might imagine! And many of the options have proven to be extremely effective. For both individuals and organizations, there are five fundamental channels of recovering from investment misconduct:⁶

1. Criminal trials
2. Civil litigation
3. Class action
4. Mediation
5. Arbitration

Through each of these five channels, various degrees of restitution and expectations for justice and equity are to be expected. Additionally, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has been described as providing a foundation for major financial reform and consumer protection. In the context of investor advocacy and market integrity, that premise will be scrubbed, turned inside out, and laid bare with all the well-deserved nakedness of suspect congressional imperatives.

Thanks to the influence of Hollywood characters such as Perry Mason and TV dramas like *Law and Order*, many individuals mistakenly associate all misconduct with criminal trials. Even though that is a misguided characterization, the violation of criminal statutes in all jurisdictions is the top of the food chain and an appropriate starting point for our analysis.

CRIMINAL TRIALS

As a victim, even though you have a stake in the outcome of a criminal proceeding, your role in the process is secondary. Understandably, that is a frustrating role for victims. You may be called as a witness or required to produce documents, but state or federal government professionals, such as the FBI, the IRS, the Secret Service, and the U.S. Postal Service, manage the investigative and litigation strategies.⁷ In effect, you are on the bench watching the starting team.

If you like intense drama, a devastating loss of all personal assets, and the likelihood of lengthy imprisonment—the violation of federal laws associated with securities is a great outlet for your interests. Nevertheless, to put things in perspective, as counterintuitive as it may appear, many individuals charged with violations of federal antifraud provisions never go to trial. Ivan Boesky and Michael Milken, through plea bargains, never stood trial for insider trading. Legendary Charles Ponzi, in some camps the spiritual leader of investment fraud, was never convicted of securities fraud. Like many others after him, Ponzi went to prison for mail fraud. John Scrusby, the imprisoned former CEO of HealthSouth, is the only chief executive to stand trial under provisions of Sarbanes-Oxley (SOX). However, Scrusby was not convicted on SOX violations. Instead, similar to Lance Poulsen, the former CEO of National Century Financial Enterprise (NCFE), his imprisonment stemmed from a conviction related to jury tampering. And probably the most obvious example is Bernard L. Madoff, who is believed to have orchestrated the largest Ponzi scheme of all time and never stood trial.

Additionally, as it relates to violations of federal statutes and criminal trials, restitution to victims is limited or nonexistent. The near-empty coffers

of the felons (even though sometimes yielding significant returns to investigative government agencies) experience any number of acts of dilution. First, felons are often drawn to earthly pleasures—and that lifestyle has a high burn rate for misappropriated funds. Second, if accused or caught, legal fees for an active defense can easily reach the stratosphere. And finally, once the prosecutor gathers enough evidence to make the case for a likely conviction, there is little need to track hidden bank accounts in all corners of the globe. Assets embezzled by the fraudster, due to limited investigative resources, remain hidden, possibly abandoned and lost forever. Perhaps government prosecutors should consider expanding the Dodd-Frank “whistle-blower” bounty to also apply to asset recovery—something like a “whistle-finder” program.

For the victim, there may be satisfaction in the criminal conviction of a perpetrator, but little else. Criminal trials for securities violations can be a nightmare for all legal representatives. For a conviction, the standard of “beyond reasonable doubt” leaves a great deal of wiggle room. Since a unanimous decision is necessary for a conviction, understandably the prosecutor needs an ironclad case before a conviction is likely.

Charles W. McCall

The high-profile 2009 conviction of Charles McCall, the former chairman of McKesson Corporation, illustrates the challenges for federal prosecutors in securities fraud cases.⁸ After the discovery of accounting irregularities in McKesson’s acquisition of HBOC, in 2003, McCall and several other officers of McKesson were charged with numerous counts of conspiracy and securities fraud. When the accounting irregularities were discovered, McKesson stock fell from \$65 per share to \$35, creating nearly \$9 billion in shareholder market losses. Unlike many cases where the damage metrics of fraud are somewhat illusive, there was no question that the accounting misconduct that had overstated revenues was the trigger that sent McKesson stock into a spiral that lopped off nearly 50 percent of shareholder value.

In 2006, after a lengthy trial, McCall was acquitted on the conspiracy charge, and due to a locked jury, a mistrial was declared on the other charges. In 2009, at the conclusion of a new trial, associated with the same set of facts, McCall was convicted of securities fraud. He was sentenced to 10 years in federal prison. Mr. McCall, federal prisoner ID # 93071-011, was described by U.S. District judge William H. Alsup as follows: “Even if he wasn’t a co-conspirator, . . . he had the duty if not the power to say, ‘*Stop*’ [emphasis in original].”⁹ McCall, through his attorney, stated that he plans to appeal his conviction.

An often-overlooked aspect of the 2002 Sarbanes-Oxley (SOX) legislation, enacted to realign corporate governance standards in the wake of the collapse of Enron and WorldCom, is Section 1348, which eliminates the “knowing scheme to defraud in connection with a security.” This replaced the narrow standard as mandated in the Securities Exchange Act of 1934 that focuses on the “willful act of fraud in connection with the purchase or sale of a security.” Under Section 1348, strategies such as hedging transactions, which may not in fact constitute outright purchases or sales, fall under the jurisdiction of U.S. enforcement agencies. Section 1349 of SOX permits federal prosecutors to file charges against senior corporate officers and recover ill-gotten gains even if the misconduct was not intentional. The complicated issue of intentionality plays an important role in the cases of Lance Poulsen and Charles McCall.

Lance Poulsen

The technical nature of some investment issues can leave all parties scrambling for common ground in the attempt to offer a coherent presentation to the jury or tribunal. Instead of battling the jargon of Wall Street, for some highly technical securities cases a common prosecutorial strategy is to focus on mail and wire fraud. Quite simply, if it is clear that you used an interstate form of communication (mail, wire, the Internet) for fraud, you are very likely to be found guilty. The sentencing guidelines for these fraudulent acts related to interstate commerce are similar to those involving securities fraud, but much easier to present to a jury. This was a strong subtext to a communication that I had in 2010 with Lance Poulsen, imprisoned former chairman of National Century Financial Enterprise (NCFE).¹⁰

Poulsen was accused of using a complex scheme that hid NCFE's finances from auditors, bond rating services, investors, and the banks that held its reserve accounts required by its bond covenants. It was clear in my communication with Poulsen that he feels that the jury, and presiding judge, did not understand the financial issues associated with the allegations. Poulsen was imprisoned for jury tampering. His attorney stated that Poulsen plans to appeal his conviction. If unsuccessful in his appeal, Mr. Poulsen is slated to remain in federal prison until 2033.

With this in mind, when there is breaking news on a conviction related to securities fraud, accept that it has been a hard-fought battle and that there will be few, if any, spoils for the victims of the fraud.

People v. Parris

In a climate of “no sentence is too stiff for theft through securities fraud,” in 2010, Eastern District of New York judge Frederic Block criticized the

mathematics “fetish” nature of sentencing advisory guidelines in the case of Lennox and Lester Parris. The Parris brothers were convicted of releasing false press reports related to their company’s bottled water contracts with major distributors.¹¹

The brothers faced 30 years to life for their conviction on securities fraud, witness tampering, and conspiracy. According to trial records, through deceptive press releases and public announcements, they created windfall profits for themselves and other investors by pushing the Queénch stock up in market value. Judge Block cited the inappropriate nature of the sentencing guidelines by noting that other convictions of securities fraud that cost victims in excess of \$100 million resulted in single-digit prison terms for the defendants.¹²

For lying, but doing so at a profit instead of a loss for investors, the Parris brothers received a five-year sentence.¹³ Even though convictions for securities fraud are often associated with months or years in prison, there is an alternative—one that some might compare to Superman’s Bizarro World—where the punishment is literally a game of chance.

Samuel A. McMaster Jr.

Undeterred by being banned in 2004 from association with any brokerage firm, Samuel McMaster shifted his focus to insurance products by setting up shop in Albuquerque, New Mexico.¹⁴ In 2009, he was indicted by a New Mexico Grand Jury on nearly 200 counts of selling unregistered securities, fraud, and embezzlement. If convicted on all charges, McMaster faced a hefty 549 years in prison.

It was clear that McMaster had picked the pockets of unsuspecting victims and he was in hot water. The New Mexico Securities Division Superintendent, Kelly O’Donnell, commented, “McMaster took advantage of hardworking New Mexicans and we’ll work diligently to prosecute this case.”¹⁵

At this point the Bizarro World welcomes Mr. McMaster. Instead of the maximum sentence or one adjusted for his relatively low-dollar embezzlement of less than \$1 million, McMaster, who had limited career options, was sentenced to a form of work-release program. Subject to review and monitoring by the court, in order to enlist the assistance of Lady Luck to pay back his victims, McMaster was permitted to play poker and frequent casinos in New Mexico and California. His court-ordered charge is to win enough to pay his investors \$7,500 per month. Unfortunately, on many fronts, Mr. McMaster’s luck ran out. In April 2011, unable to repay his investors through his work-release program, Mr. McMaster was sentenced to prison.

When I shared this case with a friend in Canada, a country struggling with criticism for very light sentences for those convicted of financial crimes,

he replied in understandable disbelief, "You're kidding, aren't you? That can't be true."

Criminal Trials versus Civil Trials

Even though Bernard Madoff is the central figure in one of the most destructive financial crimes in history, he never stood trial either in criminal or civil court. Nevertheless, before transitioning to civil litigation it is appropriate to summarize three very important issues related to criminal trials and later to compare them to civil proceedings. These issues are also grounds for government prosecutors, such as in the case of Bernard Madoff, to work out a plea agreement for asset recovery and imprisonment plus avoid the high cost and risk of a trial:

1. Prosecutors in criminal cases are bringing an action on behalf of the state, the nation, or a federal mandate. The Plaintiff, or the entity initiating the action, is a legal body and not an individual.
2. Prosecutors in criminal cases must prove guilt beyond "a reasonable doubt." The standards for burden of proof are extremely high.
3. The amount of pretrial discovery and production of documents and witness lists, depending on the jurisdiction, can be very limited. Litigators in criminal trials are accustomed to surprises.

One Big Lie

The prosecution of Bernard L. Madoff, among other distinctions, had a lot of stakeholder muscle in the room when the victims' shouting started. More than 13,000 investors had been repeatedly poked in the eye with Madoff's sharp stick. Securities regulators on all continents wanted a slice of Mr. Madoff's hide. Congressional leaders were pointing accusatory fingers at everyone (except themselves). On December 11, 2008, the brawl began and continues today. Despite the legal maze, for our purposes, the Madoff case must be viewed sequentially.

- Madoff surrendered to Department of Justice FBI agents on December 11, 2008. None of the public records indicate that SEC or FINRA officials were present during the arrest.
- December 12, 2008, the SEC charged Bernard L. Madoff and his advisory firm, Bernard L. Madoff Investment Securities LLC, with securities fraud.

- Soon after his arrest, by court order, personal and corporate assets of Madoff were frozen.
- Madoff, as a control person for Bernard L. Madoff Securities (BLMS), admitted to several counts of securities fraud and was sentenced to 150 years in prison by a federal judge.
- BLMS was forced into bankruptcy and is being liquidated by Irving Picard, a court-appointed Trustee. Picard is in charge of a complex process that, among other things, is targeting assets from all sources that can be distributed to victims.
- Presently, Picard has recovered approximately \$10 billion of the estimated \$30 billion to \$60 billion in funds believed to have been stolen by Madoff. Several multi-billion dollar complaints have been filed by Mr. Picard and are pending adjudication.
- A portion of the restitution to Madoff investors has come from SIPC coverage afforded BLMS, the broker-dealer.¹⁶ Investors in Madoff partnerships and hedge funds, at this point, have little chance of monetary recovery.
- February 2, 2010, with Madoff imprisoned and a number of his associates targeted by federal prosecutors, the SEC dismisses its suit.
- The FINRA BrokerCheck for Bernard Lawrence Madoff, CRD # 316687, posted the following on June 16, 2009:

SEC Administrative Release 34-60118; IA Release 40-2892, June 16, 2009: The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to section 15(B) of the Securities Exchange Act of 1934 and Section 203(F) of the Investment Advisers Act of 1940 against Bernard L. Madoff based upon the entry of a February 9, 2009 partial judgment on consent imposing permanent injunction and continuing other relief, which permanently enjoined Madoff from future violations of Section 17(A) of the Securities Act, Section 10(B) of the Exchange Act and Rule 10B-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in SEC v. Bernard L. Madoff, et al., Civil Action 08-10791 (LLS), in the United States District Court for the Southern District of New York.

This FINRA public record, issued as a "final order" several months after Madoff's arrest and sentencing, included the sanction of a "permanent bar"

from the securities industry. Despite Mr. Madoff's confession, the following notation in the FINRA disclosure seems to provide some flexibility upon his release from prison at the actuarially challenging age of 120:

Does this order constitute a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct?

In response to the above entry, the public disclosure for Bernard L. Madoff, without further explanation, is simply "No." If the order of a permanent ban was not based on "violations of a law, regulation that prohibits fraudulent, manipulative or deceptive conduct," what was it based on?

Given the delay between the Madoff arrest in December 2008 and the June 2009 FINRA order, it appears that while in jail he was a licensed broker and hypothetically could have solicited and entered orders on behalf of investors. Granted, as a practical matter, that is an unlikely scenario. This whimsical notion, however, does speak to the importance of timely and accurate public disclosures.

With the limited reorganization or recovery options for victims in criminal cases, we shift our attention to civil litigation. In this second venue, civil courts founded on longstanding principles of fairness and victim advocacy, one would expect better results. You be the judge.

CIVIL LITIGATION

Through civil litigation, initiated by either the victim or possibly a government agency such as the Securities and Exchange Commission, there is a possibility of financial recovery for victims. Carefully note the term *possibility* in the previous statement. Even though this somewhat positive qualifier seems to have things heading in the right direction, we have countless miles of rough road before we reach our destination. For all parties, Plaintiffs and Defendants, civil litigation is often a lengthy and costly process. A win in civil court may not translate into a lasting and worthwhile victory. Quite the contrary.

A conviction in civil court can be nothing more than a legal record noting that one party prevailed in court. Possibly there are no funds or assets that can be used for restitution. The defendant could be a long-term guest of the state or federal authorities for another criminal matter. And in extreme circumstances, the defendant was tried and convicted *in absentia* and is living the life of a fugitive.¹⁷

Imagine a large room packed with victims, federal prosecutors, state agencies, class action attorneys, and industry regulators who are all trying to sort out who gets the first pass at the accused fraudster. Each constituency has a convincing complaint: “He took my life savings!” “He broke every one of our state securities statutes.” “He lied to me about my account value and cheated on his golf score.” “He broke the antifraud provision Rule 10(b)-5 of the 1934 Securities Act.”

When the shouting subsides, the loudest voice prevails—and that is always the voice connected to the biggest legal muscle.¹⁸ And in the previous examples, Rule 10(b)-5 is world-class muscle. Therefore, federal prosecutors and investigators will either initiate a criminal action like those we outlined or perhaps lighten things up with an administrative action. Regardless of the federal course of action, state and individual civil actions will generally be subordinated.

However, when it is in the best interest of the public, crimes of serious investment misconduct can be adjudicated in civil proceedings. This includes crimes that have violated state or local laws or cases that involve allegations of fraud against an individual or group of private citizens.

Due to the number of possible devices for securities fraud, the prosecution of investment misconduct can involve several legal channels. Such is the case of Frank Gruttadauria, Cleveland-area former branch manager for SG Cowen and Lehman Brothers. It is a longstanding theory by painters that a random mixing of all colors always produces purple. If that happens to be true, then Gruttadauria is the legal equivalent to the color purple. His admitted fraud and deception laid the groundwork for extensive prosecution by state and federal authorities, civil action by numerous victims, and countless NASD arbitrations by other investors. You will learn that Gruttadauria’s court-ordered restitution for those who won civil judgments is much like the celebrated contents of Al Capone’s vault—anticipation, stale air, but no loot.

When pursued by the FBI for his theft of at least \$40 million of his clients’ assets, Frank Gruttadauria left a note referring to his “interwoven fabric of digressions.” Even though his syntax was misaligned since he probably meant “indiscretions” (or possibly “indigestion”), his skills at deception and fraud were world-class.

After suffering losses in the equity market in the late 1980s, in order to continue the ruse of generating “10 percent” returns for his clients, Gruttadauria chose a strategy with no correlation to the market whatsoever—securities fraud. In his role as a branch manager he was in a position to control investor communications and approve asset transfers. For nearly 15 years (even Gruttadauria was unsure of the timeframe of the fraud), he promised above-market returns, consistently delivering double-digit

performance even in weak markets. He provided these results through a classic Ponzi scheme of making fund distributions requested by clients by transferring assets from other clients. This charade has a limited shelf-life, around 10 years at best, unless there is a flow of new funds. It is a self-liquidating crime, doomed to a finite life.

For more than a decade, no one was the wiser since the investors were receiving what they believed to be official statements from Gruttadauria's firms. Of course, the statements were fabricated by him and his co-conspirators. Even though the estimates vary, Gruttadauria is believed to have embezzled between \$40 million and \$100 million from several dozen clients. Many of his victims were elderly and close friends.

Like Madoff, when the music stopped, there were too few chairs in the room. With cash distribution requests mounting, Gruttadauria eventually reached a point where he could not borrow from Peter to pay Paul. Peter was broke and when the story broke, so was Paul.

Frank Gruttadauria, accused of bribery, racketeering, theft, forgery, election fraud, and money laundering, in 2004 received a seven-year federal sentence and a four-and-a-half-year state sentence to be served concurrently. Numerous civil actions were initiated in the state of Ohio while many arbitration claims were pursued through FINRA. Even though it may initially seem counterintuitive, his victims fared much better in any arbitration claims than through restitution required through the state and federal trials—all due to the legal concept of *respondeat superior*. Literally, *let the master answer*.

Respondeat superior is the principle that maintains that when individuals are acting in the capacity of employee or agent of their employer, the employer is responsible for the employee's actions. For Gruttadauria's case, even though state and federal authorities seized his assets and those of anyone else deemed a beneficiary of his criminal activity, there was a shortfall in assets for restitution. However, for the investors who had accounts with SG Cowen (in a series of transactions, Cowen was eventually purchased by Merrill Lynch) and Lehman Brothers, through settlements, mediations, and arbitrations, *respondeat superior* came to their rescue. For failing to supervise their agent, indeed the masters were forced to answer.

This is not to suggest that all investors were made whole. Due to legal fees and other costs, that is not often the case. If we assume that, after all costs, his investors received 65 cents on the dollar of their claims, their trust in a friend, their adviser, extracted a steep toll. Relatively speaking, a 65 percent recovery rate is much more generous than the \$5.00 per month that Gruttadauria has been contributing through his court-ordered restitution.

Up to this point, through criminal and civil litigation, it appears that victims of investment crimes may receive some level of emotional satisfaction,

but little else. This brings us to the third channel of recovery, class action suits. From thumb drives with less than the stated memory to cases linked to deceptive investment products, nearly every American has received a notice in the mail that unless they opt out they will be included in a class action. As a member of the class, without any out-of-pocket costs, if successful in the litigation (after costs and fees are deducted), they will share in the recovery.

CLASS ACTION LITIGATION

For scholars, judges, attorneys, instructors, experts, and investors, there is a treasure trove of class action data on Stanford University Law School's Class Action web site.¹⁹ In the high stakes game of rough-and-tumble mass tort litigation, this is a resource that is both reliable and worthwhile.

According to the web site, there are five reasons why securities class action cases are important to track:

1. Thousands of investors have an interest in class action securities fraud litigation. The Internet provides a low-cost means of communicating with these members of the class. The broad public interest in class action securities fraud litigation distinguishes it from most private-party litigation in which a relatively small number of parties have a direct interest.
2. The Private Securities Litigation Reform Act of 1995 provides a clear starting point for studying the effects of major statutory reform. The web site therefore has a realistic chance of capturing the entire bitstream describing the evolution of a new area of the law.
3. There is a preexisting and well-defined community of participants who are actively engaged in securities fraud class action litigation. A relatively small number of law firms account for a large share of the litigation on the plaintiffs' side, and an identifiable group of law firms have active defense practices. Many of these law firms are technologically sophisticated and are able to take advantage of this web site quickly.
4. Even after the passage of the 1995 Reform Act and defeat of Propositions 201, 202, and 211 in California, class action securities fraud litigation continues to be a topic of great public interest. A web site dedicated to an objective representation of developments in that area of the law may be useful in the formation of reasonable public policy.
5. The 1995 Reform Act contains provisions that require public notification upon the filing and settlement of class action securities fraud litigation. These provisions are consistent with Internet access to the full litigation record.²⁰

Recently there have been several securities-related class action lawsuits that have been successful in recovering significant investor assets. For example, related to the charges against Charles McCall profiled earlier in this chapter, shareholders received a \$1.2 billion pretax settlement from the company. Other multibillion-dollar class action cases are associated with Wall Street conflicts of interest and corporate misconduct.

The arithmetic of recovery for class action litigation is complex and from some perspectives less than rewarding. But as a method of recovery, this option should not be dismissed too quickly. The lawsuits require massive legal resources and can drag on for months or years. Private investors, especially after being defrauded, are usually short on both funds and patience. Even with a victory in court, when the issue is finally settled, the agreement or decision may not cover the litigation costs. On balance, participating in an investor class action lawsuit is a hands-off, no-out-of-pocket-expense method of recovery. Results vary, but anecdotal evidence suggests that 20 cents on the dollar is an average result, with many awards half of that.

This begs the question, "Twenty cents on the dollar, why bother? I will take my chances in mediation or arbitration. I can't do much worse!" However, the answer is "It depends." It is a complicated issue and much of the solution is based on recognizing that there are several categories of victims and with each group there are distinct patterns of experience.

MEDIATION

Mediation in securities dispute resolution is based on the longstanding principle of using a neutral party to bring the sides together prior to the evidentiary hearing for a common, but not altogether pleasant, negotiation session. This option is much like the playground game of rope tug-of-war, except the tension and agony can last for hours instead of minutes.

The process has centuries of history with labor unions and maritime disputes. In securities litigation, as in most other areas, mediation is voluntary and generally not binding. It can be an abbreviated process with less document discovery, a shorter timeline for completion, and thus lower overall costs. Mediators for securities and other areas are highly specialized and in some cases certified by a national organization.

Along with lower costs, one reason to consider mediation is for the opportunity to learn the opposing counsel's hearing strategy. Even though there can always be surprises in the hearing, through the filing of the claim or lawsuit, experienced attorneys have a general idea of how the other side will present their case. However, if you are unwilling to budge from a polarized

approach to the controversy, then mediation is probably a waste of time and resources.

Mediations can be a financial and emotional compromise, or perhaps a barbaric torture chamber. If an agreement is reached, both sides will likely feel some discomfort. When mediating in good faith, Plaintiffs or Claimants should not expect to receive an offer of 100 percent of their original claim and conversely the Defendants or Respondents should not expect to escape without writing a check.²¹ Legendary sports and entertainment agent and contract negotiator Leigh Steinberg gave excellent guidance: We should never underestimate the capacity of another human being to have exactly the same shortcomings as we have. The art of mediation is eliminating (or concealing) your shortcomings while exploiting those of the other party.

My research has indicated that where an individual who is an associated person with a regulated broker-dealer has a dispute with his or her employer, unless the claim involves obvious violations of state or federal labor laws, the employee is unlikely to prevail in civil litigation or in an arbitration. In the situation of intra-industry claims in general, it has been my experience that when an employee is under contract or constrained by employment or confidentiality agreements, mediation can be a better option than arbitration or even civil trials. Panels often support a strict interpretation of the terms of the contract.

Although the expense of litigation for a firm filing an arbitration claim against an employee can be costly (especially if outside counsel is used), companies are reluctant to set a precedent by writing checks to individuals who they feel are simply disgruntled employees. There are a number of examples of disputes, some cited in the media, where firms have spent small fortunes to defend cases of principle. It is a mistake for an opposing counsel or party to assume that since it will cost a firm at least \$50,000 to litigate, the company will certainly settle for an amount less than that. That can be a costly assumption and inherently disrespectful of an important process.

In the nonbinding option of mediation, for the Claimant, the expectation should be some discount from documented losses. For example, suppose you lost \$1,000, if the facts are somewhat in support of your claim, the starting offer may be 40 percent of your losses. However, you were thinking along the lines of 90 percent of your damages. The art of the deal is for the mediator and parties to close that gap.

During the mediation, be prepared to have the case sized up by the Respondent and opposing counsel. If they believe that you will make a credible and sympathetic witness, they will understand the risk of taking a chance in the evidentiary hearing. From your perspective, if the mediator points out some weaknesses in your case, accept the fact that those observations could mirror those of a jury or arbitration panel.

Finally, as it relates to mediation or any other settlement discussion, any information or proffers extended during pre-hearing discussions are considered confidential and cannot be referred to in any other litigation or venue. Another way of looking at this process is to understand the root of word *mediation*, which is the Latin term *medius*, meaning middle. If a party, whether it is an individual or firm, is willing to accept some portion of middle ground, then mediation is a viable recovery option that will possibly yield more than one might otherwise expect in a hearing.

Approximately 80 percent of securities claims are pursued away from civil court and are settled through mediation or other prehearing options. That is not to say that launching a mediation strategy is a day at the beach. For several reasons, the preparation for both parties must be no less intensive than preparing for a hearing or trial. In the remaining chapters of this book, as we work through the arbitration process from start to finish, you should assume that a well-orchestrated mediation will consist of a similar level of preparedness.

ARBITRATION

Since the 1987 Supreme Court ruling in *Shearson/American Express v. McMahon*, courts have held that predispute arbitration clauses in account agreements are enforceable.²² Disputes with brokerage firms and their agents or managers are typically governed by FINRA guidelines, while other disputes involving other organizations such as banks or finance companies will be decided by other tribunals such as AAA or JAMS arbitration.²³ These clauses are generally found in all brokerage new account forms, bank loan agreements, leasing documents, and other areas of consumer finance.

For the past two years there has been a legislative initiative referred to as the Arbitration Fairness Act that proposes that consumers cannot be forced to arbitrate a dispute and have the option of using the civil courts.²⁴ Battle lines have been drawn on the issue and until the Dodd-Frank HR 4173 there was little to show for the legislative effort.

Dan Solin, a well-known commentator on securities disputes, offers the following characterization of arbitration:

*There will be no meaningful financial reform until FINRA's mandatory arbitration system is abolished. Investors should not be treated as second-class citizens, compelled to humble themselves before an industry appointed arbitration tribunal, and beg for mercy.*²⁵

However, swept up in Wall Street reform and consumer protection, the *Shearson/American Express v. McMahon* decision may be nullified.

Under Dodd-Frank, the SEC is charged with conducting a study related to mandatory pre-dispute arbitration. Within the foreseeable future, it is conceivable that all parties involved in a securities-related dispute will have several choices:

- Mediation, arbitration, or civil litigation.
- Engaging effective legal counsel and other resources.
- Budgeting for the chosen process.
- Preparing to be a testifying witness.
- Dealing with the results.

In the upcoming chapters, each of these issues is addressed. Breaking with tradition by providing one conclusion at the beginning of the story, I will assure you that once you complete this book you will be convinced that you must never get yourself in the situation where preparing for a civil trial or arbitration is your only option. Often with very tragic results, it is not always possible to avoid victimization.

As mentioned earlier, there are bullies and sociopaths with sharp sticks. You may have had no role in your appointment with disaster. It was made for you. In any case, as a firm or individual, you must be prepared to move past the numbness to reorganize and recover. Your power to recover is not through some disingenuous “wink and a nod” from the person who victimized you—recovery is through knowledge, insight, preparation, and persistence. Informed decisions are the goal.

At the conclusion of this book, whether you decide that you are committed to never being a victim of securities fraud, or perhaps to never being a victim again, much will have been achieved. In Chapter 2, we explore the dilemma of choosing door A, B, or C: mediation, arbitration, or capitulation.

NOTES

1. *Myoptical singularis* was first coined in the author’s initial text in this series, *Securities Fraud: Detection, Protection and Control* (Hoboken, NJ: John Wiley & Sons, 2010).
2. It should be noted that legal writing has a unique and counterintuitive style. For example, there is a longstanding rule that a lengthy word such as *notwithstanding* is preferred over its synonym, *despite*. Uppercase is also the convention for road-sign words such as Plaintiff, Defendant, Claimant, and Respondent.
3. For those interested in the psychological aspects of recovery from loss and grief, I suggest the research of Elizabeth Kübler-Ross and especially Dr. Roberta Temes

(*Living with an Empty Chair: A Guide through Grief*, New Horizon Press, Far Hills, NJ, 1977).

4. "Report to the Nations on Occupations Fraud and Abuse: 2010 Global Fraud Study" (Austin, TX: Association of Certified Fraud Examiners, 2010).
5. www.msc.gov.mb.ca/media_events/events_releases/Inv_fraud, October 2, 2007, press release (accessed August 10, 2010).
6. It can be argued that there are actually six channels that would add "regulatory or administrative sanctions" to this list. However, as the term implies, these actions can be primarily operational in nature and thus not designed to offer relief to victims.
7. According to the Federal Bureau of Investigation's web site (fbi.gov), from 2004 to 2008, pending securities and commodities fraud cases have jumped approximately 25 percent. Associated with investigations in 2008, the FBI also reported in excess of \$8 billion in restitution judgments.
8. In the matter of *U.S. v. McCall*, 3:00-CR-00505, U. S. District Court, Northern District of California (San Francisco).
9. "Ex-McKesson Chairman McCall Gets 10-Year Prison Term for Fraud," Bloomberg News Service, March 6, 2011, by Karen Gullo (accessed through Businessweek.com, August 22, 2010).
10. Written communications in 2010 through the Bureau of Prisons mail system between the author and Lance Poulsen.
11. *People v. Parris*, 05-CR-636, associated with bottled water company, Queénch.
12. The Rubik's Cube scale for sentencing guidelines is not mandatory, only advisory. As cited in *United States v. Bocher*, any mandatory scale that relies strictly on arithmetic and not the judgment of the judge or jury is a violation of the defendant's Sixth Amendment right to a fair trial and sentencing.
13. Any attempt to match the crime with just punishment is marked by extreme cases. Whereas Judge Bleck reduced the Parris sentences by 25 years, former Dynergy executive Jamie Olis was eligible for a modest sentence of six months for his role in a natural gas trading scheme and was given a staggering 24 years for his conviction. Mr. Olis's case is being reviewed by an Appeals court for possible resentencing.
14. FINRA BrokerCheck CRD # 821931 (accessed August 11, 2010).
15. "Albuquerque Man Indicted on 177 Counts of Securities Fraud-Related Charges," Carol A. Clark, April 23, 2009, <http://newsextras.wordpress.com/2009/04/23>.
16. By design and actions, SIPC offers limited coverage for the insolvency of a brokerage firm and does not cover fraud.
17. Examples of fugitives wanted for securities fraud are Eric Bartoli (a.k.a. Enrico Orlandini) and Rebecca Parrett. Bartoli escaped imprisonment in the United States by fleeing to Europe, finally setting up residence in Peru. Recently he was the subject of an investor warning by Peruvian authorities and in 2010 placed on Interpol's alert list. Parrett, a former executive at National Century Financial Enterprise (see Chapter 1 section on Lance Poulsen), escaped prior to being fitted for an electronic monitor. Despite having assumed a false identity and surgically altering her appearance, Parrett was caught in Mexcio in 2010

and is now a guest of the Federal Bureau of Prisons. One individual, Semion Mogilevich (one of many known aliases), wanted for securities fraud, is on the FBI's Ten Most Wanted Fugitives list. The resourceful Ukrainian is wanted for a wide range of criminal activity including securities fraud connected with the fictitious company, YBM. Unlike the typical profile of the Harvard-trained, starched-white-shirt Wall Street con artist, Mogilevich is considered armed and extremely dangerous.

18. Even though the bankruptcy of Lehman Brothers took place in 2008, the legal defense of corporate officers is tapping into millions in Directors and Officers insurance policies.
19. <http://securities.stanford.edu>, Stanford Law School Securities Class Action Clearinghouse (in cooperation with Cornerstone Research).
20. www.securities.stanford.edu (accessed August 29, 2010).
21. In criminal and civil litigation the person or entity filing the claim is called the Plaintiff and the other party is referred to as the Defendant. In securities arbitrations, the party initiating the claim is called the Claimant and the counterparty is the Respondent. There can also be multiple parties on each side of the case.
22. Volume 482 U. S. 220, June 8, 1987.
23. Formally, American Arbitration Association (adr.com), and Judicial Arbitration & Mediation (jamsadr.com).
24. Formally, the Arbitration Fairness Act of 2009, H. R. 1020, currently referred to the House Judiciary Committee on Commercial and Administrative Law.
25. Dan Solin, "The Ugly Side of FINRA," www.huffingtonpost.com/dan-solin/the-ugly-side-of-finra_b_594319.html?view = print, June 1, 2010 (accessed June 2, 2010).

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