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SECURITIES

Bank Liability for Ponzi Schemes: Defending Negligence Suits by Non-Customer Victims



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Introduction

Ponzi schemes (named for Charles Ponzi, who in 1920 in Boston through his “Securities Exchange Company” ran various schemes that paid early investors returns out of funds received from subsequent investors) vary in length, size and means, but always end the same way: with victims suffering massive finan-

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cial harm without any meaningful hope of recovery against the scheme's architect. In recent years, Ponzi scheme victims have expanded their targets in efforts to recoup losses, filing suit against the financial institutions used by schemers to receive and hold victims' money before these funds are misappropriated. Claims against depository institutions represent more than an abstract challenge to the general rule that these institutions owe no duty to non-customers; they broaden immensely the potential oversight responsibilities faced, and threaten substantial financial liabilities in the form of litigation costs and verdict exposure.

Efforts to overcome the general “no-duty” rule initially led some Ponzi scheme victim plaintiffs to allege that defendant financial institutions knowingly aided and abetted the schemes, but the challenges inherent in proving such a theory doomed most of these early cases. In the ongoing search for deep pockets, victims have in recent years focused on negligence theories, arguing that an institution's failure to fulfill its duty to prevent and detect Ponzi schemes creates liability for losses suffered. Plaintiffs in those cases have sought to evade the “no duty” rule by attempting to incorporate the obligations imposed by federal banking regulations which mandate that financial institutions monitor accounts for criminal and even merely “suspicious” activity by depositors. A significant number of cases have gained traction on such theories, although the over-

whelming majority were decided before the U.S. Supreme Court announced a new standard for measuring the sufficiency of civil actions.

This article examines the evolving trend of suits by Ponzi scheme victims against financial institutions from three different angles. First, it analyzes the nature and scope of liability financial institutions face when depositor fiduciaries misappropriate funds. Second, it explores the legal strategies available to defend such suits, especially in light of a recent seismic shift in the standard under which complaints are tested. Finally, it considers and proposes preventative measures calculated at least to minimize, if not eliminate, the risk of incurring liability for conduct of depositor fiduciaries.

The Contours of Financial Institution's Liability for Actions of Depository Fiduciaries

Absent extraordinary facts, courts generally hold that financial institutions owe no duty to protect third parties from the unlawful acts of bank customers. This notion is grounded in both legal and practical concerns. As a general legal principle, a duty arises where the nature and scope of harm to another is readily foreseeable. Without some identifiable evidence demonstrating foreseeability in a given scenario, most courts have declined to conclude that it is foreseeable to the institution that a particular bank customer will defraud a non-customer. Moreover, courts have recognized the practical implications of recognizing such a duty: a tremendous increase in the administrative burdens already imposed on financial institutions.

The prevailing wisdom concludes that individuals who retain fiduciaries stand in the best position to investigate thoroughly the would-be fiduciary's background, and monitor his or her performance on an ongoing basis. To conclude otherwise would effectively require individual institutions to monitor thousands of accounts (or more, depending on the institution's size) at considerable expense. Imposing that obligation would carry great cost, which would be passed on to other bank customers.

It is important to recognize that suits which allege that the bank actively assisted the Ponzi scheme are not barred by the no-duty rule. As a result, some Ponzi scheme victims have sought recovery on the theory that the financial institution in question aided and abetted the schemer's efforts. While such claims avoid the difficulty inherent in establishing the existence of a duty of care, they face two much more arduous challenges: 1) demonstrating that the bank had actual knowledge of the Ponzi scheme architect's fraudulent activities; and 2) proving that the bank rendered substantial assistance in those efforts. Not surprisingly, in light of the relative infrequency with which federally regulated financial institutions knowingly and actively facilitate a fraudulent scheme against their customers, plaintiffs proceeding on this theory have seldom been able to carry their burden.

Negligence claims are different. To prevail on a negligence claim, a plaintiff must plead and establish four elements: 1) duty owed to the plaintiff by the defendant; 2) breach of that duty; 3) causation between the breach and harm to the plaintiff; and 4) damages. The first element is the most critical. As a general legal principle, a duty arises where the nature and scope of harm to another is readily foreseeable. The existence of a duty

serves as a threshold question; without it, the claim fails regardless of how much money the plaintiff lost.

To avoid application of the no-duty rule and pursue a negligence claim, a plaintiff must establish that the financial harm caused by the Ponzi scheme architect was foreseeable to the financial institution. Without some identifiable evidence demonstrating foreseeability in a given scenario, most courts have declined to conclude that it is foreseeable to the institution that a particular bank customer will defraud a non-customer. Many Ponzi scheme plaintiffs have endeavored to fulfill this obligation by demonstrating the existence of facts which, they contend, provide notice to financial institution of ongoing fraudulent activity. Those plaintiffs often rely on the requirements imposed on financial institutions by the Bank Secrecy Act (31 U.S.C. § 5311 *et seq.*) to identify and report potentially suspicious activity. Particularly industrious plaintiffs have attempted to transform the BSA's requirements, particularly those relating to monitoring of suspicious activity, into obligations which insure to the benefit of non-customers. This strategy seeks to create a legal responsibility – a duty, as it were – on banks to monitor accounts for activity which may negatively impact not simply the institution or society at large, but also individual non-customers.

Potential Strategies to Employ When Defending Suits by Ponzi Scheme Victims

Limitations on bank liability narrow, but do not foreclose entirely, the risk of suits by Ponzi scheme victims. Those defrauded will frequently explore the possibility of recovering at least some of their money, and very often the bank where the schemer held the funds is the only viable source. As many financial institutions know (often from firsthand experience), litigation represents a costly and time consuming endeavor — even when the bank ultimately prevails. Financial institutions facing claims from Ponzi scheme victims need to understand and implement strategies calculated not only to defeat such claims, but to do so as expeditiously as possible. The discussion below reviews strategies to consider in seeking to achieve that result.

Take Full Advantage of the Recently Heightened Standard for Evaluating the Sufficiency of a Complaint

Regardless of the type of claim faced, defendants typically seek to exit litigation as quickly as possible. As a general principle, terminating litigation at its infancy serves not only to avoid substantial legal fees and resource expenditures on the particular suit in question, but also to deter follow-on claims by others similarly situated. Suits by Ponzi scheme victims are no exception.

Prior to 2007, banks seeking to dismiss suits filed by defrauded victims faced an uphill challenge. Courts evaluated those motions under a time-worn standard which provided that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his or her claim which would entitle him to relief.”¹ The Supreme Court retired that standard in two recent decisions, however, and completely overhauled the framework for evaluating the sufficiency of complaints.

¹ *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

In place of the “no set of facts” standard, *Bell Atlantic Corp. v. Twombly*² and *Ashcroft v. Iqbal*³ directed courts to employ a two-step review process. First, courts must separate a complaint’s factual allegations from its legal conclusions. While the former are assumed to be true, the latter are not. Second, after sifting through the complaint’s well-pleaded factual allegations, court are to evaluate “whether they plausibly give rise to an entitlement of relief.”⁴

While *Twombly* and *Iqbal* will have a dramatic impact across the spectrum of civil cases, their effect is particularly pronounced in the context of suits against financial institutions by Ponzi scheme victims. Regardless of the theory of recovery a Ponzi scheme plaintiff advances, the complaint will almost always rest on the claim that the bank had “knowledge” of the fiduciary depositor’s breach of his or her obligations. The allegations that a defendant acted with a particular state of mind, including “knowledge,” is a legal conclusion under *Twombly* and *Iqbal*. As such, that allegation is “disentitle[d] to the presumption of truth.”⁵

This means that plaintiffs must demonstrate knowledge through specific allegations linked to factual events, rather than relying on conclusory assertions un tethered to any substantive allegation. Instead of the blanket claim that the defendant financial institution had knowledge of the depositor fiduciary’s breaches of duty, plaintiffs must ground their case in specific details which demonstrate the institution’s awareness not only that the account was fiduciary in nature, but also that the customer was engaging in the type of activity which could plausibly signal harm to non-customers. Simply cobbling together some number of factual allegations will not insulate the complaint from challenge. Under the second prong of *Twombly* and *Iqbal*, the court must determine whether those allegations have sufficient “heft” to justify putting the defendant to the expense of defending the suit. In carrying out this obligation, courts are obligated to consider the existence of innocuous explanations which are equally or more plausible than the nefarious conclusions plaintiffs have drawn.

When applied to negligence suits by Ponzi scheme victims, the *Twombly* and *Iqbal* standard should improve a financial institution’s ability to challenge the component parts of those claims. Foremost among the advantages those cases offer is the ability to challenge the existence of a duty, a threshold determination; unless specific factual allegations are made demonstrating reasonably foreseeable harm to the plaintiff, the plaintiff has not established a duty owed to him or her by the bank. No longer are plaintiffs able to avoid dismissal of their lawsuits simply by asserting conclusory claims of the bank’s knowledge of the schemer’s fraudulent activity, especially where the misappropriated funds were not held in a fiduciary account. *Twombly* and *Iqbal*-based challenges should serve as a standard response to negligence claims by Ponzi scheme victims.

Assert Contributory and Comparative Negligence Defenses

When a plaintiff alleges that a financial institution was negligent in dealing with a fiduciary account, that necessarily makes relevant questions about whether the

plaintiff was negligent. There are three main doctrines concerning how a plaintiff’s negligence affects a plaintiff’s ability to recover from a defendant, and most states use a version of one of the three. Under each, a judge or jury assigns a percentage of fault to a plaintiff for the plaintiff’s injury. Depending on the doctrine and a plaintiff’s level of fault, a plaintiff may be limited or precluded from recovering any damages in a specific case. The three doctrines are:

- *Contributory Negligence* — if a plaintiff’s negligence contributed in any way to a plaintiff’s damages, then the plaintiff cannot recover damages. The doctrine of contributory negligence completely bars a plaintiff from recovery even if the plaintiff is only 1 percent at fault. Given the perceived harshness of the contributory negligence doctrine, few states use it.

- *Pure Comparative Negligence* — if a plaintiff’s negligence caused part of the plaintiff’s damages, then the plaintiff cannot recover the part of the damages that a judge or jury attributes to the plaintiff.

- *Modified Comparative Negligence* — like pure comparative negligence, a plaintiff cannot recover the percentage of the damages attributed to the plaintiff, but if the percentage of a plaintiff’s fault meets or exceeds a certain amount (often 50 percent), then the plaintiff cannot recover damages.

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Under each, a plaintiff must account for both the plaintiff’s failure to investigate the would-be fiduciary before investing with the fiduciary and the plaintiff’s failure to monitor the fiduciary’s activities subsequent to the investment. As to the first, there are often many red flags to alert an investor to a Ponzi scheme that reasonable investors should notice and that many investors choose to ignore in pursuit of high returns. Fraud detection expert Tracy Coenen has noted more than fifteen red flags signaling a Ponzi scheme that any investor could spot with a reasonably diligent (and fairly simple) investigation.⁶ These items include:

- The schemer’s past history of involvement in such schemes, including findings of misconduct issued by regulators and licensing authorities;

- Implausible and unsupported claims about the amount of return the investment will yield; and

² 127 S. Ct. 1955 (2007).

³ 129 S. Ct. 1937 (2009).

⁴ *Iqbal*, 129 S. Ct. at 1950.

⁵ *Iqbal*, 129 S. Ct. at 1951.

⁶ Ms. Coenen’s article, “Ponzi Scheme and Investment Fraud Red Flags,” is available online at <http://www.sequenceinc.com/fraudfiles/2012/01/ponzi-scheme-investment-fraud-red-flags/>.

■ The absence of any independent third-party review of the schemer's company.

Similarly, a plaintiff must reasonably monitor a fiduciary's activities. A reasonable beneficiary would not ignore the failure to receive periodic account statements reporting investment performance or the receipt of any account statements that lack specificity regarding the number and nature of transactions in the account. Exploring the number and nature of the opportunities the Ponzi scheme victim enjoyed to detect and prevent (or at least minimize) the financial harm caused is essential to defending a suit against the bank.

It is important to remember that, in applying the doctrines of contributory and comparative negligence, the goal of the financial institution is not to blame a plaintiff for the unfortunate and illegal actions of the Ponzi scheme promoter. Rather, the financial institution uses these doctrines as a defense when the plaintiff attempts to shift the blame and responsibility from the schemer. In other words, where a plaintiff elects to point the finger at someone other than the Ponzi scheme promoter, she opens the door to an evaluation of his or her own conduct, and his or her failure to capitalize on opportunities to avoid or minimize harm caused by the schemer. On the most basic level, the doctrines of contributory negligence and comparative negligence present an opportunity to demonstrate the unfairness inherent in holding a financial institution liable when an individual investor fails to take reasonable steps to protect his or her own money.

Make Full Use of Any Criminal Prosecution of the Ponzi Scheme Architect

Lawsuits against financial institutions usually occur parallel to criminal prosecutions of the would-be fiduciary. Information churned up during the investigation and prosecution of a Ponzi scheme promoter can be valuable information, if the financial institution can acquire it. Obtaining documents directly from the government can be challenging, especially when an investigation or prosecution is ongoing. Opportunities exist to acquire potentially helpful information, however, and should be exploited.

At a minimum, counsel for a financial institution should monitor the government's investigation and remain alert for opportunities to acquire: 1) evidence of the Ponzi scheme promoter's concealment, especially concealment of information from a financial institution; and 2) evidence concerning earnings the plaintiff's account has yielded or distributions the plaintiff has received that should have caused a reasonable investor to inquire about the possibility of a Ponzi scheme (especially consistently high rates of return in down markets).

Obtaining such evidence can be challenging, but is not impossible. During the course of the criminal proceeding (especially if the matter proceeds to trial), the government will often offer evidence in one or both of these categories. This can occur during court hearings, and may also be reflected in pleadings filed. When the schemer pleads guilty, the transcript of his or her guilty plea hearing and sentencing can contain a treasure trove of helpful admissions demonstrating that the

scheme succeeded because of his or her criminal activity, rather than active assistance or passive negligence on the part of the financial institution. At a minimum, the financial institution can question the Ponzi scheme victims during the discovery process about their communications with the government, including statements made and documents supplied.

Depending on the nature of the criminal proceeding, those of the schemer's victims who have trained their sights on the financial institution may have numerous opportunities to provide their version of events. In a setting focused on the schemer – either a trial intended to establish his or her guilt or a sentencing hearing designed to calibrate his or her punishment – victims' statements will center on the defendant's wrongdoing, not the bank's. While the two are not necessarily mutually exclusive, effort should be made to search for and identify those instances where the victim's statements are fundamentally inconsistent with the notion that the bank bears any culpability.

Proposed Preventative Measures

While there is no panacea for suits by Ponzi scheme victims, financial institutions are not helpless to prevent against such claims. Better understanding of the nature of the risk presented is an important first step. The effectiveness of that comprehension can be compounded by implementation of some basic strategies calculated to reduce the potential for such claims. Those include:

1. Reviewing the bank's new account information forms to confirm that they elicit sufficient information such that the fiduciary nature of the account is clear (so as to better identify those accounts which may require additional attention);

2. Enhancing disclaimer language in the bank's new account information forms requiring fiduciary depositors to acknowledge that the bank has no responsibility to the fiduciary or its beneficiaries to inquire into or otherwise monitor the fiduciary's activities on behalf of the account;

3. Considering other mechanisms for the bank to disclaim liability for the actions of fiduciaries, e.g., adding a section on the bank's website explaining what steps a reasonable beneficiary should take to prevent or detect being victimized by a Ponzi schemer.

4. Augmenting the bank's BSA compliance efforts to include a component directing the BSA officer evaluating suspicious activity to determine whether the accounts in which suspicious activity appears are fiduciary in nature; and

5. Renewing efforts to educate bank employees of the need to report concerns about potential impropriety in fiduciary accounts, even if the harm is threatened to parties other than the financial institution.

So long as the financial institutions remain the sole source of financial recovery when the dust of a Ponzi scheme clears, the battle over the scope of bank liability for negligence claims by victims of such schemes will wage on. These and other preventative measures will serve financial institutions well in those efforts, as well litigation strategies calculated to bring a quick and decisive end to such challenges. Forewarned is forearmed.