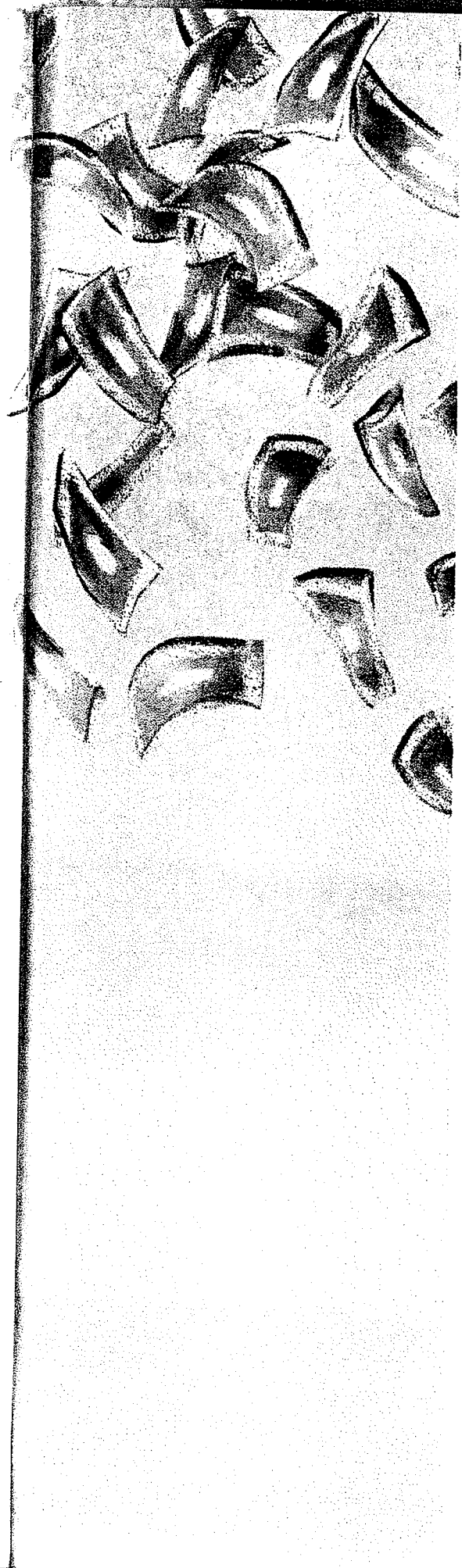




RESTITUTION LAW FOR FRAUD EXAMINERS

Recouping losses,
detering fraud
in public entities

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Each year, employees embezzle millions of dollars in taxpayer monies from public entities. Here are ways that fraud examiners can help find and recover some of these funds.

Dr. Frank A. Tassone, the former superintendent of the Roslyn School District, in Long Island, N.Y., stood before Judge Alan R. Honoroff of Nassau County Court on Oct. 10, 2006. Once nattily attired in tailored suits, Tassone now wore an orange jail jumpsuit and shackles. "My actions were shameful, deplorable," Tassone said tearfully. "I am deeply sorry to the people of Roslyn and to the children."

The judge then sentenced Tassone to four to 12 years in prison for stealing \$2.2 million from the Roslyn School District. He is the sixth person sentenced so far in connection with a six-year \$11.2 million larceny scandal, which implicated relatives, friends, and associates of the school district's top administrators.¹ Now comes the tough part – reclaiming some of those millions.

There are few limits to the ingenuity of corrupt insiders and suppliers who defraud school districts and other governmental entities of millions of dollars in taxpayer monies. The intentional breach of fiduciary and contractual obligations by product and service suppliers is too often nurtured by school district or other government employees who seek only personal gain.

Taxpayers and local governments in school districts should ponder, for instance, the media firestorm in the Roslyn School District after the discovery that school administrators had pilfered millions of dollars from the district. State auditors found that the \$11.2 million in school funds had been misappropriated in several ways including payment of excessive compensation to certain district officials as well as reimbursement for such personal benefits as flights aboard the Concorde, mortgage payments for vacation homes in Florida and the Hamptons, and ATM cash advances exceeding \$1 million. The state audit pointed to a lack of oversight and internal controls as contributing factors to the large-scale corruption.²

Arrests and indictments of 29 Roslyn officials and local outside school auditors followed these disclosures. In addition to Superintendent Tassone's guilty plea, an assistant superintendent admitted she stole more than \$1 million, and her niece, a former school accounting clerk, misappropriated in excess of \$300,000.³

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In another case, the Paterson (New Jersey) School District suffered at the hands of unscrupulous school officials who used taxpayer funds to pay for shoddy work, phantom services, or just plain personal enrichment.⁴

Can such criminal misconduct also be the subject of civil remedies to recoup the losses? Several civil remedies might be available.

SUIT AGAINST FORMER EMPLOYEES

Although suits against former employees of school districts and other public entities might be cumbersome, they could still form part of a strategy to begin recovery of losses. School districts can sue former employees for fraud. School officials who have snatched millions of dollars by intentionally misrepresenting their actions, padding expense accounts, doctoring payroll expenses, entering into cozy contracts with family and friends, or rigging the bid process have acted for personal gain and with deceit. Such clearly fraudulent practices merit civil recovery in tort.⁵

Additionally, employees, whether current or former, might be sued for breach of their "fiduciary obligations" – their responsibility for managing taxpayers' money.⁶ Although the remedies for fiduciary breach might resemble those for other causes of action, the fiduciary employees, depending on the purpose and functions of the posts held, might owe to the public employer affirmative duties (or positive steps such as acting with scrupulous honesty, undivided loyalty, and utmost good faith) distinct from those found in a case of garden-variety fraud.

A "fiduciary agent" (a school employee, in this case) is presumed to be acting with "absolute devotion" to the principal (the school district) at all times, and any commissions, bonuses, or other payments given by a third person to an agent are in law presumed to be for the benefit of the principal.⁷ For instance, superintendents in New Jersey are charged with the responsibility of having "general supervision over the schools of the district or districts under the rules and regulations prescribed by the State board."⁸ Although this description gives the superintendent a fair amount of discretion, the chief administrator's function remains efficient management of a school district's resources for the district's benefit, which makes him a fiduciary agent for the district. Should a superintendent use public monies to pay for personal items or bill the district for work done by his or her own dummy corporations, the superintendent has breached his or her duty as the school district's fiduciary agent and should be held liable for that breach. Any similar public administrator or employee empowered to enter into contracts on behalf of the public entity should be similarly accountable as a fiduciary agent.

CONSTRUCTIVE TRUST

Yet, how does a school district trace the money lost to a fiduciary breach? If the ill-gotten gains haven't already been spent at the racetrack or lost to some other vice, the corrupt employee might have used the funds to buy a tangible asset for later use

and enjoyment such as a home or boat.

In this situation, in which the disloyal public employee now has "legal" title to some identifiable property traceable to the stolen money or item,⁹ the district might request imposition of a "constructive trust" on the asset in the district's favor.¹⁰ In essence, seizure of the asset by the court is predicated on the concept that the public official who has received a benefit in breach of his fiduciary duty holds that benefit in trust for the public.¹¹ In imposing a constructive trust, the court declares the public official a "constructive trustee" of assets gained through misconduct and then orders the official/employee to transfer these assets to the trust beneficiary, namely the public employer.

The constructive trust is thus a useful method of restitution or repayment because it restores to the district the asset or proceeds from the asset that, in all fairness, belongs to it.¹² Furthermore, the public employer might demand not only what it lost but also the gains realized by the public employee from any increase in the property's value, its transfer, or its use.¹³

PUNITIVE DAMAGES

Another important remedy available against current or former insiders for bad faith or intentional misconduct is the imposition of punitive damages designed to punish the insider. When the underlying cause of action relates to egregious misconduct like fraud or malice, some courts will deny punitive damages unless the claimant shows misconduct even worse than that required for establishing compensatory damages.¹⁴ Other courts, however, have rejected such limitations.¹⁵ Still others postulate that punitive damages might be particularly justified in cases in which the wrongdoer has abused a special power or position. That is, if an employee's misdeeds result from the opportunity afforded by a position of special power or prominence, the employee might be especially subject to an award of punitive damages.¹⁶

Suing a former employee doesn't guarantee recovery. The saga of a South Worcester, Mass. school district provides a cautionary tale. In 2000, a former assistant superintendent in the district spent \$5.4 million on gambling and horse stables; five years later, however, the district had only managed to recoup \$500,000 from the former official.¹⁷

SUIT AGAINST VENDORS

Public entities can also sue vendors who commit fraud or contractual breaches. Corrupt third parties might be as culpable as the public fiduciary:

A third person who has colluded with a fiduciary in committing a breach of duty, and who obtained a benefit therefrom, is under a duty of restitution to the beneficiary. [*Restatement of Restitution* § 138(2) (1935).]

Thus, the third-party vendor who knowingly participates in the fiduciary's breach of duty would be considered a "joint tortfeasor" or wrongdoer who contributes to the injury as the fiduciary has and is liable as such.¹⁸

However, the liability of corrupt vendors to the public body might be difficult to establish when contracts are performed satisfactorily and at a reasonable price. Courts have nonetheless found that a public entity still sustains non-monetary damages when third parties corrupt and unduly influence its officials. As determined in *Continental Management, Inc. v. United States*, harms inflicted by corruption of public officials included loss of employee loyalty, diminution of public confidence in government, and the need to fire and replace the official. The court explained that:

[a]ll who knowingly participate in a scheme by which an agent obtains secret profits should be held liable to the principal. The opinions evidence the strong policy against the payment of money or other benefits to another's agent, a commitment giving full relief to the principal, a willingness to draw all reasonable inferences from the available evidence, and a flexibility in devising remedies to run against all available participants. [527 F.2d 613, 617 (Ct. Cl. 1975).]

The court concluded that third parties bribing the public officials must pay damages to the government in the amount of the bribes paid.¹⁹ A trial court in New Jersey echoes the *Continental* court's reasoning in stating that "[o]ne who causes or assists an agent to violate his duty to a principal may be subject to liability to the principal for such action."²⁰

The damages owed by the third-party vendor for such misconduct extend beyond the bribe. Punitive damages might be imposed, too, when a vendor defrauds a public entity.

Disgorgement of all "gross profits" might be an available remedy as well. In the recent case of *County of Essex v. First Union National Bank*, 186 N.J. 46 (2006), the county sued a bank for various misdeeds associated with fees the bank charged as the lead bond underwriter, a position the bank had obtained through bribes of a county official. The New Jersey Supreme Court held that the bank must disgorge the entire amount of fees paid to it as lead underwriter. The unanimous court would tolerate nothing less. It stated:

Strong remedies are necessary to combat unlawful conduct involving public officials. Disgorgement in favor of the public entity serves as a harsh remedy against those who bribe a public official to secure a public contract and provides a deterrent to such unlawful activity. We hold that when a

public contract is obtained by bribing a public official, the public entity is entitled to the gross profits obtained by the wrongdoer. [186 N.J. at 58.]

The only offset permitted to the bank lay in the fees paid to other, innocent underwriters who had performed bond work without knowledge of the defendant bank's unlawful acts. Because there was no showing that the fees paid to the other underwriters directly benefited the defendant bank, the court didn't order disgorgement of those sums.²¹

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SUIT AGAINST AUDITING/ ACCOUNTING FIRMS

Another possible source of recovery by school districts for losses stemming from public corruption are auditing and accounting firms charged with monitoring the districts' finances and transactions. When unusual activity and excessively large sums are transferred, a red flag should arise within a reasonably constructed accounting system. When such irregularities or anomalies pass unnoticed, however, the auditing and accounting firms might be responsible for the failure to provide the proper level of services for which they were retained.

One facet of the Roslyn story illustrates the point. In late 2004, the accounting firm handling the Roslyn School District account had been cited in the state audit report as partially responsible for the fiscal abuses committed in that district. The report described the firm's work as "unprofessional" and "appallingly inadequate," and it accused the firm of neglecting such basic duties as reviewing canceled checks.²² The Roslyn district sued the firm for \$12 million for "unskillful and grossly negligent" work. Roslyn's lawsuit also alleged that defects in the software developed by the accounting firm allowed users to manipulate entries to disguise theft as legitimate spending.²³

Needless to say, a new school administration fired the accountants in May 2004 upon the discovery of details of the earlier administrators' unprofessional financial practices.²⁴ A principal in the accounting firm has been indicted for, among other crimes, tampering with public records and falsifying business records.²⁵

Other school districts and public entities facing the kind of pervasive corruption found in the Roslyn School District might not necessarily be plagued with a negligent accounting firm, but there are undoubtedly other instances in which the financial misconduct of school or other public administrators could have been earlier discovered, if not prevented entirely, had the

accounting firm performed its duties in a diligent and careful manner. In such instances, a civil suit for damages might provide a justified and necessary remedy and deter similar neglect by others in the future.

OTHER SPECIFIC REMEDIES

An assortment of equitable remedies distinctive for their flexibility and adaptability to circumstances remains available in public fraud and corruption cases.

For example, in contrast to a constructive trust in which the property or assets might be transferred from the wrongdoer to the public beneficiary, imposition by a court of an "equitable lien" gives to the public claimant a security interest in the property rather than complete title. Thus, the creditor-public entity having a lien upon the property of the debtor-public employee/vendor is entitled to have the property sold and use the proceeds to extinguish the debt.²⁶ The public lienholder further stands in a better position than an unsecured creditor. Therefore, when an equitable lien is imposed by the court, it affects other creditors as the claimant-creditor secures a higher priority for payment than those with an unsecured status seeking satisfaction of their own claims from the same property.²⁷

Another method to gain restitution in cases of fraud or unjust enrichment lies in an accounting for profits, which extends the constructive trust idea to properties producing income or appreciating in value. In such instances, the claimant might recover not only the value of the property but also the net income or gain it produced while held by the wrongdoer. Unlike a constructive trust, accounting for profits doesn't require a particular fund of money but might force the wrongdoer to pay from any monies he or she possesses. Because the claimant can look to any of the wrongdoer's assets rather than a particular fund earmarked to pay for claimant's damages, the accounting for profits imposes a greater burden upon the wrongdoer by exposing a broader pool of assets for recovery.²⁸

In addition, accounting for profits might have special status in civil actions against current or former public employees and fiduciaries. This form of restitution – in other words, restoring to the claimant that which it is rightfully owed – not only forces the fiduciary to surrender the gains realized from the improper or fraudulent use of the claimant's property or entitlements; signif-


icantly, it also imposes upon the defendant the burden of proving appropriate deductions for expenses he or she incurred so the gain can be calculated.²⁹ This type of information about asset concealment and usage might provide public employers with insight on how deceptive practices develop as they search for effective measures to stem the spread of corrupt activities.

If the factual circumstances warrant, federal and state RICO statutes present another civil suit option against wrongdoers.³⁰ RICO statutes are remedial and authorize treble damages for certain types of commercial fraud, official corruption, and bribery.³¹ Successful maintenance of a civil RICO suit requires that special factors be present, such as a "pattern of racketeering activity" and an "enterprise." The specific facts that enable individuals and entities to perpetrate a commercial fraud on a school district might satisfy these and other RICO requirements. Because "RICO's flexibility, breadth, and power make it one of the fearsome weapons available to combat procurement abuse," the potential to obtain treble damages and counsel fees makes RICO a potent option to consider.³²

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REBUILDING TRUST

Finding the means to recover the monetary losses suffered by the school district, of course, speaks to only one of many problems facing districts and other public entities plagued by corruption. Halting corrupt and lax practices that have hobbled governments for years and making business operations more efficient and effective must be major goals for public bodies rocked by scandals like Roslyn. Conducting thorough background checks of potential employees and compelling employees to complete conflict of interest disclosure forms might prove helpful, too.

Equally important, however, should be the successful pursuit of remedies for the damages suffered. Such remedial efforts not only recoup financial losses and deter future misconduct, but they also rebuild the trust and goodwill of the taxpayers who finance the very services government provides. Absent abiding trust and goodwill, effective government becomes all too illusory. 

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- ¹ Paul Vitello. "Former Schools Chief of Roslyn Gets 4 to 12 Years in Fraud." Oct. 11, 2006. *The New York Times*.
- ² "Hevesi Audit Finds School Employees Used At Least \$11.2 Million of Roslyn School Funds for Personal Benefit." Office of the New York State Comptroller press release. March 2, 2005.
- ³ Karla Schuster & Eden Laikin. "Tassone's Partner Pleads Guilty." *New York Newsday*. Jan. 18, 2006; Janon Fisher. "Auditor for Schools in Roslyn Is Charged." *The New York Times*. Sept. 9, 2005; "Roslyn School Scandal Called 'Breathtaking.'" March 3, 2005, at 1010wins.com.
- ⁴ Kathleen Carroll. "Paterson ex-school official is indicted." *The Bergen Record*, Sept. 22, 2005; John P. Martin. "Painters admit bribing school official." *The Star Ledger*. June 22, 2005; Kathleen Carroll, "Contractor ripped off Paterson Schools - Guilty of bribing employees, overbilling for work." *The Bergen Record*, April 15, 2005; John Mooney. "School Executive in Paterson admits graft." *The Star Ledger*, Feb. 18, 2005.
- ⁵ See, e.g., N.J.S.A. 2C:21-34(b), which criminalizes the conduct of one who knowingly makes a false material representation in the negotiation, award, or performance of a government contract.
- ⁶ *Jersey City v. Hague*, 18 N.J. 584, 589-90 (1955).
- ⁷ *Jaclyn, Inc. v. Edison Bros. Stores, Inc.*, 170 N.J. Super. 334, 369 (1979).
- ⁸ N.J.S.A. 18A:17-20. For state-operated districts, see N.J.S.A. 18A:7A-35.
- ⁹ Dan B. Dobbs, *Law of Remedies* §4:3(1) & (2) (2d ed. 1993).
- ¹⁰ *Id.* at §10.4.
- ¹¹ Alan C. Brown, "Civil Remedies for Official Corruption," in "Identifying and Prosecuting Fraud and Abuse in State and Local Contracting" 57, 58 (ABA 1984).
- ¹² Dobbs at §4.3(2).
- ¹³ *Id.*
- ¹⁴ *Id.* at §3.11(2).
- ¹⁵ E.g., *Woodson v. AMF Leisureland Centers, Inc.*, 842 F.2d 699 (3d Cir. 1988) (stating that in assessing punitive damages, the trier of fact can properly consider the character of the defendant's act, the nature and extent of the harm to the plaintiff that the defendant caused or intended to cause, and the wealth of the defendant; the court further noted that Pennsylvania has adopted the position that authorizes punitive damages to deter the defendant and others from similar conduct in the future).
- ¹⁶ Dobbs at §4.3(2).
- ¹⁷ Patrick O'Gilfoil Healy. "School District May Have Hard Time Recovering Losses." *The New York Times*. March 4, 2005.
- ¹⁸ Brown, *supra* note 10, at 59.
- ¹⁹ *Continental Management, Inc.*, 527 F.2d at 617-18.
- ²⁰ *Jaclyn, Inc.*, 170 N.J. Super. at 367.
- ²¹ *County of Essex*, 186 N.J. at 59-60.
- ²² Patrick O'Gilfoil Healy. "Troubled Schools' Auditor is Closing, L.I. Officials Say." *The New York Times*. Jan. 20, 2005.
- ²³ *Id.*
- ²⁴ *Id.*
- ²⁵ Janon Fischer. "Auditor For Schools In Roslyn Is Charged." *The New York Times*. Sept. 9, 2005.
- ²⁶ Dobbs at §4.3(3).
- ²⁷ *Id.*
- ²⁸ *Id.* at §4.3(4).
- ²⁹ *Id.*
- ³⁰ See 18 U.S.C. §§1961 to 1968 & N.J.S.A. 2C:41-1 to -6.2.
- ³¹ Judah Best, et al. "Civil RICO" in "Identifying and Prosecuting Fraud and Abuse in State and Local Contracting" 87 (ABA 1984).
- ³² *Id.* at 87.