

Intelligence Brief 1.2

Contents

- **Ponzi Schemes Abound – Learning From History or Repeating It**
- **Insurers Beware: Suicides and Fraudulent Death Claims Likely to Spike**
- **Corporate Due Diligence in the Modern Era – An exploration of the challenges faced by modern businesses seeking to engage unknown foreign partners and the solutions available to ensure compliance**

Ponzi Schemes Abound – Learning from History or Repeating It

“After all, you only find out who is swimming naked when the tide goes out.”

So wrote Warren Buffett to Berkshire Hathaway shareholders in his 2001 Chairman’s letter in the firm’s annual report that year, when discussing the financial difficulties insurance companies, particularly reinsurers, would face in the wake of another 9/11-like catastrophe. Buffett’s admonition might apply equally to investors looking for unusually high returns from seemingly well-reputed, yet somewhat mysterious, hedge fund managers like Bernard Madoff. Indeed, in the current economic climate, the economic sea has receded far more than it did following 9/11 and the number of skinny dipping fraudsters turning up is remarkable. Many of these too-good-to-be-true “portfolio managers” are in fact running simple Ponzi schemes.

Ponzi schemes are named after Charles Ponzi, an Italian immigrant to Boston in the early 1900s. After moving to Montreal he did a stint as a bank teller there for a bank catering to the Italian immigrant community, where he learned a few things about fraud. The bank manager promised interest on deposits of six percent – about double the going rate – and the bank grew rapidly. Ponzi soon discovered that the bank was in serious financial trouble because of bad real estate loans. Moreover, Ponzi realized that the bank was able to fund these unusually high returns by using the money from later depositors. Eventually, the scheme collapsed, the bank folded, and the bank’s manager fled to Mexico, along with much of the bank’s money.

Following a subsequent three year sentence for an unrelated check fraud, Ponzi returned to Boston and bounced around various jobs. Then he hit upon an idea involving the buying and selling of “international reply coupons” (IRCs). Essentially, IRCs were coupons for postage stamps which could be purchased at one country’s post office, then sent overseas, and the recipient could convert them to another country’s postage. Since postage in Italy after World War I was fairly inexpensive, relative to U.S. postage stamps, Ponzi could purchase IRCs in Italy, ship them back to America, and have them redeemed for U.S. postage resulting, he claimed, in a 400% net profit. This effectively was a form of arbitrage, and was not illegal.

Ponzi borrowed money from friends, which he sent to Italy, for compatriots there to purchase the IRCs in Italy, which were then shipped back to him in Boston. However, he encountered a tsunami of red tape when he tried to redeem them for U.S. postage in Boston. Nonetheless, he used the concept of IRC exchange, even though it did not work in reality, to convince numerous friends that he had an unbeatable investment opportunity, in which he could double their money in three months. He then used later investors’ money to pay the earlier investors their promised returns. Many of the investors would reinvest their money with him. A snowball effect ensued as word spread, and Ponzi was soon taking investors’ money from throughout New England and New Jersey. In a matter of months of launching his scheme, Ponzi had taken in \$420,000 (in excess of \$4.5 million in 2009 dollars).

With people mortgaging their homes and investing their life savings, Ponzi had taken in millions within a year of starting his scheme. He purchased a mansion and other luxuries, and kept the scheme going by paying early investors with later investors’ infusions of

capital, apparently never making an effort to generate legitimate income.

When a Boston financial writer began looking at Ponzi's operation, he recognized that the outsized returns offered by Ponzi were simply not plausible. He wrote an article to that effect, Ponzi sued him for libel – and won \$500,000. The libel judgment stifled further scrutiny by other analysts.

Suspicion, however, continued to develop when Ponzi was sued by a furniture seller for unpaid bills. Although Ponzi won the suit, the scandal caused others to begin questioning Ponzi's history and how the operation could be so profitable. Shortly thereafter a run on his firm began, which he was temporarily able to stem by paying back some investors. This resulted in a favorable article about Ponzi appearing in the *Boston Post*, which caused a new rush of investors to buy into his scam. Ponzi was reportedly taking in \$250,000 per day at this point.

Post editors and writers were still suspicious however, and, along with Commonwealth of Massachusetts investigators, began digging deeper. The *Post* contacted Charles Barron, the editor of the financial paper *Barron's*, who noted that despite Ponzi's company's enormous returns, Ponzi himself was not investing his own money in his firm's operation. Barron also reportedly pointed out that in order for Ponzi's firm to cover the investments made for the purchase of postal reply coupons (the IRCs), there would have to be 160 million IRCs in circulation; however, the Post Office reported that only about 27,000 IRCs were in circulation. Additionally, the Post Office noted that, although the gross profit margin resulting from the purchase and sale of the IRCs could, in theory, be very high, the administrative expenses required to effect the buying, selling, shipping, and redeeming of the coupons would cost more than that gross profit. A series of articles by the *Post* detailing these facts caused a panic among Ponzi's investors and a run on his headquarters.

Ponzi scrambled to stave off collapse, but within weeks, the coup de grace was delivered, when the *Boston Post* ran a front page article detailing his check forgery conviction in Canada 13 years earlier, and his role in the Montreal bank fraud scandal. The Ponzi house of cards collapsed, and Ponzi spent the next 14 years in prison on various state and Federal charges.

The Federal Bureau of Investigation issued a press release on (fittingly) April 1, 2009, discussing the spate of Ponzi-like schemes (i.e., “pyramid schemes”) and listed 17 cases of charges or convictions against Ponzi scheme operators involving in most cases millions or billions of dollars stolen. FBI press releases discussing each of these cases can be found at <http://www.fbi.gov/pressrel/pressrel09/ponzi040109.htm>.

In the April 1 press release, Assistant FBI Director Kenneth W. Kaiser of the Criminal Investigative Division said, “Too often investors are blinded by dreams of untold wealth. These schemes highlight the need for law enforcement and regulatory agencies to be ever vigilant of white-collar crime both in boom and bust years. We also want to remind the public to exercise due diligence in selecting investments and the people with whom you entrust your money.”

Just as in the case of Charles Ponzi, Bernard Madoff concocted a story about a clever new investment strategy that was plausible enough to dupe many investors into handing over their life savings to him. And just as a skeptical financial analyst questioned Ponzi's bona fides, a skeptical analyst – Harry Markopolos – was questioning Madoff's legitimacy for over 15 years. Yet even the Securities and Exchange Commission would not listen to him.

The allure of high returns will always cause some to abandon their healthy skepticism regarding promising investment schemes, but history should inform our investment decisions and remind us to look deeply into both the person offering the high returns and the method they use to realize them.

Insurers Beware: Suicides and Fraudulent Death Claims Likely to Spike

As if insurance companies were not embattled enough with exposure from credit default swaps, lectures from ill-informed politicians, and falling share prices, economic crises of the sort we are facing now pose a more prosaic challenge – desperate policyholders taking their own lives or faking their own deaths as a solution to increasing financial hardship.

While taking one's own life to cash in on a life insurance policy in order to provide financial relief to

one's family is nothing new – think George Bailey in “It’s a Wonderful Life,” who considered jumping into the river in Bedford Falls on a snowy Christmas Eve – the unprecedented financial stresses placed on many Americans who overextended themselves in recent years will compel some to resort to this “solution” to their problems. Likewise, others who wish to be relieved of their financial burdens, but without the complication of actually dying, will fake their deaths. Evidence suggests that this will oftentimes occur in foreign countries, where forged documents are easier to procure, law enforcement is lax and sloppy, and insurance companies are perceived to have less ability and/or interest in investigating. While this phenomenon is also nothing particularly new, the incidence of its occurrence, in our view, is likely to increase significantly as the economy contracts further.

We offer two illustrative examples from recent investigations we conducted.

One case involved an insured with life insurance policies paying several million upon his death. He had been an apparently successful electrical contractor for a number of years in New England. As the real estate market heated up, he decided to branch out into property development, constructing a number of made-to-order homes and developing properties in New England and the South. He took out mortgages for these properties, and when the mortgage market collapsed in 2008, he was left unable to sell some of the properties he had developed. His principal contracting business also fell off, as clients retrenched and cut their discretionary spending. Toward the end of the year, he travelled alone to a Caribbean country, purportedly for a two-week vacation, and died there two months later of multiple organ failure, despite being a relatively young man with no serious prior medical history.

There were what appeared to be red flags on the claim initially. Somehow this insured's “two week” vacation, per the Foreign Death Questionnaire submitted by the beneficiary, turned into a two month stay. He had travelled alone to the Caribbean for a “vacation,” when he had a family of four. And his body was cremated, which is often the case in insurance frauds, when one wants to eliminate the possibility of exhumation and analysis to ensure that the person who died was actually the insured.

Similarly, public records research in the United States at the outset of the investigation raised additional red flags. We discovered that the insured's two residences had both been foreclosed upon. He was being sued at the time of his death by multiple vendors whom he had failed to pay. He failed to renew his contractor's license, which was due shortly before his departure from the United States. Additionally, interviews with friends, family and co-workers in New England revealed indications of a potential fraud. No one seemed to have a clear understanding of what caused the insured's death. He was estranged from his wife and his business had grown dormant.

It was not until investigation was conducted in the Caribbean country that the complete picture emerged. The insured had appeared suddenly on a popular tourist island needing a place to stay. He was brought to a private rental home by a taxi driver, and agreed to rent a vacation unit with cash up front. He seemed, according to the landlord, to be severely depressed, and embarked on a month-long drinking binge. He ran out of money after several weeks and could not pay the rental fees any longer, telling the landlord he was doing subcontracting work and would pay him as he could. Shortly thereafter, the landlord discovered the insured had collapsed, unable to walk. The insured was hospitalized and discovered to be suffering from extreme pancreatic necrosis, which in turn caused his liver and kidneys to fail. Following a three-week hospitalization, the insured died of multiple organ failure. The landlord discovered numerous empty liquor bottles in the insured's rental unit, as well as a recently updated will, copies of his life insurance policies and emergency contact information conveniently placed on the kitchen table.

Although manner of death was not ruled suicide by local authorities, one can draw reasonable conclusions. The insurance policies were not contestable in any event. This case highlights one tragic trend that insurers are likely to see more of.

In a second case, an insured from a mid-Atlantic state was found to have returned to his native Southwest Asian country, where he purportedly died of a heart attack. He too was a relatively young man with no prior serious medical history. He held numerous life insurance policies with multiple insurance companies totaling over one million dollars. His wife, as in the case outlined above, seemed to know surprisingly little

about the nature of the insured's business, his activities during his foreign travel or the circumstances of his death.

Once again, public records research was initiated in the United States, revealing that the insured had declared bankruptcy in late 2007 (as well as 10 years prior), his home had been foreclosed upon, and he was being sued for fraud and misrepresentation by a bank with whom he had defaulted on a sizeable loan. He had secured a large mortgage for an opulent home by claiming an income in excess of 10 times his actual salary, according to figures contained in his bankruptcy filing. Interviews conducted in the United States revealed that he had defrauded a client of a large sum of money for merchandise he never shipped, had defrauded his employer of significant monies for merchandise he shipped to his home country for which they were never compensated, and defaulted on loans owed to several friends made to him shortly before he left the United States.

Extensive investigation in the insured's home country in this case revealed a high probability of a faked death. Acquaintances of the insured who were asked about his whereabouts (and apparently unaware of the ongoing fraud), revealed that the insured had been seen in the country five months after his purported death. His death certificate was not issued until six weeks after the date of death. The people who had arranged the insured's alleged funeral refused to meet with us in person to discuss their involvement in the funeral, or provide their physical addresses. Interviews with the insured's son revealed serious discrepancies in the account of where the insured's body was found, when compared with the account provided by the insured's wife. Ultimately, it was discovered that official mortuary records had been doctored for the purpose of creating what was, in all likelihood, a bogus death certificate. Eventually, US consular officials, working with the host government officials, began to investigate the death certificate and other official documents produced by the claimants. This case awaits resolution, but the outcome seems positive for the insurance companies involved.

Reliable statistical data on the incidence of suicides and faked deaths in economic downturns is difficult, if not impossible, to come by, primarily due to the lack of a sound reporting mechanism by insurance companies of such cases. The reasons for this are varied, but include

anti-trust concerns, issues over marketing and competition, and disparate state regulations regarding the reporting of fraud. Therefore, we must rely on anecdotal information and the experience of industry professionals to gauge any change in the number of such cases during periods of economic contraction.

Frederick Hegner, a retired Vice President of ALICO, the life insurance subsidiary of AIG, and a 37 year veteran of the insurance industry, noted that in his lengthy experience, "whenever there was an economic downturn the number of questionable claims increased; not only death but disability as well."

Noting that a Florida newspaper recently reported a 36% rise in shoplifting crimes, Hegner opines that this is an "'indicator' produced by the economic downturn and reflects the moral decay which certainly also impacts insurance fraud and abuse. Here again in my opinion the thief sees the store or store owner as a non-person just like insurance fraud is committed against that big and wealthy impersonal insurance company."

If the insurance industry is to adequately protect itself against fraud in the coming years of financial hardship greater cooperation, openness, critical claims assessments, and aggressive investigation will be required.

Corporate Due Diligence in the Modern Era

Several years ago, I undertook a due diligence investigation into an apparently well-respected and sophisticated Colombian gentleman being considered for a joint venture with a prominent U.S. client. The Colombian investor presented himself as a maritime industry executive, and indeed owned a sizeable shipping fleet. Our investigation, however, revealed a less reputable source of the Colombian's wealth - cocaine trafficking. It was only through interviews with Colombian law enforcement sources that we uncovered the well-documented investigations of which the Colombian gentleman had been a target.

Several years after our investigation, the Colombian was arrested, extradited to the United States and prosecuted for smuggling an estimated 100 tons of cocaine per year into the United States aboard his ships. The potential damage to the valuable brand of

the U.S. client could have been significant had the deal been consummated and the joint venture partner's past later discovered. Fortunately, this outcome was averted when the transaction was cancelled based on the information unearthed in the due diligence.

Whenever I speak to a client who is considering an investment, an acquisition or a joint venture, particularly overseas, I raise the issue of conducting a due diligence investigation of the company. The response I generally receive is along the lines of: "Well, we got audited financials from the company, and everything checks out."

Perhaps my twenty years of law enforcement, intelligence and private sector investigations' work has jaded me. Or perhaps my skepticism is fueled by headlines but a few statistics illustrate the point. In 2007 there were 776 investigations initiated by the SEC, 262 civil proceedings, and 394 administrative proceedings. The investigations and proceedings covered a range of malfeasance, including corporate financial fraud, stock option backdating, insider trading, mutual fund fraud, and violations by broker-dealers. These enforcement actions resulted in \$1.6 billion in disgorgements and penalties.

Whatever the basis for my own cynicism, my clients' refrain that their "due diligence" consisted of examining a company's financials reflects the need for a new paradigm for proper corporate due diligence, in which an examination of the books is but one aspect. We live in a global economy and have witnessed a massive increase in foreign direct investment in the past 20 years. The value of U.S.-owned assets abroad increased from approximately \$930 billion in 1980, to \$2.1 trillion in 1990, to \$6.2 trillion in 2000, to \$13.7 trillion in 2006, according to the U.S. Commerce Department's Bureau of Economic Analysis.

Consequently there is a vital need for reliable, in-depth information regarding the companies and principals with whom we are dealing, particularly in foreign markets where transparency is often lacking. The potential damage to a company's bottom line and its reputation by involving itself with an unscrupulous actor can be enormous. Add to that recent legislation promulgated by Western governments, such as the USA Patriot or Sarbanes-Oxley Acts in the United States, and the need for due diligence skyrockets. The

requisite due diligence goes far beyond "looking at the books".

The failure by U.S. companies to recognize the potential consequences of transactions with dubious foreign entities and to adequately research these entities and the people behind them can be devastating. However, the risk of civil litigation, criminal sanctions and reputational damage, while very real and potentially costly, is limitable if companies implement a due diligence regimen as a matter of corporate policy. The question often is to whom to turn for these services.

Of Databases and Dun & Bradstreet

There is a perception among many corporate executives, fueled in part by the ubiquitous Internet, that there is plenty of information available online about virtually any individual and any company. While it is often true that much raw data may be present online about a subject, the more important question is: what is the credibility of the information I am obtaining via the Internet or, for that matter, from proprietary databases?

While information obtained from an Internet search can be useful for initial lead information about a subject, much of the information found online is from unknown sources, may be distorted or false, hardly an objective cornerstone for sound financial decision making. Although Internet research is naturally incorporated in any thorough due diligence investigation even proprietary database information must be considered inherently suspect. Much of the information supplied about a company in, for example, a Dun & Bradstreet report is volunteered by the principals of that very company. Most of the operational history of the company, biographical information of principals and officers, and some of the financial information of a corporation is supplied by the company being reported upon.

I mention this shortcoming not to discredit Dun & Bradstreet, which markets a useful research tool that does have its purposes; rather, I cite it as an example of the limitations of business profile services. These limitations are true of all such electronic corporate reporting services, particularly with respect to foreign entities. The profiles found in these reports provide useful leads for investigators, and even the information supplied by company principals is important for an

investigator to have, because the investigator can corroborate it through secondary sources. If a company owner or senior executive is found to have provided false or misleading information to a business reporting service, that knowledge itself may be important to a client.

Apart from the questionable quality of the information found online about an individual or company, oftentimes there simply will not be much information available online about companies located overseas, particularly small or low-profile companies, or companies situated in remote or technologically undeveloped countries. Given the increasing push by Western companies into resource-rich, but often underdeveloped, markets, this handicap becomes ever more pronounced.

Pounding the pavement

Much like a modern war cannot be won by air power alone, a Western company considering investing in a foreign entity cannot rely simply on Internet searches, databases and emailed information from a potential investment target when considering an investment. Investors must review corporate filings and financial records maintained in the foreign country's government agencies, gather criminal and civil litigation records located in the country where the subject company is located, and interview local industry players and analysts knowledgeable about the company in question. It is also vital that the research include local investigators who have the language skills, knowledge of the local market, and access to well-informed sources, as well as the ability to conduct their work discreetly.

The importance of on-the-ground examination of a foreign entity acquisition or investment can be illustrated by the following example. While conducting research for a client considering a multimillion dollar investment in an Asian company, we gathered the requisite corporate records and made checks with relevant government agencies. However, it was not until we discreetly visited the location of the alleged "office" of the subject company that we discovered it was actually a night stall in a local marketplace rather than the robust operation our client believed it to be. The principals of the company had grossly overstated their financials, revealed by an actual look at their operation.

In cases like these, the vital information needed by our clients could not have been uncovered solely from electronic research; yet it is easy to drown in raw data without discerning reliable information when making a strategic investment decision.

Companies don't lie, people do

What we occasionally see clients lose sight of is that companies are only as ethical as the people who own and manage them. Frequently we will be asked to conduct a due diligence investigation of a company, but a company is simply a legal construct for activities engaged in by people, so any determination of a company's legitimacy must focus upon the legitimacy of its principals.

Such an examination would include a thorough review of media reports, criminal records, civil litigation, industry certification and disciplinary records, educational credentials and other records pertaining to the senior executives. If a principal defrauded someone in the past, or has otherwise engaged in unethical or illegal behavior, the odds are very high that the behavior will repeat itself in the context of the deal under consideration.

Performing such a thorough due diligence investigation in advance of a transaction serves to demonstrate a company's commitment to good corporate governance. In the case of public companies, a well-prepared due diligence report can also serve as a vital legal bulwark in management's defense in a shareholder lawsuit should a deal turn disastrous.

The art of the deal

Due diligence today – particularly in foreign countries – requires skills and contacts more akin to intelligence officers than the traditional gumshoes of popular imagination. Not surprisingly, the best firms engaged in this niche industry are founded and staffed frequently by retired intelligence officers, criminal investigators with international experience, and military intelligence officers and analysts who had been stationed overseas.

These highly qualified persons often have in-depth, expert level knowledge of foreign cultures and may speak any number of languages. They frequently have networks of high-level, sensitive contacts in countries

in which they perform research – contacts developed and maintained oftentimes over decades. They understand their clients' need for discretion, responsiveness and reliable information. Perhaps most critically, they have 'access': specialist knowledge of how to obtain information in foreign cultures. Given the disparate localities from which information is required in today's global economy, with its patchwork of laws, traditions, information archival systems and forms of government, international business intelligence is an art form that should be a component of any dealmaker's repertoire.

Credible and timely information translates into higher profits and protected reputations. Due diligence is no longer a luxury. It is vital to maintaining a company's competitive edge and remaining compliant with the law.

About Veritas Intelligence

Veritas Intelligence enables its clients to succeed in complex or hostile business environments. To this end, Veritas Intelligence provides a broad range of investigative, intelligence, financial and research services to help clients reduce risks, solve problems, and capitalize on opportunities.

Veritas Intelligence is headquartered in the Washington, DC metropolitan area with a branch office in London, United Kingdom. Veritas Intelligence serves a global clientele of law firms, financial institutions, multinational corporations, insurance carriers, investment organizations, non-profit organizations, and high net worth individuals. Our operational hubs in the Washington, DC area and London oversee our global network of investigators who are located across the world.

William F. Marshall, President & CEO

Prior to founding Veritas, Mr. Marshall was Managing Director of global investigations firm GlobalSource LLC. He has also served as the head of the North American Investigations Division of ArmorGroup, Senior Investigator for the Investigative Group International, and as an Intelligence Analyst with the U.S. Drug Enforcement Administration, specializing in money laundering methodologies, trends and detection techniques.

