

VALLEY LAWYER

JUNE 2009 • \$4

A Publication of the San Fernando Valley Bar Association

The Mechanics' Lien Law

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A Skeptic's Guide To Networking

Foreclosure Safety Nets

Real Estate Fraud Litigation

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Valley Lawyer is published 11 times a year. Articles, announcements, and advertisements are due by the first day of the month prior to the publication date. The articles in Valley Lawyer are written for general interest and are not meant to be relied upon as a substitute for independent research and independent verification of accuracy.

Design & Printing

Master Graphics Printing (818) 343-0500
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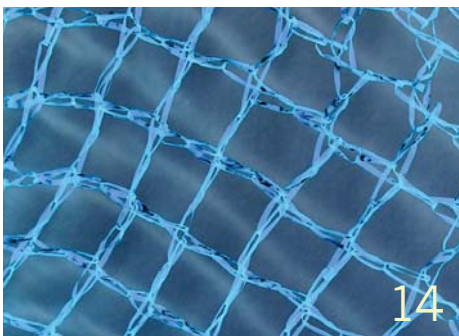
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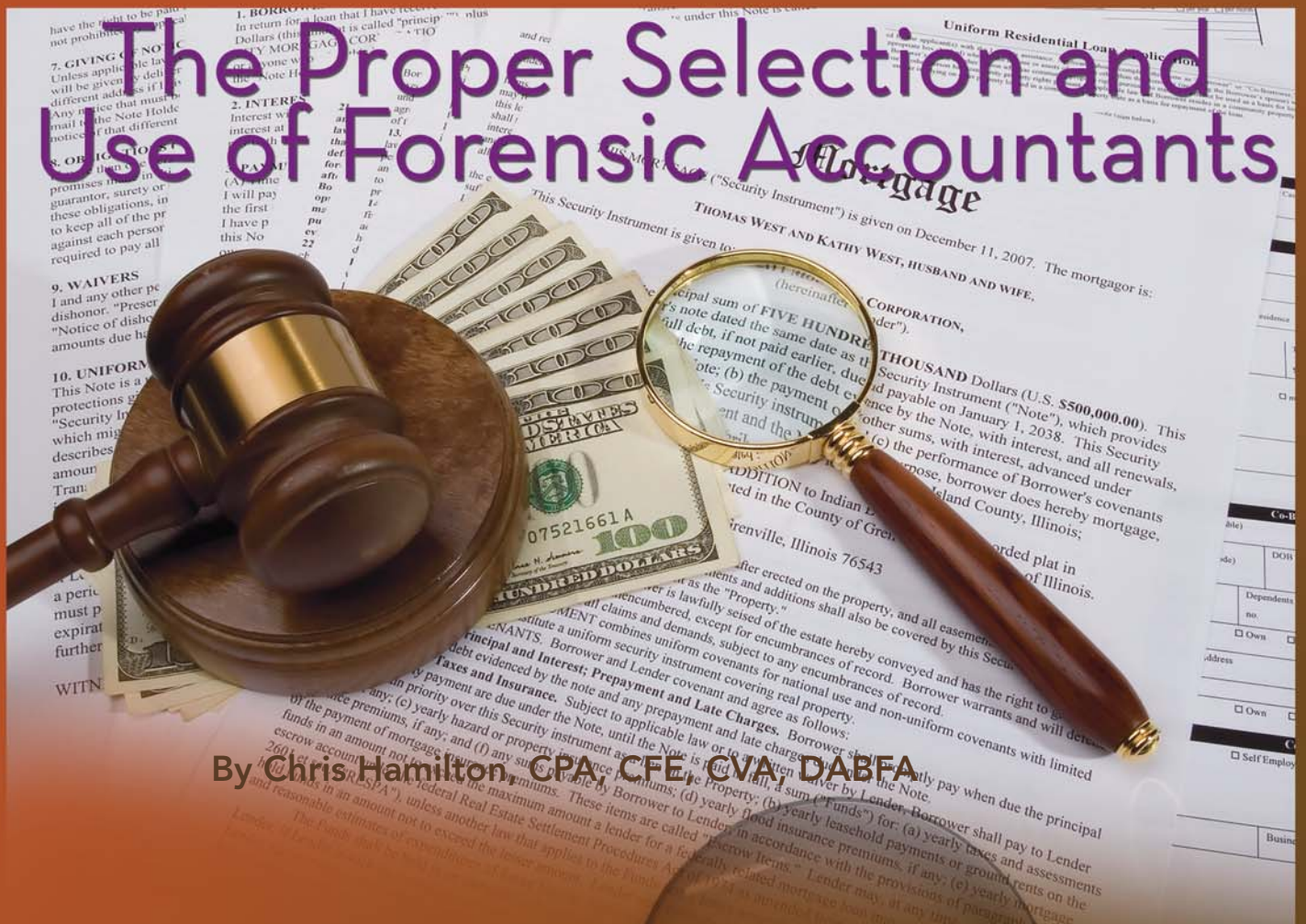
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REAL ESTATE FRAUD LITIGATION

The Proper Selection and Use of Forensic Accountants



By Chris Hamilton, CPA, CFE, CVA, DABFA

REAL ESTATE VALUES HAVE FALLEN considerably, credit markets have frozen, and the general economy has slowed down severely. This series of events originated in the real estate market and arguably has affected the real estate market the most. The media has widely reported that the reason for the collapse in the real estate market is “fraud” and “easy credit.” There are several expected results from a severe economic event such as is being witnessed in our economy and in the real estate industry. One sure consequence is increased litigation alleging fraud. This litigation will be initiated primarily by regulators, lenders and investors – and has, in fact, already begun.

Real estate litigation usually involves large amounts of money and deep emotion. There is usually a sense of violated trust since investors often “rolled the dice” on a real estate investment with a material portion of their net equity. It is common that the investors know each other and/or are associated with the other investors based on common interests such as church, social club, employment, etc. The “operator” (general partner, managing member, etc.) is the center of the association and becomes the focus of intense scrutiny and accusation. The investors often struggle to remain unified

in their quest for “justice” and/or reimbursement and the lawyers often are pulled into the middle of this complex network of relationships and money.

Often it is the lawyer’s role to play gatekeeper (and referee) in real estate fraud cases. The attorney must assess the probability that fraud took place, the legal and financial viability of the case, and the best approach to move towards formal litigation. Real estate fraud litigation is expensive, complex, and usually dependant on the use of experts. The proper selection and use of experts is important in each phase of the litigation. But in the formative stages of the case it is critical to establishing the proper course in the most efficient manner. Experienced accounting experts can provide critical assistance in each phase of the case.

Types of Fraud

It is important to understand the types of fraud generally associated with real estate transactions. The type of potential litigation dictates the evidence that may be needed, the role the experts may play, and the viability of the case.

Civil and criminal fraud litigation is already being initiated by banks and regulators against borrowers who

are defaulting on repayment obligations. Predictably, the allegations include false loan applications, appraisal fraud, misrepresentation of income, conversion of collateral, "shot gunning" (encumbering real estate multiple times), and diversion of loan proceeds for use other than disclosed to the lender.

Investor-generated litigation is generally initiated by non-control partners/investors who become unhappy or suspicious when the real estate investment does not meet expectations. In each case a determination must be made whether to initiate litigation and, if so, whether to involve law enforcement. Allegations often include:

- Assets were not purchased as disclosed to investors
- Financial transactions took place that were not authorized and/or disclosed
- Investor funds were used for the personal benefit of the control partner(s)
- Inaccurate or incomplete financial reporting to the investors
- "Ponzi" schemes where the operator pays promised returns to current investors with either borrowed money or contributions made by new investors
- Diversion of income from the real estate entity by the control partner

Deciding to Sue

When real estate fraud is suspected, significant investigation is required prior to filing the lawsuit and in preparation for trial. A significant question is whether the operator simply made bad business decisions as opposed to intentionally misleading the other investors for personal gain. In most jurisdictions there is a threshold of proving some level of intent in order to get a verdict against the alleged fraudster.

There are two general types of investigators that plaintiff and defense attorneys can use to make the threshold determination about whether sufficient evidence exists to support the financial commitment of litigation. Private investigators are used to establish evidence of the lifestyle, possible motivations for the alleged fraud, and the assets of the person(s) suspected of fraud. Forensic accountants are used to evaluate documents that can be obtained and to synthesize the accounting record evidence with the evidence gathered by the non-accounting investigation. In short, private investigators gather evidence and forensic/fraud accountants evaluate, analyze, summarize, and present the evidence.

Discovery

Accountants experienced in forensics and fraud are key to plaintiff and defense attorneys. They are experienced in developing a list of documents that will be needed, discovery approaches, and management of documents and evidence for complex litigation.

Documents that will be needed include partnership/operating agreements, entity bank statements and cancelled checks, escrow statements for all real estate transactions, copies of disclosures made to investors, entity tax returns, loan application files

(usually obtained via subpoena from the lender), title reports, and any available accounting records maintained by the entity or operator including bank statements, cancelled checks, etc. These cases are paper intensive and, depending on the activities of the operator, will involve a lot of tracing and detailed accounting work.

Teamwork between lawyers and competent accounting experts will result in efficient and effective assistance provided to clients in the upcoming period of real estate transaction disputes. It can also result in damaged investors recovering their losses and prevent unjust verdicts against organizers who happened to be managing real estate investments when the market topped out and contracted. ⚡

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