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From Roslyn to Remedies

When civil officials pilfer funds, civil remedies can be used to recoup losses

There are few limits to the ingenuity of corrupt insiders and suppliers who defraud governmental entities of millions of dollars in taxpayer monies.

Ponder, for example, the media firestorm surrounding the Roslyn School District on Long Island upon discovery that school officials had pilfered millions of dollars. There, school funds had been misappropriated by payment of excessive compensation to certain district officials, as well as by reimbursement for such personal benefits as flights aboard the Concorde, mortgage payments for vacation homes in Florida and ATM cash advances exceeding \$1 million. A state audit calculated losses exceeding \$11.2 million. See “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. Arrests and indictments of Roslyn officials and outside school auditors followed these dis-

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closures.

New Jersey is no stranger to such criminal abuses by unscrupulous public officials. See, e.g., 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.

Can such criminal misconduct also be the subject of civil remedies to recoup any losses? As described below, several civil remedies may be available.

Suit Against Former Employee

Suits against former public employees or officials may form part of a strategy to recover the losses incurred. Officials who have snatched millions of dollars by intentionally misrepresenting their activities, padding expense accounts, doctoring payroll expenses and entering into cozy contracts with family and friends — all have acted for personal gain and with deceit to merit civil recovery in tort. See N.J.S.A. 2C:21-34(b), which criminalizes a knowing false material representation in the negotiation, award or performance of a government contract.

Additionally, current or former employees, as holders of positions of public trust, may be sued for breach of

their fiduciary obligations. See *Jersey City v. Hague*, 18 N.J. 584, 589-90 (1955). Although the remedies for fiduciary breach may resemble those for other causes of action, the fiduciary — depending on the post held — may owe affirmative duties toward the public employer beyond those found in an ordinary case of fraud.

A fiduciary agent is presumed to be acting with “absolute devotion” to the principal at all times and any commissions, bonuses or other payments the fiduciary receives from a third person are in law presumed to be for the benefit of the principal. *Jaclyn, Inc. v. Edison Bros. Stores, Inc.*, 170 N.J. Super. 334, 369 (1979). Should an employee use public monies to pay for personal items or allow vendors to bill for work not done, the employee has breached his fiduciary duty and should be held accountable.

Yet how does a public body trace money lost to a fiduciary breach? If the ill-gotten gains are not lost at the racetrack or to some other vice, the corrupt employee or official may use the money to buy a tangible asset, such as a home or boat.

Now that the disloyal employee has “legal” title to identifiable property linked to the money or item taken, the public employer may request imposition of a “constructive trust” to restore to the public body the assets that fairly belong to it. See Dan B. Dobbs, *Law of Remedies* §§ 4.3(1) & (2) & 10.4 (2d ed. 1993). In imposing a constructive trust, a court declares the public official a “constructive trustee” of assets gained

through misconduct, and then orders the official to transfer them to the "trust beneficiary," i.e., the public employer for whose benefit the court deems the assets to be acquired and held. See Alan C. Brown, *Civil Remedies for Official Corruption*, in *Identifying and Prosecuting Fraud and Abuse in State and Local Contracting* 57, 58 (ABA 1984). Furthermore, the public employer may demand not only what it lost, but also the gains reflected in any increase in the property's value, its transfer, or its use. See *Dobbs* at § 4.3(2).

Another important remedy available against current and former insiders for bad faith or intentional misconduct is the award of punitive damages. When the underlying cause of action relates to egregious misconduct like fraud or malice, some courts deny punitive damages unless the claimant shows misconduct even worse than that required for establishing compensatory damages. *Id.* at § 3.11(2). Other courts reject such limitations. See, e.g., *Woodson v. AMF Leisureland Centers, Inc.*, 842 F.2d 699 (3d Cir. 1988). Still others postulate that punitive damages are particularly justified in cases where the wrongdoer abuses a position of special power or prominence. *Dobbs* at § 3.11(2).

Suit Against Vendors

Public entities can also sue vendors who commit fraud or contractual breaches. Corrupt third-party vendors who knowingly participate in a fiduciary's breach of duty may be as culpable as the official and liable as a joint tortfeasor for damages. Restatement of Restitution § 138(2) (1935); *Brown* at 59.

Yet the liability of vendors to the public body may be difficult to establish when contracts are performed satisfactorily and at a reasonable price. Courts have nonetheless found that a public entity still sustains nonmonetary damages when third parties corrupt or unduly influence its officials. In such instances, the harms inflicted include loss of employee loyalty, diminution of public confidence in government, and the need to fire and replace the official.

That is:

[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. *Continental Management, Inc. v. United States*, 527 F.2d 613, 617 (Ct. Cl. 1975).

When parties bribe public officials, damages to the government include the amount of the bribes paid. *Id.* at 617-18; *Jaclyn, Inc.*, 170 N.J. Super. at 367. Punitive damages may be sought, too.

Suit Against Accounting Firms

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

As one facet of the Roslyn story illustrates, an accounting firm providing "unprofessional" and "appallingly inadequate" accounting services such as reviewing canceled checks or developing effective accounting software may cause liability to attach. Patrick O'Gilfoil Heally, "Troubled Schools' Auditor Is Closing, L.I. Officials Say," *N.Y. Times*, Jan. 20, 2005.

Other Specific Remedies

An assortment of equitable remedies distinguished for their flexibility

and adaptability to circumstances remains available in public corruption cases.

For example, in contrast to a constructive trust wherein the subject property may be transferred from the wrongdoer to the public beneficiary, imposition of an "equitable lien" gives the public entity a security interest in the property rather than complete title. Thus, the creditor public entity that possesses a lien on the property of the debtor-public employee/vendor is entitled to have the property sold and use the proceeds to extinguish the debt. *Dobbs* at § 4.3(3). The public lienholder also secures a higher priority for payment than those with an unsecured status seeking payment from the same property. *Id.*

Another method to effect restitution in cases of fraud or unjust enrichment lies in an accounting for profits, which extends the constructive trust idea income-producing properties. In such instances, the claimant may seek to recover not only the value of the property, but also the net income it produced while held by the wrongdoer. Unlike a constructive trust, accounting for profits does not look to a particular fund of money, but may force the wrongdoer to pay from any pool of assets he may possess. *Id.* at § 4.3(5).

If factual circumstances warrant, federal and state RICO statutes present another source of recovery against wrongdoers. See 18 U.S.C. §§ 1961 to 1968 & N.J.S.A. 2C:41-1 to -6.2. RICO statutes are remedial and authorize treble damages for certain types of commercial fraud, official corruption and bribery. Judah Best et al., *Civil RICO in Identifying and Prosecuting Fraud and Abuse in State and Local Contracting* 87 (ABA 1984). Successful maintenance of a civil RICO suit requires the presence of special factors, such as a "pattern of racketeering activity" and an "enterprise." Because "RICO's flexibility, breadth, and power make it one of the more fearsome weapons available to combat procurement abuse," the prospect of recovering treble damages and counsel fees renders RICO a potent option to consider. *Id.*

Conclusion

Halting corrupt and lax practices and making business operations more efficient must be major concerns for state and local governments rocked by

scandal like Roslyn. Of equal concern should be the successful pursuit of remedies for the damages caused by scandal: 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 that abiding trust and goodwill, effective government becomes all too illusory. ■