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A Matter of First Impression

By: Carlos Concepcion

In a matter of first impression in Puerto Rico, and applying Delaware law, District Judge Gustavo Gelpi dismissed all the claims against 11 defendants, all of whom were the most senior executives at Westernbank, formerly Puerto Rico's second largest bank. Westernbank, a $10 billion bank with hundreds of branches scattered throughout the island, was closed by the FDIC in 2010 for reasons unrelated to the lawsuit.

The derivative lawsuit, brought by a shareholder of the bank, alleged that the majority of the board of directors and senior management purposely ignored the warning signs of a massive, $200 million structured fraud initiated against the bank's asset based lending division by a significant client of the bank. The shareholder claims included breach of fiduciary duties as officers and directors of the bank, waste of corporate assets, unjust enrichment, Sarbanes-Oxley violations, and violations of numerous Puerto Rican statutes.

Attorneys Carlos F. Concepcion, Manuel A. Rodriguez and Scott A. Burr, and Forensic Investigator and CPA Francisco Gomez, assisted the Special Litigation Committee of the board of directors in determining the viability of multiple derivative claims initiated against the bank's officers and directors.

The investigation involved a review and analysis of over 100,000 documents related to the fraud and interviews of nearly 40 bank officials, directors and officers with knowledge of the events leading to the fraud. The Committee's report, a nearly 200 page single-spaced report detailing its factual and legal analysis, was ultimately filed with the court along with the Committee's motion to terminate or otherwise dismiss the case. The factual investigation also required detailed analysis of Westernbank's internal control systems and their remediation that resulted from nearly a dozen third-party reports and analysis.

Resolution of the derivative claims required a full and thorough investigation, however, as the Committee had to be careful not to enhance or otherwise fuel the parallel class action case that was asserted concurrent to the derivative claims.

The Committee and its counsel also had to be very careful not to waive claims of privilege or otherwise divulge sensitive or confidential proprietary information.

The forensic investigation was conducted through the prism of the legal claims being asserted, and the investigators and attorneys had to understand the factual significance of the events and legal elements of the claims. This interplay would have been very difficult without attorneys who were also experienced forensic investigators themselves.

The Special Litigation Committee had no subpoena power, and sought the cooperation of the corporation's inside counsel, whose ultimate allegiance was to the corporation.

The Special Litigation Committee, while comprised of members of the board of directors, had to maintain its independence, both in appearance and in fact, while adjudicating the claims. This tightrope dictated that the Special Litigation Committee not permit either the corporation's counsel or plaintiff's counsel to dictate or otherwise manage the investigation and its conclusions. The Special Litigation Committee, though, sought the cooperation of plaintiff's counsel, the corporation and its counsel.

In its lengthy order, the Court held that:

1. The Special Litigation Committee members did not have such significant commercial ties to the defendants to render them impartial to their duties;
2. Formation of the Special Litigation Committee did not raise serious questions as to their ability to independently assess the shareholder's claims;
3. The Special Litigation Committee acted in good faith and conducted a reasonable investigation upon which it based its conclusions, and
4. The Special Litigation Committee's recommendation that the derivative action be summarily terminated was reasonable.
5. The court declined to exercise its own independent judgment because the result reached by the Special Litigation Committee was not "irrational or egregious".

In reaching its conclusions, the District Court validated several years of independent research by Francisco Gomez and Manuel Rodriguez. Both Mr. Gomez, who lead the initial factual investigation, and Mr. Rodriguez, are Certified Public Accountants and Certified in Financial Forensics. Additionally, Mr. Rodriguez is also an attorney.

Ultimately, Westernbank became a victim of the excesses of the national banking industry this decade. Its irrational commercial real estate lending practices, coupled with a severe economic downturn in Puerto Rico led to its demise. The fraud perpetrated against it in this instance was but a drop in the proverbial bucket. Mitigation of this fraud, even at the onset, would not have stemmed the flood of losses that it eventually would realize and that doomed the stricken bank.

The overwhelming amount of fraud occurring and uncovered in South Florida, including mortgage, banking, securities, and regulatory fraud demands at least a cursory analysis of the personalities and behaviour that typify these fraudsters. Stanford, Rothstein, Freeman, Tolz, etc., are merely the tip of a very large iceberg penetrating South Florida.

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I am often asked to explain, or even justify, criminal behaviour, not merely for the sake of curiosity, but to prevent being swindled by these schemers. We believe that if we can understand the criminal mind, we can identify their attributes and prevent from getting swindled. Unfortunately, the pathology of crime is far more complex than we dare imagine.

There are two ways of preventing a fraud from occurring. One technique is quantitative, and involves the use of sophisticated due diligence to ferret out the fraud or any inconsistencies in the fraudster's "stories". These quantitative techniques take the form of pre-investment financial due diligence, background checks, verification of financial history with third-party sources, current customer verification, etc. These quantitative techniques are typically performed before investments are made and throughout the history of the investment. Unfortunately, very little of these techniques are actually performed, witness the Madoff scandal. Here, very little, if any, investigative due- diligence was ever performed, and even when it was, the SEC summarily dismissed it.

The second technique, the subject of this article, is far more complex and qualitative. It involves understanding and profiling the criminal pathology as a means of detecting potential firestorms later. This subtle technique involves profiling the types of personalities that might be inclined to commit criminal fraud.

What personality type is prevalent or stands out amongst the great fraudsters of our time? The Narcissist. The malignant narcissist, or NPD, is the uncontrolled or dangerous narcissist. Adolph Hitler and Osama Bin Laden are both prime examples of malignant narcissists who subdued entire nations or cults into unspeakable acts of violence and war, and who used their charisma to achieve these ends. Both Hitler and Bin Laden, though, exposed the cultural conformity that must occur within an entire nation or group to allow blind obedience to occur. Fortunately, American individualism means that most Americans are unlikely to become seduced by a lock-step mentality of destructive conformity. At the group level, Americans are fairly well insulated from this behaviour.

How does one spot the individual criminal, the one who steals our millions and destroys our finances? What characteristics do all NPD's share that might become obvious to potential investors or business partners as a qualitative warning? The following list, admittedly imperfect, is fairly comprehensive:

1. A surface presentation that is often captivating, igniting feelings of attraction, admiration or intimidation;

2. A relentless need to manipulate people in order to maintain an endless supply of attention, control, status, money power or recognition;

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3. Great sensitivity to criticism, or intolerance of anything perceived as less than a perfect performance;

4. Endlessly entitled to special consideration and attention;

5. Constantly bending the rules for himself although outwardly criticizing others for similar behaviour;

6. No real remorse for the effects of his offenses on others and will rationalize deceptive manipulations;

7. Severe sense of entitlement, i.e. unreasonable expectations of especially favourable treatment or automatic compliance with his or her expectation;

8. A pervasive pattern of grandiosity, need for admiration and lack of empathy;

9. Grandiose sense of self-importance (exaggerates achievements and talents;

10. Is preoccupied with fantasies of unlimited success, power, brilliance, beauty or ideal love;

11. Believes that he or she is "special" and unique and can only be understood by high status people;

12. Requires excessive admiration;

13. Is interpersonally exploitative, i.e., takes advantage of others to achieve his or her ends;

14. Lacks empathy, is unwilling to recognize or identify with the feelings and needs of others;

15. Is often envious of others or believes that others are envious of him or her;

16. Shows arrogant, haughty behaviours or attitude.

Diagnostic and Statistical Manual of Mental Disorders, Fourth Edition (DSM IV)

Some of these characteristics remind us of Scott Rothstein, Bernard Madoff, or other noteworthy criminals of the 21st century. Criminal NPD's likely exaggerate the above characteristics, as they are considered extreme on the continuum of NPD.

What lessons do these diagnostic tools offer ordinary investors? What real-world applications do these tools have to investor decisions? Human behaviour is not susceptible to strict compartmentalization.

Individuals who exhibit many of these same tendencies cannot easily separate their behaviour between different facets of their lives. Their bad behaviour bleeds into every component and facet of their lives, work, personal, play, etc.

Individuals exhibiting these behaviours must be critically examined. Quantitative tools must be especially keen, and third-party verification must be a component of this analysis. Trust, even once earned, must not be granted lightly, or taken for granted by the recipient.

Bernard Madoff and Scott Rothstein exhibited many or most of the above diagnostic characteristics. Both had severe entitlement issues, exhibited grandiosity, lack of remorse, and exhibited great sensitivity to criticism or suspicion. How no one bothered to apply quantitative analysis to these individuals or their businesses is nearly beyond belief or incredulity. Certainly, even the regulatory agencies missed the Madoff scandal, and Scott Rothstein's law partners failed to critically examine Rothstein's income sources.

Human behaviour is fairly predictable, and science has done a fairly nice job of summarizing bad behaviour. What has not kept pace is our ability, as humans, to discern bad behaviour and act defensively. Either because we've chosen to ignore the warnings or because we've never learned to see them, we continue to fall prey to the criminal NPD. Frankly, not much has changed since the days of Charles Ponzi, whose scam originated in South Florida. Not much has changed, sadly.

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