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# RECOVERING THE PROCEEDS OF FRAUD

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Association of Certified Fraud Examiners

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## **PART ONE: THE LAW IN A FRAUD RECOVERY CASE**

### **I. LEGAL CAUSES OF ACTION IN GENERAL**

A fraud victim's right to recover money or property, or their equivalent in monetary damages, from another person—and the remedies by which they can recover them—requires that the person obtained that money or property unlawfully (i.e., by conduct that violates one or more laws). A person who violates the law—either by conduct that is prohibited or by failing to fulfill a duty—is legally obligated to redress the injury or loss caused to the victim by that violation. The victim enforces that obligation to redress their loss through specified remedies that correspond to different legal offenses.

Thus, to recover the proceeds of fraud, it must be shown that the loss was caused by unlawful conduct. In practical terms, this means fraud examiners must be able to recognize which laws were potentially violated, and they must be able to match the facts and circumstances of a specific loss to one or more legal causes of action. This is their *legal theory of recovery*.

In this chapter, fraud examiners learn about the different legal offenses, or *causes of action*, that can support a fraud recovery. This discussion provides definitions of these various *causes*, and it provides some information that bears on practical, strategic, and tactical decisions about the recovery plan, which is discussed in more detail in later chapters.

#### **Bringing Multiple Claims in a Single Legal Action**

Although this course generically refers to fraud and fraudulent conduct, fraud is not the only legal wrong with which fraud examiners may be concerned. *Fraud* (see definition of *fraud and deceit* that follows) is a very specific kind of unlawful conduct, but it is not the only way in which a perpetrator can wrongfully deprive a victim of money or property. Also, not all fraudulent conduct is criminal. In addition to fraud and deceit, there are many more state and federal causes of action, each of which are described in the following sections. Even if a perpetrator's conduct does not rise to the level of fraud, it might constitute some other legally recognized civil or criminal wrong.

Moreover, fraudulent conduct may—and often does—violate more than one law. And because the same conduct can violate more than one law, a fraud victim can file a lawsuit that includes all the applicable causes of action that can be proven. Whether to include more than one potentially provable cause of action—and which ones to include—usually depends on which causes of action will provide the best tactical and strategic advantages and maximize the possibility of a recovery.

### State Versus Federal Offenses

All legal wrongs in the United States are defined either by state or by federal law, but the legal courses of action given for the same offense might differ between state and federal law. Likewise, the available remedy might vary between state and federal offenses. Also, the choice of state or federal law might dictate the court in which people may—or must—proceed. Thus, a fraud examiner might encounter the distinction between state and federal law both in choosing from among different legal causes of action to assert and in choosing the court in which they file suit. (Choosing the court is discussed in Chapter 10.)

Both state and federal governments may define conduct as criminal, but their authority differs. States have broad power and authority to legislate and define offenses for the general welfare of their citizens, but the federal government has limited, defined powers and can only legislate and control conduct within these powers.

#### EXAMPLE

*Any fraud violates state law, but fraud alone does not violate federal law. Federal statutes can only prohibit fraud or fraudulent conduct in dealings with federal agencies or where the conduct affects or impacts an area of federal interest, such as the regulation of interstate and foreign commerce. So, for example, federal law prohibits bribery of a federal official, use of the mails or interstate wire facilities to carry out a fraudulent scheme, and obstructing the examination of a financial institution that is federally insured or whose activities affect interstate or foreign commerce.*

To hear and decide a case, a court must have *jurisdiction* (i.e., the power to hear and decide a given case) over the subject matter involved. Consistent with the limited powers of the federal government, federal courts can hear cases that arise under federal law; however, they can also hear cases arising under state law but only in certain limited circumstances. In contrast, state courts can hear any case arising under state law and any case under federal law, as long as the federal law does not give the federal court exclusive jurisdiction. (This refers to the court's *subject matter jurisdiction*—the court's authority to hear a particular kind of case.)

Federal courts have subject matter jurisdiction in two kinds of cases: diversity jurisdiction cases and federal question cases. Under *diversity jurisdiction*, a federal court can hear a state action that involves more than \$75,000 and is between parties who are citizens of different states. Diversity of citizenship must be complete—all of the plaintiffs must be citizens of a different state(s) from all of the defendants. For purposes of determining diversity jurisdiction, a party is a citizen of the state where they are domiciled (i.e., where they are present and intend to make their permanent home). A corporation is a citizen of the state in which it is incorporated and the state in which it has its principal place of business. Federal courts also have jurisdiction over cases based on federal law.

There are also cases in which a federal court may agree to try any state law claims that are related to the federal law claims. These related cases were previously called *pendant* or *ancillary* jurisdiction, but they are now codified as *supplemental jurisdiction*.

There are numerous rules (and exceptions) that are used to determine where cases may be filed. An attorney will work with the client to decide which forum is the most advantageous. Just be aware that sometimes there is a choice, and often the type of wrong and the possible recovery might be a factor in such a decision.

### Civil Wrongs Versus Crimes

Legal offenses generally are classifiable as either *civil* or *criminal*, and they differ significantly in their respective remedies. In fact, civil and criminal offenses are principally distinguishable by the difference in their respective purposes or remedies and not by the nature of the conduct that gives rise to the offenses. The same conduct can violate both criminal and civil laws (e.g., for fraud, theft, or bribery). In addition, some statutorily created offenses (such as RICO, discussed in the following section) have both criminal and civil consequences. Accordingly, an offense cannot be classified as civil or criminal strictly by the nature of the prohibited conduct.

In short, a *civil action* is designed to compensate the victim for the loss or injury suffered or, sometimes, to prevent future injury. Accordingly, civil actions provide a variety of direct remedies to compensate the victim. But, as we shall see in Chapters 5 and 6, there are remedies in a civil case that are punitive (i.e., inflict punishment) in nature; generally, however, punitive remedies are incidental or supplemental to compensatory damages. A victim bringing a civil action may also seek an *injunction*, which is an order by the court that compels a person to perform or refrain from a certain future act.

Conversely, a *criminal action* is designed to punish the wrongdoer with imprisonment, a monetary fine, or some other prescribed sanction. The threat of such punishment is meant to deter others from violating the law. Generally, criminal actions for fraud do not afford fraud victims any direct remedy against their wrongdoers, but criminal actions are still relevant to professionals concerned with recovery. As we will discuss in Chapter 8, fraud victims sometimes can obtain compensation from convicted defendants through the criminal process. In all courts, the judge may require the convicted defendant to make restitution (i.e., repay a victim for financial losses). Furthermore, in an increasing number of states, judges are directed to order restitution even when the defendant is not placed on probation.

Additionally, the parties who are permitted to pursue criminal and civil actions differ. Private parties file civil cases against other individuals, businesses, or government agencies. Conversely, criminal actions are brought by state or federal officials against individuals or corporations on behalf of the public.

Also, a finding of guilt in a criminal action may be used as evidence of liability in a civil suit. Under certain circumstances, a criminal conviction establishes the essential facts in a later civil case against the same defendant. In other words, if a defendant is convicted in a criminal case, a subsequent civil case involving the same issue will not retry the defendant's guilt; the defendant's guilt is accepted.

A criminal conviction can also establish the facts that entitle a fraud victim to benefits under an employee dishonesty insurance policy or fidelity bond.

Finally, certain criminal offenses may be the basis for a suit under the federal Racketeer Influenced and Corrupt Organizations (RICO) statute (18 U.S.C. § 1961 et seq.) or other comparable state criminal enterprise statutes. These statutes outlaw the investment of ill-gotten gains in another business enterprise, the acquisition of an interest in an enterprise through certain illegal acts, and the conduct of the affairs of an enterprise through such acts, and they provide both criminal penalties and civil remedies (see discussion that follows and in Chapter 3).

### **Essential Elements of a Cause of Action**

In attempting to recover the proceeds of a fraud, fraud examiners must first be able to show that the victim's loss was caused by unlawful conduct. In practical terms, this means the examiner must be able to recognize which laws were potentially violated, and they must be able to match the facts and circumstances of a specific loss to one or more legal causes of action. This will be the legal theory of recovery.

Both civil and criminal complaints set forth a grievance, or legal claim, which is divided into particular elements of the claim. The definition of any legal offense (or cause of action) consists of the essential elements that must be proven by the evidence.

The elements of any legal offense specify what must be shown to prove the claim. Thus, if the examiner finds evidence that a fraud might have occurred, they must develop the evidence necessary to establish the legal elements of the fraud claim. That is, a legal offense (referred to as a *cause of action*) is established by providing all of the essential elements of the underlying claim. If a party fails to prove one or more of the elements, then the party has not established that offense.

Note again, however, that specific conduct may violate more than one law, and that under such circumstances, those laws probably share one or more essential elements. Thus, even if a party fails to prove all of the elements of one offense, it might be possible to prove all of the elements of a different offense.

EXAMPLE

*Evidence that the perpetrator permanently deprived a rightful owner of his property or money without consent can be used to establish either embezzlement or conversion, depending on whether the perpetrator had lawful possession of the money or property when he took them. If you prove that the defendant deprived the victim of property without the victim's consent, but you do not prove that the defendant had lawful possession of the property, you cannot establish a claim for embezzlement, but you can establish a claim for conversion.*

The essential elements of a legal cause of action generally are set out in the statute that creates or defines the offense. These can be found in the statute books of the relevant jurisdiction. In addition, written decisions or opinions in which courts have interpreted and applied these statutes in real cases might result in further delineation, explanation, or limitation of the statutory language by the courts.

A client and their attorney must consider the evidence carefully and critically to determine if there are enough facts to establish each element of the cause of action that they are considering. The legal elements of specific offenses are discussed in more detail in the next two chapters.

### **Vicarious Liability**

In civil law, a victim may not only recover from the principal offender, but they may also recover from a third party, as if the third party were a principal. That is, in civil law, a third party may be liable for the misconduct of another party. This is referred to as *vicarious liability* (i.e., the absolute liability of one party for the misconduct of another party).

Vicarious liability might become important in planning a fraud recovery. If, for example, the primary actor is judgment-proof (insolvent or lacks funds to satisfy a judgment), seeking a recovery from a third party should be explored. In short, vicarious liability might be a good option if it is not practicable to seek recovery from the primary actor for some reason. If seeking recovery from the primary actor is not practical, another liable person or entity, preferably one with insurance or with the means to satisfy a judgment, must be identified.

Briefly, the general rule is that employers, principals, co-conspirators, partners, joint venturers, and corporations are vicariously liable for any acts done on their behalf by their employees, agents, co-conspirators, partners, joint venturers, or directors and officers. But to hold a third party vicariously liable, the primary actor must have acted within the course and scope of their employment or contractual relationship with the third party.

Similarly, in criminal law, one who aids, abets, solicits, attempts, or conspires to commit the offense can be punished as a principal. For the same reasons already discussed, fraud examiners might be interested in the vicariously liable criminal defendant, who might be more able to pay restitution than the primary actor.

If a person or entity is found vicariously liable, they are *jointly and severally liable* to the same extent as the primary actor. That means the plaintiff can recover all or any part of the judgment from either the primary actor or the vicariously liable parties.

The major factual issue that usually arises in cases seeking to establish vicarious liability is whether the primary actor was acting within the course and scope of the relationship with the third party. Although wrongful conduct is presumptively never within the course and scope of a legitimate relationship, and there is some authority that intentional torts by the principal actor cannot be charged to the employer, principal, and so on, many courts do not look to the nature or quality of the primary actor's misconduct. Instead, these courts look to whether the primary actor was acting within their role in the relationship and for the purpose of serving or furthering the interests of their employer, principal, and so on.

Even if the conduct at issue was not within the course and scope of the relationship, the third party can assume vicarious liability for the primary actor's misconduct by adopting, approving, or ratifying the conduct. Whether that occurred is a question of fact to be decided at trial.

### **Criminal Conspiracy**

*Conspiracy* is defined as an agreement between two or more people to commit a crime, and a member of a conspiracy can be held vicariously liable for the crimes of their co-conspirators.

To hold conspirators liable, they must intend to enter into an agreement, and they must intend to achieve the objective of the agreement. The agreement need not be express, and the agreement and intent may be manifested by the conspirators' concerted actions over time and under the circumstances. Also, it is not necessary that all of the co-conspirators know each other or agree with each other. If each co-conspirator shares the common goal(s) of the larger conspiracy, then each may be considered a member of the larger conspiracy even if a conspirator's agreement was only with some of the co-conspirators.

Also, federal law and most states also require that, to hold conspirators liable for the actions of their co-conspirators, one of the co-conspirators must commit some overt act in furtherance of the conspiracy. An *overt act* is an activity that moves toward the commission of the crime. The overt act need not be criminal or unlawful, and it might be as innocuous as making a phone call or writing a letter.

All co-conspirators are liable for the unlawful acts that their co-conspirators committed in the course and scope of the conspiracy.

A co-conspirator who withdraws from the conspiracy does not avoid liability for the conspiracy itself, but they do avoid liability for any unlawful acts committed by other co-conspirators subsequent to their withdrawal.

EXAMPLE

*Bob and Steve work in the accounting department. Together, they agree to steal checks from their employer and cash them. Steve steals the checks, makes them out to himself, and cashes them. When Steve attempts to give Bob his share of the money, Bob gets scared and says that he no longer wants to be a part of the scheme. Even though Bob did not take the checks, cash them, or share in the proceeds of the crime, he can still be guilty of conspiracy because he conspired with Steve to commit the crime. He also can be criminally and civilly liable for Steve's theft and fraudulent cashing of the checks. In short, as a co-conspirator, Bob can be held responsible for Steve's actions and can be prosecuted for the crime.*