DON'T DEPEND ON A HANDSHAKE

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> **"Once someone is entrusted in a fiduciary relationship, an opportunity is created for that person to become less trustworthy, or worse, a thief."**

An attorney representing a local condominium association called our firm to set up a meeting. Her client, a residential homeowners' association consisting of 32 unit owners, learned that the property manager, we'll call her Jane, had been using its funds for personal purposes. The board of directors, comprised of unit owners with varying degrees of financial knowledge, relied solely on the monthly financial reports provided by Jane.

The board had established a reserve fund and budgeted contributions to it for many years, and the association needed to use the reserve to fund a roofing project. Financial issues surfaced when Jane reported that the reserves were deficient and that they'd need to borrow outside money to undertake the project.

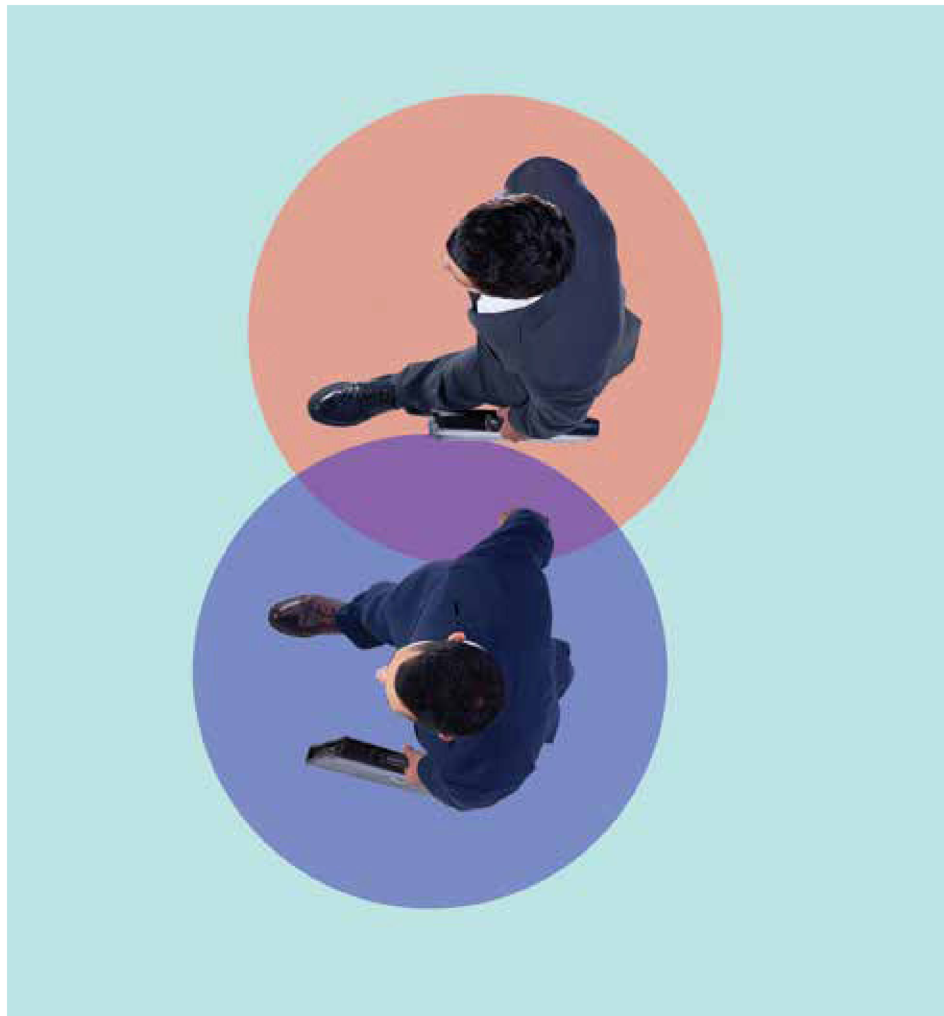
The board members, surprised to learn of the insufficient funds, demanded to see the monthly bank statements controlled by Jane, which she hadn't shared. After several meetings and many emails, she still hadn't provided the bank statements. The board grew more frustrated, so it held one final meeting and told Jane that the president was going to the bank to obtain replacement statements and check images for the association's accounts. At that meeting Jane told the board that she'd been using the association's funds to fuel a gambling addiction at a local casino, and she'd depleted the association's reserves. The board members quickly realized that the reports they'd been relying on were fictitious.

Jane abruptly left the meeting and subsequently stopped communicating with the board, which left the association high and dry. The board members had no records, no bank accounts, no listing of delinquencies, no contracts — nothing. Even worse, because of personal responsibilities, they couldn't manage the property themselves. They needed to find a new property manager — and quickly.

The president contacted the association's counsel, who called our firm.

The board retained a new property manager who worked with the bank to remove Jane from the accounts and establish new bank accounts. The bank requested replacement statements and check images for each association account, and the cleanup process began.

We reconstructed the bank activity for the past several years and easily identified when Jane had withdrawn funds and transferred amounts from the association's reserve account into the checking account. We identified frequent ATM withdrawals — often at multiple times a day at the same location (the casino) — and we watched as the account balances dwindled to nearly zero. In the end, Jane had abused her position of trust — it was her duty to safe-guard the association's funds and use them solely for the association's benefit with prior authorization from the board. The association lost more than $150,000 and recovered only $10,000 through its insurance policy. Clearly, Jane had violated her fiduciary duty to the association. She was charged for her crime, but because there were no means for recovery, the association elected not to pursue her civilly because the cost of litigation outweighed any potential recovery on a judgment.



Fiduciary responsibilities beyond property management

Were the association's board members responsible in this case for their actions or lack of actions about Jane's theft? The answer is yes. Board members can be and often are held responsible for their fiduciary duties to organizations for which they serve. Compensated or uncompensated, board members have responsibilities to their stakeholders, who can sue them. That's why most prudent boards require insurance coverage and other protection policies for their directors and officers.

To understand how someone in a position of control can exploit their responsibilities for personal benefit, we need to first identify some common, easily recognized contexts for fiduciary fraud.

The first is the world of investing. Individuals and organizations place their funds "in trust" with other individuals or an organization, like investment managers or hedge funds, with the expectation that their funds will be safeguarded and invested in accordance with their directions. Of course, investment managers, both individuals and institutional, sometimes divert investor

"Some large fiduciary frauds... have gained notoriety. But countless cases have attracted little-to-no media attention when investment managers steal lesser amounts from clients"

funds. But countless cases have attracted little-to-no media attention when investment managers steal lesser amounts from clients. However, the results are often the same: Individuals and organizations are deprived of funds with few means of recovery.

Other common fiduciary contexts, to name only a few, involve:

- Property managers entrusted to collect fees from tenants and owners.
- Insurance agents charged with collecting and remitting clients' insurance premium payments.

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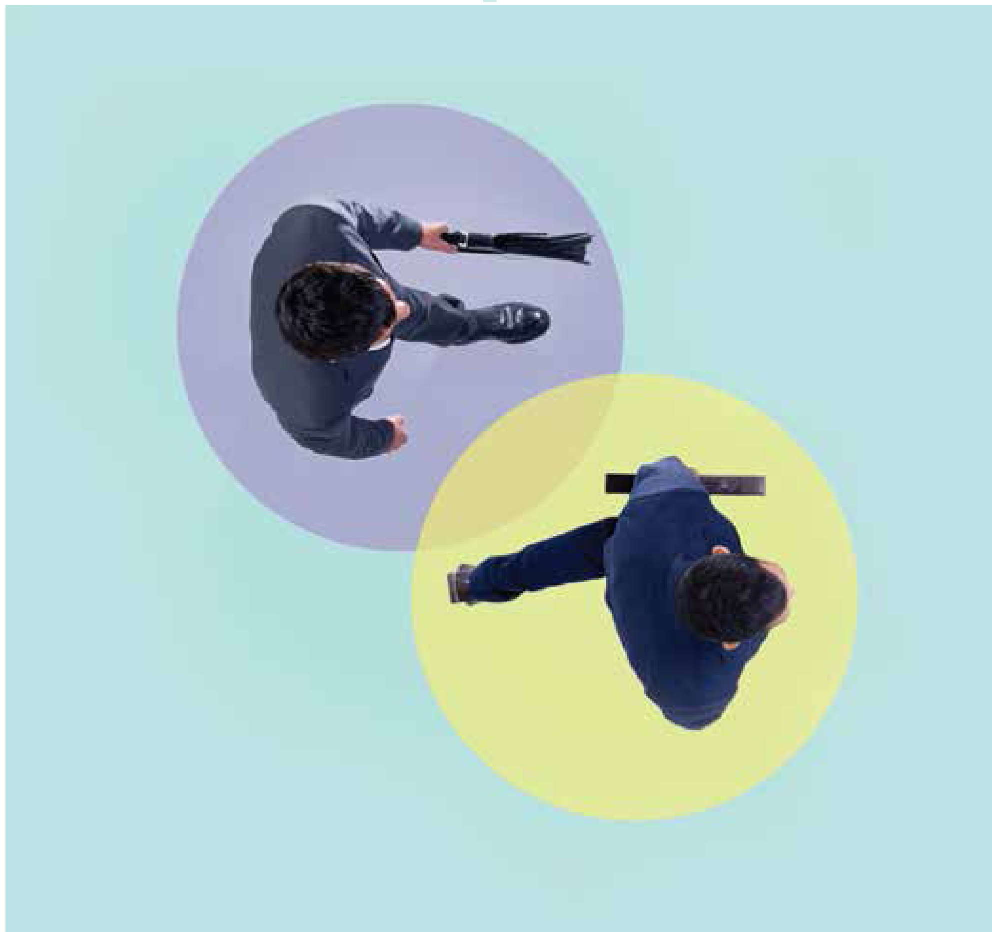
- Attorneys performing residential refinancing transactions.
- Payroll companies withholding federal and state-required payroll taxes.
- Treasurers of clubs, leagues, associations and organizations protecting funds.

The names and dates change, but the stories, motives and frauds remain the same. Someone placed in charge of funds crosses the line and uses the funds for personal purposes — to the detriment of the beneficiary of the funds.

When people are placed in positions of trust and violate those positions for personal gain, their actions are described as a breach of fiduciary duty (breach). In the opening case, Jane was a fiduciary of the association and specifically of the association's funds. She and the association had signed a written property management agreement.

Although board members run the risk of breaching their own fiduciary duties, an association commonly designates a property manager to perform services without a written contract. The written contract helps define the scope of the relationship and provided services, but a property manager acting with or without a written contract can be held responsible for breach of fiduciary duty if that manager uses the funds for personal purchases. The property manager also can be charged with larceny.



Steward of the funds

Fiduciaries can make bad business decisions that result in losses, but if the fiduciary acts in the best manner with the best information known (also called acting in good faith), then the fiduciary can use that as a defense if complaints are lodged. There's a world of difference between acting in good faith — but suffering a loss — and stealing.

During engagements, I'm often asked to describe fiduciary duty in layman's terms. My response is always the same: If an individual or organization acting in fiduciary capacity has the mindset that they or it is a steward of the funds, and the funds will be used only for the sole benefit of the beneficiary, then that individual or organization has fulfilled the fiduciary duty to the best of their abilities.

If, under subsequent review, all transactions result in an easily identifiable benefit to the beneficiary, there shouldn't be an issue. However, if two piles of transactions exist — one set that benefited the beneficiary and one set that benefited someone else — then the fiduciary has questions to answer. Simply put, there shouldn't be transactions in the second pile.

Issues arise when the distinction between the two piles gets blurred, or worse, when transactions are commingled with the fiduciary's personal funds and assets. Commonly, a fiduciary has commingled managed funds with funds in a personal bank account. In these cases, fraud investigators or examiners must remain objective, and every case is different. Seasoned examiners know that a fiduciary commingling assets and funds doesn't automatically indicate that fraud has occurred. The intent and actions of the fiduciary play a major role in resolving the matter along with the reconciliation of the commingled funds and activities. The examiner's findings will influence the beneficiary's decision to pursue criminal and/or civil remedies.

The living and the dead: probate matters

Probate is the court-supervised process of authenticating a last will and testament of the deceased, according to "Learn What Happens During Probate," by Julie Garber, (the balance, March 25, tinyurl.com/y8xn-bbyt). It requires fiduciary duty and can be at risk for potential breaches, abuses and frauds. Probate jurisdiction in most states in the U.S. (and in many global jurisdictions) might also include:

- Statutory durable power of attorney/attorney in fact.
- Guardianships
- Conservatorships
- Estates
- Trusts (of virtually every kind)

Each of these areas warrant a brief explanation to highlight the fiduciary duty and the potential engagements for qualified fraud investigators, such as Certified Fraud Examiners (CFE). All have four common elements:

- An individual or organization is specifically identified to act as the fiduciary.
- The fiduciary must act in the best interest of the beneficiary.
- The potential for fiduciary fraud and abuse exists.
- The fiduciary always risks accusations of not acting in the best interest of the beneficiaries.

In some instances, the fiduciary has broad powers and authority to conduct transactions, and in others, court approval is required. In every matter, the fiduciary is required to act as a steward of the funds, which involves any asset including money, and the fiduciary has a duty to act in the beneficiary's best interest to the best of his or her abilities.

Statutory durable power of attorney/attorney in fact

When one individual wants another person to conduct transactions, manage affairs or act on their behalf, the individual must complete a power-of-attorney form that names the designated person and identifies the level of authority granted to that person. Most states in the U.S. require this form to be witnessed and notarized to ensure that it was properly executed and the individual providing the power of attorney understands the form.

Selecting someone to be your power of attorney, in many cases, involves handing over all your assets to someone else to manage on your behalf. Commonly, aging parents give power of attorney to their child, so as they get older and are less able to manage their affairs, the child can take charge and manage them on their behalf. Whenever someone gives another person access and control over assets, there's always a risk that the fiduciary will take advantage of the situation and divert assets for the fiduciary's personal use. When the suspicion or actual knowledge of such activity comes to light, the individual — if still competent — can revoke the power of attorney and identify a new fiduciary. The beneficiary (the potential victim) typically begins the case in probate court and requests that the court remove the authority of the person holding the power of attorney. The fiduciary is required to prepare and file a financial accounting report that identifies the assets with which they were entrusted and what they did with those assets. The fiduciary, in most cases, must produce a detailed accounting for each transaction, along with the underlying records though a summary accounting might sometimes suffice.

Fraud examiners could assist in resolving a matter in two contexts. First, beneficiaries could retain an examiner to assist the fiduciary in preparing the accounting and defending the fiduciary's decisions. Disgruntled family members, motivated by jealousy or bitterness, who might or (more likely) might not be heirs to the individual's estate, often bring these cases. However, even if the fiduciary did use assets for personal purposes, the fiduciary might still require assistance in preparing the accounting and defending their actions.

Second, beneficiaries could retain an examiner to review the fiduciary's accounting and trace the reported amounts to the underlying documentation. The examiner could assist counsel for the beneficiaries who are seeking explanations and possibly ultimately testify in civil and criminal actions against the fiduciary.

In some cases, the probate judge might appoint an examiner to investigate the accounting and underlying records and report back on the findings. Counsel for the fiduciary and the beneficiaries might sometimes mutually engage an examiner to report back to both counsels.

In the end, the challenge in these cases lies in gaining access to all the accounting records to determine what happened under the fiduciary's watch. The author has found that the more the fiduciary or the fiduciary's representative hinders the beneficiaries' access to necessary statements, records and documents, the more likely it is that the fiduciary has crossed the line and breached fiduciary duty (i.e., stolen assets for personal use).

Guardianships

For those who are unable to manage their affairs because of incompetence, disability or age (those under the age of 18), the court will appoint a guardian to manage funds on their behalf. The role of the guardian as a fiduciary, which is similar to a power of attorney, must be as a steward of the entrusted funds and to act in the individual's best interests. However, a guardian — unlike a fiduciary who acts under a power of attorney — is answerable to the court. A beneficiary could accuse a guardian of mishandling or misusing funds. A victim's counsel could retain an examiner to determine whether a guardian used funds for purposes other than the victim's benefit. Alternately, fiduciary's counsel could retain an examiner to defend the guardian against accusations and ensure that no malfeasance occurred. Or both parties (or a court) also could mutually engage an examiner.

Conservatorships

A conservator is similar to a guardian: A court appoints them to manage a person's financial affairs and/or daily life when that person becomes physically or mentally unable to do so — commonly because of age or health.

In some jurisdictions, guardians handle personal and health-related decisions, whereas conservators handle financial affairs.

Estates

When people die, they leave behind estates comprised of the assets held at the time of their deaths. Sometimes, no assets exist, but significant assets often remain in other cases. If an individual planned in advance, they might have formalized instructions, often in a will, for handling these assets. (The person who memorializes wishes in a will is called a testator.) However, the person could also die

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intestate, meaning that they never executed a will. Either way, someone needs to manage and settle the estate, marshal any assets, pay any outstanding obligations and debts, file required forms and tax returns, and distribute residual assets to beneficiaries. If named within a will, the person in charge of an estate is called an executor; if court-appointed, this person is called an administrator

Trusts

An individual can create a separate legal entity, called a trust, and transfer personal assets into the trust. The person who establishes the trust is called the grantor. A trust can be established during the person's lifetime ("inter vivos"), and the trust can be revocable or irrevocable. A trust created through a will after a person's death is called a testamentary trust.

Regardless of the type of trust, the fiduciary role is, generally speaking, the same — to be fiscally responsible and act in the best interest of the beneficiaries. A fraud examiner or investigator might be retained in all types of trust matters.

Don't underestimate a fiduciary

Fiduciary fraud, like employee embezzlement, financial statement fraud and corruption, provides potential engagement opportunities for fraud examiners. In these cases, examiners can get involved and help resolve financial issues. I highlight only a few of the contexts where an individual or organization operates in a fiduciary capacity and can be investigated for breach of fiduciary duty. Those who maintain finances on behalf of others or are responsible for overseeing the use of funds likely have fiduciary duties to the beneficiaries of the funds. In many cases, the beneficiaries of the funds are those who report new matters to investigate.

Even if a fiduciary has done nothing wrong and acted with utmost care, we could still investigate potential matters. Because of frequent fiduciary thefts, courts must investigate allegations to ensure no wrongdoing has occurred even if the motivation for the allegations obviously stems from beneficiaries' sense of entitlement.

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