Protecting America's Pensions Plans from Fraud: Will Your Savings Retire Before You do?
Bill Number:
Hearing Date: June 9, 2005, 10:00 am
Location: SD430
Witness:
Mr. Barclay Grayson
Capital Consultants, Portland, OR
Former CEO
Testimony

Good afternoon. My name is Barclay Grayson. I am 35 years old. I have a wife and three young children. I obtained my undergraduate business degree from the University of Oregon in 1992 and I obtained an MBA from Colombia Business School with an emphasis in Finance and Real Estate in 1996. I am currently Senior Vice President of BDC Advisors, LLC, based in Portland, OR, where I facilitate senior housing real estate acquisitions.

In 1996, I joined my father's registered investment advisory firm which he founded in 1968. At its height, Capital managed assets in excess of $1 billion. Approximately 75% were Taft-Hartley regulated funds, of which half were derived from my father and the other half from Dean Kirkland who was my father's primary union salesman. The Company invested about half of its clients' capital in privately originated loans and investments.

One of Capital's private borrowers was named Wilshire Credit Corporation, led by Andrew Wiederhorn. Over a period of nine years, Wilshire borrowed over $150 million which it used to acquire high risk, sub-performing loans. These loans represented nearly 15% of Capital's total assets. Two years after I joined the firm, Wilshire defaulted on its loans and effectively failed.

Instead of disclosing Wilshire's default and shutting down the borrower, Capital advised its clients that it was undertaking a "work-out". This work-out first involved maximizing what little was left following the collapse of Wilshire. It next involved the formation of three new shell entities that then collectively borrowed $80 million of additional funds from Capital's clients. The majority of these funds were used to make high risk car and credit card loans. The balance was used to keep the original Wilshire loans current. As a result of these complex transactions, the Company's clients largely had no idea that their on-going contributions were effectively being circulated through each of these shell borrowers to keep their Wilshire investments current. This gave the false impression that all of the firm's loans were fully performing, fully secured and of limited risk.

At the end of 1999, a year following the effective loss of the Wilshire assets, my father appointed me President of the Company. In mid 2000 the SEC determined that the initial Wilshire loans were likely worthless, that the loans being made going forward were highly risky and that the disclosures to clients were insufficient. This resulted in Capital being place into court-ordered receivership on September 21, 2000. I immediately cooperated with all parties to maximize the recovery of client assets and assist in the ensuing DOJ investigation. It quickly became clear to me that I had failed to live up to my fiduciary duties as President relative to required disclosures to the firm's clients. In 2001, I therefore pled guilty to one count of mail fraud. I thereafter entered into a global settlement with all of the company's clients and the SEC.

Due to my extensive cooperation, the prosecution ultimately recommended that I be sentenced to one year of home detention. However, due to public accountability issues, I received a sentence of 18 months and a 3 year term of subsequent probation. After spending 14 months at FPC Sheridan, I returned home and started over. Due to my conduct and extraordinary assistance, the sentencing Judge terminated my probation 2 years early. She explained that this was a very rare occurrence but was warranted.

There are three natural questions that would follow after hearing this story:

The first question that arises is why did Capital loan so much money to Mr. Wiederhorn.

The reasons include:

1. My father received improper personal loans from Mr. Wiederhorn;
2. Capital received a management fees of 3% from clients on promptly invested assets;
3. Mr. Wiederhorn acquired earlier failed investments at face value;
4. Capital's excessive concentration with Mr. Wiederhorn resulted in a loss of control.

The second question is why did the union client's invest so much money into Capital's private investment program initially and why did the money keep flowing in for so long after Wilshire's failure?

1. Gifts and gratuities provided by my father and Dean Kirkland to the firm's union trustees including:

i. Expensive Dinners & Golf Trips;
ii. Club Memberships;
iii. Lavish parties/transportation/travel, etc.(trustees and families);
iv. Sporting Events (Football/Basketball/Golf);
v. Very Expensive Fishing/Hunting Trips;
vi. Establishment and funding of Foundations;
vii. Hiring relatives of Union members;
viii. Donations to causes/raffles of trustees/family;
ix. Investments in directed investments benefiting trustees (labor only investments, relatives, friends, etc.);
x. Loans (trustees and family) and Cash or equivalents
xi. Employment of trustees post union employment. Big compensation
2. Established relationships with service providers associated with recommending which investment advisors are selected for management.

The third question is whether there was any regulatory oversight?

Due to complaints dating back to the early 1990's, the DOL reviewed many of Capital's private investments. No specific issues were found to exist with Wilshire, but the DOL did determine that Capital was charging excessive fees. This resulted in a $2 million fine. There was little detailed follow-through to ensure that the funds Capital used to pay this fine were derived from legitimate sources; of which they were not. Although the DOL opened another investigation into Capital's private investments (including Wilshire) in 1997, the Company continued to be allowed to operate for almost 3 years until the SEC announced the receivership proceedings. All told, the DOL effectively witnessed almost 10 years of abuses without taking significant action to close the firm.

Based on my observations, the DOL has a limited understanding of private investments and a general lack of accounting skills. This results in the DOL having long "open files" which makes them largely ineffective. In this case, the DOL were largely reactionary as opposed to being pro-active.

2. The SEC began its' core investigation in 2000. They first spoke to past employees and existing borrowers of Capital. Then they came in hard and fast with a team of forensic accountants. They looked at every private investment in the portfolio and met with all members of the private investment management team at Capital. Within very short order they were working towards placing Capital into receivership.

The last question relates to what recommendations would I make to Congress to better protect pension assets:

First, we need to educate:

1. Courses and licensing should be required for all parties associating with Taft-Hartley regulated funds. No such requirements exist. Trustees would particularly benefit.
2. Courses and licensing should be required for all parties investing in privately held loans/investments. Many are ill-prepared to properly analyze private investments.

Second, we need to strengthen regulatory oversight:

1. The DOL needs to employ highly trained accountants and business experts like the SEC who will audit pension investments at least once every two years, as well as all of the service providers providing services to the unions themselves to ensure that no conflicts of interest exists.
2. The DOL needs to implement more strict Taft-Hartley investment guideline requirements that set real limits on investment alternatives and investment concentration.

Third, we need to expand the laws regulating Taft-Hartley assets:

1. Limit receipt of gifts and gratuities by trustees and service providers associated with a Trust to no more that $100 per item or event and no more than $500 per year. The law

should be clear that if a trustee or service provider accepts a gift or gratuity over stated level, regardless of whether influence can be proven, that it is a violation of the law.
2. Any trustees or service providers desiring to accept gifts or gratuities within legal limits should be required to disclose said items to the Trust prior to taking receipt.
3. To help mitigate future pension losses there should be a minimum level of E&O insurance coverage required for all investment advisors. This minimum should be tied to each manager's total assets under management, so as to provide additional coverage, but yet still be cost effective for providers.

English Testimony
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Stephen F. English
Bullivant Houser Bailey, Portland, OR
Esquire
Testimony
Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss with you an area of concern to all of us, protection of retirement funds.

I am an attorney in practice in Portland, Oregon with the regional law firm of Bullivant Houser Bailey, PC. I have been a trial lawyer on both sides of the bar for 32 years. Although much of my experience has been as a defense attorney, I have taken the lead role as plaintiffs attorney in a number of complex commercial and financial cases.

I have been asked to provide you with a description of the process I worked to develop to investigate the claims against Capital Consultants and related entities. As you know, the losses in this scandal were estimated in the range of $350,000,000 to $470,000,000. Capital Consultants had more than 300 client, and over 150 of them were employee benefit plans. Those plans had more than 300,000 participants and beneficiaries and they came from nearly every state in the country. We built a business model that I think can be replicated to investigate and recover losses in this type of case. We were successful in putting together litigation settlements in excess of $125,000,000 from the time I started working on the case in August of 2000. Subsequent recoveries are in the $35,000,000 range and the Receiver was able to conserve approximately $170,000,000 in assets, all for the benefit of the pensioners and others who were defrauded by Capital Consultants and the players associated with the fraud.

In total, the litigators and the Receiver were able to return in excess of $330,000,000 at a cost in legal fees, Receiver fees, and investigation costs of less than 10%. I would like to give you an overview of how we handled the litigation and mediation effort in an efficient and expedient manner. The key to what we accomplished lies in the fact that we developed a plan to engage in settlement negotiations that would yield the greatest net return to the clients in exchange for a complete release in favor of any defendant that agreed to settle, and a mechanism to ensure that they would not be sued by any other claimant or sued for contribution by any other potential defendant.

1. I led a small group of attorneys and investigators to identify the scope of the legal and factual problem and obtain a sufficient understanding of the problems and potential liability to be able to speak knowledgeably and get the potential defendants' attention. We did not expend unnecessary resources on any specific individual defendant, but rather focused on developing a case against a number of potential defendants so as to create a broader base from which recovery could be sought. The initial case focused on approximately 10 of the major entities responsible for the losses. The case focused on Capital Consultants as the investment manager, the borrowers with the greatest culpability, and the lawyers and accountants that worked with those companies.

2. We purposely did not engage in an exhaustive scorched earth approach at this stage for the simple reason that we did not know whether there would be a recovery sufficient to make such efforts worthwhile to our clients and because we felt time was of the essence in any recovery.

3. We prepared a lawsuit based on a sufficient amount of information to be able to tell our story to the defendants and give other claimants an understanding of what we were doing.

4. We made available to all other potential plaintiffs all of the information that we had obtained, as well as giving them full access to our investigation. We based this on the condition that they agree to cooperate with us in forming a united front so as to maximize recovery and minimize overlapping of effort. We gave each group of claimants the right to veto any settlement decision submitted to the group, and that element proved to be one of the strengths in keeping the group together and providing a unified front to the numerous defendants.

5. We negotiated an agreement among all plaintiffs to work together and divide the work in such a way so that all lawyers involved could have meaningful participation, but with a minimum of duplication of efforts and costs. As a group, we understood and committed that the approach would be one which would aim toward a speedy resolution as opposed to an exhaustive, scorched earth approach. Such an exhaustive, scorched earth approach would be financially beneficial to the attorneys, but could be financial disaster to our clients. We then sought a mandate from U.S. District Court Judge Garr M. King to require defendants to enter into a mediation process which combined a sufficient exchange of information so that a businesslike evaluation could be made by the defendants of their potential exposure. Again, in the interest of moving a resolution forward, we sought and obtained the court's approval and guidance so as to freeze or limit the amount of time spent on expensive, time consuming discovery tactics that could be employed by defendants and plaintiffs in this type of case. Our overriding goal in this

regard was to approach the resolution as a business solution as opposed to a legalistic or legal solution.

6. As we anticipated, at least a few of the defendants immediately saw the value in this. As a part of the resolution we offered these defendants, we first gathered authority from all potential plaintiffs and obtained the court's authority to act on their behalf. By doing this we were able to promise and make good on promises to defendants that when they settled with us they resolved all claims by all plaintiffs. As a further condition of this approach, we agreed that once they resolved claims with us we would protect them from cross-claims by other defendants. This essentially allowed us to go to a defendant and say, settle with us and you can resolve everything. This translated into a monetary value for not just the defendants, but their insurance carriers, who understood the value of having finality obtained quickly and efficiently on a case of this exposure.

7. Once it became clear that the court not only approved of this process, but was fully supportive of it, were able to utilize the mediation services of senior status Ninth Circuit Judge Edward Leavy, who proved nothing short of brilliant in his ability to move the parties forward. The process allowed for several weeks of mediation, with each party generally mediating two to three times before resolution was obtained satisfactory to both parties.

8. Once the settlements began, there occurred a "tipping point" at which it became apparent that no defendant wanted to remain as the only holdout. In addition, the fact that many defendants paid less than they might have had to pay if they had chosen to go through a trial created a sufficient amount of money so that plaintiffs did not have to have the maximum possible amount from any individual defendant. Again, one of our overriding strategies was that a businesslike approach required getting money quickly and at the least possible cost as opposed to holding out to squeeze every last dime from entities or individuals and risk the cost of trial and appeals.

9. The individual lawyers for various plaintiffs understood that in order to maximize the overall recovery in the most efficient manner possible, they had to sacrifice aggressive attempts on their part to maximize their personal clients' recovery to the detriment other plaintiffs. In other words, it became apparent to the plaintiffs attorneys that by following a strategy that would move the recovery process forward in the most beneficial way for the plaintiffs as a whole, they were actually acting in the best interest of their individual clients.

10. The case was able to be concluded from initial investigation through filing of the lawsuits, completion of the mediation of defendants and the court approval of the full settlement and claims bar in 22 months. All of the lawyers on the plaintiffs side meaningfully participated, but because of the coordination of effort and cooperation, the legal fees for the recovery amounted to under 10% of the total recovery. To date, approximately $330,000,000 has been recovered for distribution to pensioners and others. Under the calculation of losses in the distribution plan approved by the Court, this equates to approximately $.70 on the dollar for every dollar paid invested in a retirement

account or investment account by a retiree or investor at a cost of under $.07 on the dollar. We believe this formula and its success should not be unique to Oregon.