A CASH INVOLVING ALLEGED BREACH OF DUTY, FRAUD AND A VIOLATION OF CIVIL RICO

General Case Background:

The case involved a joint venture of 2 families that each owned a 50% interest in a to-be-developed 750 to 800 unit apartment complex. Prior to the commencement of construction, one of the brothers who owned 25% got into financial difficulty. This brother, who had borrowed substantial sums from his brother in law ("New Partner"), assigned his 25% interest to his brother in law in partial payment of the debt. One of the members of the other family sent a letter welcoming the New Partner into the partnership. This family member later died. Without the knowledge of the New Partner, the assets of the old partnership were transferred to a new partnership, but the New Partners 25% interest was not recognized. Instead of a partnership owned 25% by the New Partner, 25% by the other brother in law, and 50% by the other family, the new partnership was owned 25% by the other brother in law who was now a minority partner ("Minority Partner") and 75% by family members of the other family.

The New Partner did not hear any information about the status of the project for some time. He attempted to contact the other family's partners on several occasions. Finally, he sent one of his employees to their offices where he was told that the New Partner was no longer needed since the project was financed.

The New Partner filed a law suit in 1992, which went to trial many years later. The 25% remaining Minority Partner was not a party in the case at that time. The judge found that the defendants had improperly excluded the New Partner from the project, but found no damages. This decision was appealed by both the plaintiff and the defendants. The court of appeals found for the plaintiff and remanded the case back to the court for an accounting. This decision came in 2006. A new lawyer was hired by the New Partner. I was hired in 2007. I began conducting an accounting, pursuant to the appeals court order.

<u>The Accounting That Became An Investigation:</u>

During my review of books and records, I found certain significant transactions that were misstated, related party transactions not disclosed in the financial statements and transactions that took away benefits from both the Minority Partner and from the New Partner and were irregular in nature. Many of these transactions were hidden by a maze of entries in the project's books and records, which were not completely maintained by the owners, but maintained by an outside accounting firm.

<u>The Defendant's Motion And The Minority Partner Joins in:</u>

About 2 years after I was hired, the defendants filed a motion that said in non-legal terms that while they did not believe they did anything wrong, if the court were to decide they did, the

Minority Partner should be responsible for 25% of the damages. The Minority Partner hired a lawyer who decided it was time for the Minority Partner to become a Plaintiff. The New Partner and Minority Partner filed amended complaints alleging damages, fraud and a violation of a state Civil RICO statute. RICO stands for the Racketeer Influenced and Corrupt Organization Act.

With the permission of my client and his attorney, I also computed damages for the Minority Partner. The damages were different because the New Partner never received any distributions from the partnership. The Minority Partner did.

<u>The Trial:</u>

After numerous delays, the trial began. This was several years after I had been hired. It was a bench trial, meaning that there was no jury. Just a judge to hear the evidence and decide the case. Opening statements took about a week. The attorneys decided, since this was a trial on damages, I should be the first witness. It felt that this would help the Court focus on certain important facts and certain matters of law that had to be decided. I took the stand for my initial testimony which lasted many days. In addition, I testified on two additional occasions. In total, I testified for about 30 days.

During the initial testimony, I began laying out a 25 year plus accounting, describing in detail various transactions that in my opinion were a misuse of project funds by the defendants to the detriment of the Minority Partner and New Partner. These included, but were not limited to, significant interest payments to the defendants or affiliates (sometimes when no loan existed), excessive management fees well in excess of market value, payroll of employees of the defendants who did not work at the project, rent and utilities paid to an office building owned by the defendants and located in another state for no apparent reason, excessive insurance premiums paid to an affiliate of the defendants, legal fees paid in defense of the law suit and excessive advertising fees paid to an affiliate of the defendants even though the project was running at very high levels of occupancy.

To compute damages, I used a theory that if one were to take all recorded distributions of partnership profits to all partners plus misuse of project funds paid to the defendants or their affiliates and assume that it was added back to a hypothetical bank account. Once back into this bank account, I then redistributed the funds 25% to the New Partner and 25% to the Minority Partner. In the case of the Minority Partner, I deducted the actual amount of distributions he had already received. In response to a question from the Judge, I explained it was like taking an improperly scrambled egg, putting it back in the shell and scrabbling the egg properly.

I think it would require a substantial book to explain my findings in this matter. In trying to be brief, I will explain in some detail my findings of only one of the above areas I uncovered, excessive management fees. A typical management fee for this type of project should approximate 3% to 5% of collections. Our management fee expert opined that a management fee of 3% would be market for this size project considering how the project was staffed by project employees paid by the project. The defendants paid themselves substantially higher amounts, ranging from a low of 1% (a year in which the project had virtually no revenues and that was an outlier) to a high of 38% of revenues. The average over a 22-year period was 15% or revenues. This simply did not make sense.

The partnership agreement (drafted by the defendants affiliated law firm) required that no payments could be made to any partners or affiliates without the permission of a partner from the other family. In other words, these payments of “management fees” paid to the defendants would have required approval by one of the two plaintiffs. No such approval was given. In addition, there was no written management agreement.

One of the things that became apparent to me was that many of the payments changed to management fees and paid to the defendants (or their affiliates) were disguised partnership distributions. By way of background, the Minority Partner was paid a monthly salary of $4,167 per month or $50,000 annually for his work in developing, construction and managing the project. This was obviously approved by the defendants because they wrote the checks. Therefore, this payment was in accordance with the partnership agreement. In addition, once the project was up and running, the Minority Partner would receive regular partnership distributions. These payments were often made monthly and treated as a distribution of partnership profits. Most, but not all of the checks taken by the defendants as “management fees,” were nothing more than disguised distributions as they were in proportion to the distribution paid to the Minority Partner. By way of example, if $10,000 was paid to the Minority Partner and changed as a partnership distribution, a check or checks in the total amount of $30,000 was paid to the defendants. The ratio of the total paid to the Minority Partner and the defendants was 25% and 75% respectfully, ($10,000 or 25% to the Minority Partner computed as $10,000 / $40,000 and $30,000 or 75% to the defendants computed as $30,000 / $40,000). The ratio of 25% to 75% is the ownership of the new partnership after the New Partner was improperly excluded. Over the 20 plus year period, the amount of these disguised distributions paid to the defendants (or affiliates) and treated as management fees was approximately $16,000,000.

During my testimony on this issue, I used the term “disguised distributions” after I had given a few examples to the Judge. The defendant’s lawyer objected to the term “disguised distributions”. The judge overruled the objection and commented that she agreed that these were, in fact, disguised distributions.

In her decision, the judge decided that the defendants were not entitled to any management fees for two main reasons. First, based on testimony at trial, she found that the Minority Partner had been responsible for managing the project as he was usually onsite or in contact with and supervising the project employees. She agreed that he was entitled to the agreed to $50,000 annually as a fee for his services and that this fee was approved by the defendants. She also found no creditable testimony describing what the defendants did to “manage” the project. In addition, she found that no approval had been given by either the Minority Partner or the New

Partner for any of the management fees paid to the defendants, which was required by the partnership agreement.

In addition to laying out the damages in this case, I also explained how the defendants created misleading financial statements and books and records relating to many of the payments paid to the defendants or affiliates. In an attempt to be brief, I will now describe one series of related transactions as an example.

In year 19x1, a year-end adjustment by the outside accountant was made creating a loan payable to affiliate 1 in the amount of $400,000 and increasing interest expenses. Prior to the entry, no obligation was payable to this entity. In other words, $400,000 of interest was being charged on a loan that did not exist. There were amounts due by the project to other affiliates. However, the footnotes to the financial statements disclosed that the obligations to the affiliates were non-interest bearing, except for one of the affiliates. That affiliate was owed $1.7M as of the beginning and end of the year. The bottom line was that this entry increasing interest expense by $400,000 made no sense.

In year 19x2, a check was written by the project to affiliate1 in the amount of $319,000 and changed to a suspense account. During the same year, a check was written by the project to affiliate 1 in the amount of $350,000 and charged to management fees. By a year-end adjustment prepared by the outside accountant, this $350,000 charged to management fees is taken out of management fees and added to the suspense account bringing the balance in the suspense account to $669,000. An additional year-end adjustment is made by the outside accountant decreasing the suspense account to zero (a $669,000 reduction) and increasing interest expense by $100,000 and increasing an amount due by affiliate 1 to the project by $569,000.

For the next two years, nothing happened related to this series of transactions. In year 19x5, a check was written by the project in the amount of $431,000 to affiliate 1 which increased the amount due the project by Affiliate 1 by $431,000 bringing the balance due to the project by affiliate 1 of $1,000,000.

For the year 19x6, a year-end adjusting entry was made by the outside accountant, The $1,000,000 due by affiliate 1 to the project was reduced by $500,000 resulting in a balance due by affiliate 1 to the project 1 of the remaining $500,000. Management fees are increased by $500,000 for this reduction.

For the year 19x7, a year-end adjusting entry was made by the outside accountant, The amount of the due by affiliate 1 to the project was reduced by an additional $500,000 resulting in a balance due by affiliate 1 to the project of zero. A supervisory fee was charged in the amount of $500,000 as an expense for this reduction.

In summary, over a seven-year period, the project paid affiliate 1 $1,000,000 that was ultimately charged off as various expenses and created a factious obligation due by the project to affiliate 1 in the amount of $400,000 for interest on a loan that did not exist. Without the work papers of the outside accountant, one could not determine how these transactions were recorded in their entirety because the year-end adjustments were made by the accountant and never recorded in a general ledger maintained by the defendants.

If you are confused by this maze of transactions, don't be surprised or dismayed. The court found them hard to follow as well and ultimately found that they, along with others not described herein, were done so with the intent to deceive and cover up the improper taking of funds from the project by the defendants.

<u>The Result:</u>

At the end of about 200 trial days, the Judge made her decision, which she read into the record. She awarded compensatory damages, punitive damages for the fraud and damage for a violation of Civil RICO. The punitive damages were awarded at 2.5 times compensatory damages. By statute, RICO damages are 2 times compensatory damages; however, they cannot be awarded if punitive damages are equal to or greater than 2 times compensatory damages. However, she did award, pursuant to the RICO statute as damages, legal and accounting fees by requiring the defendants to reimburse the plaintiffs for a major portion of their legal fees and 100% of my fees. In total, the award was approximately $103,000,000. The case is under appeal.

In addition, at the request of the Plaintiffs, the Judge ordered that the real estate be sold and all partnership assets be distributed by the partnership to the partners. The project sold for approximately $135,000,000. At that time, the mortgage was approximately $12,000,000. These funds were distributed and each plaintiff has received a substantial amount of funds from the sale.

After the decision but before settlement of the sale of the project, the Plaintiffs requested that the judge assign a court ordered management company to manage the financial affairs of the Project. They argued that the defendants could not be trusted with project funds given the judge's findings. The judge decided not to assign a management company to manage the financial affairs. Instead, she appointed me as a financial monitor. The judge required the defendants to provide any reasonable documents for my review to monitor and to try to insure that the defendants were no longer improperly taking project funds. For several months, I prepared a report to the partners dealing with issues I noted during my review. All issues I raised were resolved without court intervention.