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Case & Project Experience

NERA Expert Provides Testimony on Behalf of Insurer in Successful Denial of D&O Coverage for Executives of Stanford Investment Bank—One of the Largest Ever Ponzi Schemes (*Laura Pendergest-Holt, et al. v. Certain Underwriters at Lloyd's of London and Arch Specialty Insurance Co.*)

Overview

In March 2012, R. Allen Stanford was convicted of running a $7 billion Ponzi scheme. He is currently serving a 110-year jail sentence.

Prior to the criminal trial, the US District Court for the Southern District of Texas was asked to determine whether Certain Underwriters at Lloyd's of London and Arch Specialty Insurance Co. (the "Underwriters") were entitled to deny coverage for the defense costs of Mr. Stanford and other executives of the Stanford Financial Group (SFG) pursuant to an exclusion clause under the D&O insurance policy.

The court found that, on a preponderance of the evidence (the standard of proof in the civil insurance coverage action), Mr. Stanford and his executives knowingly prepared and approved false financial reports and facilitated the concealment and transfer of the bank's funds through related companies without disclosure to investors or regulators. As such, the exclusion clause was found to apply and the Underwriters were entitled to deny coverage and seek reimbursement of payments previously made.

Background

SFG consisted of more than 140 separate legal entities, including Stanford International Bank Limited (SIBL or the "Bank")—an Antiguan-domiciled bank, which was principally in the business of selling various types of certificates of deposit (CDs) to investors.

The purported business model of SIBL was to invest the proceeds raised from the sale of CDs in order to provide a return on investment sufficient to cover, *inter alia*, the required interest payments on the CDs and generate profits for the Bank. SIBL described its investment strategy as being *"designed to minimize systematic and unsystematic risk while maintaining liquidity, portfolio efficiency (highest yield/minimum risk), operational flexibility and absolute yields."*

SIBL claimed that its CDs had outperformed US bank CDs by an average of 4.6 percentage points over the decade prior to 2008.

SIBL attributed its ability to pay higher rates on its CDs to its investment strategy and financial strength. Its financial advisors and its brochures, reports, and other marketing documents variously emphasized that SIBL was "strong, safe and fiscally sound," and that its investment strategy was "conservative" and "long term, hands on and globally diversified with strong liquidity and minimal leverage."

In a "monthly" report to investors for December 2008 (which was the first and only such report), about six weeks prior to charges being filed in the US, SIBL reported approximately $7.2 billion in outstanding investor deposits and total assets as of 28 November 2008 of over $8.5 billion.

By the fall of 2008, the US subprime crisis that began in 2007 had evolved into a global credit and liquidity crisis—what became the worst financial crisis in recent history. In that context, SIBL began to experience an increase in CD redemptions during the latter part of 2008. By the beginning of October 2008 (and continuing to February 2009), payments to SIBL's existing investors exceeded the proceeds from new investor deposits.

Investors, financial advisors, regulators, and employees of SFG began to ask questions regarding the viability of SIBL. Investors expressed concerns about the liquidity of the bank and the security of their money and an increasing number wanted to liquidate their accounts with the SIBL. Similarly, questions were being asked by SFG employees about SIBL's investments. In addition, there was open speculation about the legitimacy of SFG and/or SIBL in the media.

In response to questions and concerns of investors, regulators, and SFG employees, Plaintiffs made representations to investors, regulators, and others including reporting that: Mr. Stanford himself had contributed more than $700 million in additional capital during 2008; that its balance sheet was strong; and that the Bank's exposure to subprime mortgage securities was limited.

Notwithstanding these attempts to reassure investors and regulators, the Stanford entities were placed into involuntary bankruptcy on 16 February 2009. On 17 February 2009, the Plaintiffs were charged with fraud.

NERA's Role

NERA was asked by counsel for the Underwriters to examine the financial nature and economic substance of certain activities of, and representations made by, the Plaintiffs and SIBL to determine whether these activities and representations had characteristics that the court might classify as fraudulent and that would therefore trigger the application of the exclusion clause of the D&O policy. The NERA team, led by Senior Vice President Mark Berenblut, conducted a financial investigation and economic and accounting analyses of internal documents, emails, regulatory filings, and other public disclosures of SFG and SIBL.

NERA's financial investigation identified that the Plaintiffs had reported false returns on investment figures for SIBL to investors and regulators; made misrepresentations about the investment strategy, assets, and financial position of SIBL and other Stanford entities; misappropriated investor funds; and attempted to further conceal the scheme and the misappropriation of assets in response to inquiries from regulators and an increase in investor redemptions in late 2008 and early 2009.

In particular, NERA's investigation traced the process used by the Plaintiffs to reverse engineer the investment returns that were reported by SIBL to investors and regulators. Internal spreadsheets and emails discovered by NERA's investigation documented the construction of artificial investment returns such that the Bank was able to report the revenues and total assets to support the volume of investor deposits and make the CDs attractive to purchasers.

NERA's investigation also found that the investment strategy of the Bank was significantly different than was represented to investors. NERA's analysis further demonstrated that the purported investment returns of SIBL could not have been generated by any real investment portfolio in that they were both too high and too consistent to be economically realistic. Finally, NERA's investigation also identified documents which demonstrated that the assets of the Bank as reported in its financial statements and filings with regulators were false. Such documents included purported lists of the assets and their values, the majority of which were fictitious (including a $935 million asset described as "Needed") and/or inflated. At least $1.7 billion of the purported assets of SIBL were in the form of notes receivable from Mr. Stanford himself—in contrast to its representations to investors and which were not disclosed in its financial statements as required by International Financial Reporting Standards.

These misrepresentations appeared to have been made for the purpose of concealing the operation of a fraudulent scheme, whereby payments of principal and interest (or "returns") to investors are made from funds raised from new investors, rather than from actual returns on invested assets—that is, to conceal that the Bank was actually a Ponzi scheme. Indeed, SFG and SIBL exhibited many of the characteristics commonly associated with Ponzi schemes.

Mr. Berenblut produced an expert report and provided expert testimony at trial describing the findings of the financial investigation and economic and accounting analyses.

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The Result

In ruling in favor of the Underwriters and effectively denying insurance coverage for the executives of SIBL, the court, relying in part on the testimony of Mr. Berenblut, found that:

> *"...to the extent that internal SFG documents listing SIBL assets reflect assets actually owned by SIBL, the composition of the reported assets was grossly inconsistent with SIBL's widespread representations that it invested in liquid, highly marketable securities, and that it only engaged in cash-secured lending to CD holders. If, on the other hand, the list of assets was a mere fabrication then the representation by SIBL of its investment of CD proceeds in secure liquid assets, strong multinational companies, and securities issued by stable governments and major international banks, are similarly misleading."*

As such, the court found that the funds obtained by SIBL from CD sales were "Criminal Property" as that term was defined in the D&O Policy. The court further found that each of the individual Plaintiffs knew, or reasonably should have known, that the investment returns were fictitious, and had participated in efforts to conceal from investors and regulators the true business and financial status of SIBL.

As such, the court found that the exclusion of the D&O policy applied and that the Underwriters were entitled to deny coverage and seek to recover amounts paid.

Expert Involved

Mark L. Berenblut, Senior Vice President

Mr. Berenblut provides expertise in economics, finance, securities valuation, accounting, financial investigation, and dispute resolution to the legal and business communities, as well as to government. He has over 25 years of experience in securities and business valuation for complex litigation, complex claims including economic damage quantification, mass torts, product liability, insolvency and restructuring, major securities and antitrust class actions, financial investigation, and intellectual property. Mr. Berenblut has provided expert reports and testimony for matters in the US, Canada, and Europe at trial and arbitration. A graduate of The London School of Economics, Mr. Berenblut is a Fellow Chartered Accountant, Investigative Forensic Accountant, Certified Fraud Examiner, Accredited Senior Appraiser, Fellow Chartered Business Valuator, and Certified Mediator. He is recognized by the Academy of Experts.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

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