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# FROM ONE BIG HOUSE TO ANOTHER: LESSONS LEARNED FROM THE COMMUNITY BANK PROSECUTIONS

WILLIAM C. ATHANAS

*Financial institutions of all sizes can benefit from becoming aware of the Community Bank saga. This article deconstructs the Community Bank scheme by examining its component parts and the manner in which the schemers joined together to loot the institution. From those premises, this article focuses on the challenges presented by insider fraud at financial institutions — especially small and medium-sized regional banks — and offers advice for implementing strategies designed to prevent, detect, and remedy such conduct.*

Each day, on his route to and from the Guntersville, Alabama, post office where he picked up his mail, Mike Alred passed a nondescript commercial construction site. For a period of several months in the spring of 2000, Alred rarely, if ever, saw any workers at the site. Its progress reflected that fact — months after the project began, only a small amount of

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demolition and excavation work had been performed.

In a vacuum, these facts were not particularly significant. Construction projects often vary in scope and speed. The lack of measurable development at a given site might result from any number of causes, including permitting delays, financing difficulties, or priorities at other locations.

But this site was not just any construction project — it was the proposed new home of the Guntersville branch of Community Bank, Alred's employer. As an area vice president, Alred oversaw numerous branches in the region. As an inside director on the bank's board, he had access to information which transformed the lack of progress on the Guntersville site from a minor curiosity into a major concern.

In the same months that he observed the absence of any construction activity on the Guntersville site, Alred noted that Community Bank's fixed asset reports reflected that the institution was paying contractors hundreds of thousands of dollars for work supposedly performed there. Alred's concerns were elevated when he learned that the companies receiving these substantial sums — Morgan City Construction, Inc. ("MCC") and J&M Materials, Inc. ("J&M") — were also the primary contractors involved in the ongoing construction of a 17,000 square foot mansion owned by Kennon Patterson, Community Bank's chief executive officer.

Alred shared his concerns with a select group of individuals. Among this group was Mike Bean, then the bank's CFO and also an inside director, and George Barnett, an outside director. Working together, the three men soon discovered they were witnesses to a massive fraud on Community Bank, orchestrated by Patterson and carried out by Larry Bishop, the bank's executive vice president, and the principals of MCC, Dewey and Linda Hamaker, and J&M, Jimmie Childers. In June of 2000, Alred, Bean, and Barnett voiced their concerns to other bank directors, setting off a series of events which resulted in a lengthy grand jury investigation and eventually multiple federal criminal prosecutions.

Patterson, Bishop, and the principals of MCC and J&M all went to prison for their participation in the Community Bank scheme. While the court that sentenced Patterson ultimately calibrated the loss to the institution at approximately \$1.7 million, the impact of the scheme was far greater and more diverse than that monetary harm. Just as the damage caused was more

extensive than the financial loss the court calculated, the value of understanding the lessons of the Community Bank scheme extends beyond the confines of the rural Alabama town where it was formulated and carried out.

Financial institutions of all sizes can benefit from becoming aware of the Community Bank saga. This article deconstructs the Community Bank scheme by examining its component parts and the manner in which the schemers joined together to loot the institution. From those premises, this article focuses on the challenges presented by insider fraud at financial institutions — especially small and medium-sized regional banks — and offers advice for implementing strategies designed to prevent, detect, and remedy such conduct.

## **BACKGROUND<sup>1</sup>**

At its core, the Community Bank scheme was designed to misappropriate bank funds to pay for construction services performed on Patterson's mansion. To accomplish this goal, the schemers identified or created and then exploited gaps in the bank's internal controls to siphon off money intended to fund legitimate bank construction projects. Recognizing that the volume of money diverted might at some point raise eyebrows, the schemers capitalized on Patterson's tight-fisted control over the institution to deter and stifle inquiries from bank employees.

### **The Relevant Parties**

Community Bank and its holding company, Community Bancshares, were headquartered in Blountsville, Alabama. At its peak, the institution held over \$700 million in deposits, making it the seventh largest bank in the state. For approximately twenty years, Patterson served as the CEO of Community Bank and Bancshares, and served as the chairman of both boards. Patterson also owned and operated Heritage Valley Farms ("HVF"), a horse and cattle farm located on approximately 1,000 acres in Blountsville which included barns, stables, storage buildings, an enclosed horse arena, and several homes. In 1998, Patterson began construction of a 17,000-square-foot mansion at HVF, which was to serve as his personal residence.

Bishop held the title of "Vice President of Construction and Mainte-

nance” at Community Bank, a position created especially for him. Bishop was responsible for overseeing maintenance issues at the bank and serving as an “in house” general contractor, exercising control over various Community Bank construction projects. Bishop also acted as the *de facto* general contractor on Patterson’s mansion. The overwhelming majority of the contractors who worked on bank projects also worked at Patterson’s mansion and Bishop directed the nature and volume of construction work performed at both sites.

Jimmie Childers owned and operated J&M, an excavating company which performed construction services such as excavating, hauling, and paving on various Community Bank construction projects as well as Patterson’s mansion. Community Bank and Patterson were J&M’s two biggest customers during the relevant time period. Dewey and Linda Hamaker owned and operated MCC. MCC provided construction services such as demolition, framing, and finishing on Community Bank projects as well as Patterson’s mansion. During the scheme, MCC received 93 percent of its revenue from Community Bank.

## **The Structure and Execution of the Fraudulent Scheme**

The Community Bank scheme had five distinct components:

- (1) Patterson installed Bishop in a position of authority and conspired with him to orchestrate an arrangement whereby contractors would be selected to perform work both on Community Bank projects and Patterson’s mansion, would provide construction services at the mansion, and then be paid with bank funds for those services;
- (2) Bishop directed contractors to perform work at Patterson’s mansion and then prepare false invoices (either representing that work performed at Patterson’s mansion was actually performed on a bank project, or combining services provided at both bank and non-bank sites in one invoice issued to the bank), which Bishop then approved by certifying that the work referenced therein had been performed only on bank projects;
- (3) at Bishop’s direction, MCC and J&M, the contractors who were complicit in the scheme, fraudulently invoiced Community Bank for work performed at Patterson’s mansion;

- (4) at Bishop's direction, numerous contractors who were not complicit in the scheme submitted generic invoices which combined work performed at bank sites and Patterson's mansion; and
- (5) Patterson exercised his authority and influence to deter and stifle inquiries by others at the bank.

In his capacity as vice president for construction and maintenance, Bishop alone had the authority to choose which subcontractors worked on bank projects. He exercised that authority not by soliciting and reviewing written or even oral bids from competing contractors, but rather through application of some mysterious, unidentified criteria ostensibly grounded on Bishop's views regarding the contractors' reputation and competence. In reality, Bishop chose contractors based on one factor — whether they would advance the scheme, either knowingly or otherwise. No one reviewed the legitimacy of Bishop's methodology or the products of its application.

Bishop also failed to execute written agreements, on behalf of the bank, with any of these contractors. He claimed that the arrangements were done "on a handshake" because that was how he did business. The effect of this approach was to deprive the institution of the ability even to learn, much less enforce, the process the contractors planned to employ to provide and invoice for services. In practice, Bishop was the sole source of direction to the contractors regarding the nature, volume and location of work to be performed, and functioned as the sole party empowered to approve their invoices for payment. Under the internal controls in place at Community Bank, Bishop needed only to initial each invoice and designate the project it was to be charged to in order to trigger payment of the invoice by the bank's accounts payable department.

The overwhelming majority of construction work on Patterson's mansion was performed between January 1998 to July 2000. During that period, MCC filled out daily time sheets on which they recorded the location and number of hours they worked. Once these hours were recorded and approved by MCC supervisors, the timesheets were provided to MCC administrative employees, and the data inputted into the company's Quickbooks accounting software. MCC used Quickbooks to create individual accounts for various projects, and posted costs and expenses (including materials, labor, and other

charges) to those accounts.

MCC employees worked a total of 61,617.50 hours on HVF from January 1, 1998 to July 15, 2000. MCC incurred a total of \$691,359.58 in labor costs as a result, and had to pay that amount in salary to its employees each week. Despite the fact that MCC was literally a “Mom and Pop” operation with no independent means to carry this expense, the company invoiced Patterson only twice during the length of the scheme, seeking a total of only \$47,500 for work on the mansion.<sup>2</sup> Patterson paid a mere \$10,000.

In contrast, MCC sent Community Bank hundreds of invoices during the same time period. Every single week, without fail, MCC dispatched multiple invoices to the bank, each one ostensibly tied to a different location where MCC was supposedly providing services. The invoices typically bore nothing more than the most generic description of services provided (“Demo,” “Site Prep,” “Framing”), and contained no itemization for labor, overhead, or profit.<sup>3</sup> The invoices sought payment of round amounts (normally \$8,000 or \$10,000). Bishop approved and Community Bank paid every single one of these invoices, which totaled in excess of \$3.1 million during the scheme.<sup>4</sup>

J&M performed excavating and hauling services on certain Community Bank projects and Patterson’s mansion. The company performed a portion of this work directly and subcontracted the remainder. Like MCC, J&M invoiced Community Bank in an effort to fund its activities on Patterson’s mansion. Those invoices as well provided purely generic descriptions, lacked itemization, and sought payment of round amounts.

During the time period from January to July 2000, J&M submitted invoices totaling \$324,045 on a weekly basis to Community Bank, ostensibly for construction services performed on bank sites. In reality, J&M (or the subcontractors acting at its direction) performed little, if any, work on those sites. Instead, the company and the subcontractors it retained did virtually all of their work on Patterson’s mansion.

In addition to the complicit participation of MCC and J&M, the schemers lured five contractors into the scheme. These parties — an architectural firm, a lighting wholesaler, a painter, a stone materials provider, and an electrical contractor — all submitted invoices to Community Bank which included services performed at non-bank locations, primarily Patterson’s mansion.<sup>5</sup> In



marked contrast to MCC and J&M, however, these contractors were wholly unaware of the scheme. Their invoices were generic or combined not because they sought to perpetrate a fraud, but because they were explicitly instructed by Bishop to prepare and submit them in this fashion.

### **Questions Raised About and Investigation of the Scheme**

Begun in early 1998, the scheme continued virtually unabated until a Community Bank board meeting on June 20, 2000, when Alred expressed concern the bank had spent over \$700,000 on the Guntersville site (exclusive of land acquisition costs), yet nothing had been built above ground. Patterson claimed to be surprised by this fact and promised to look into the issue. On July 11, 2000, soon after Alred voiced these concerns, Patterson asked a director known to be a friend of Alred's to meet in Patterson's office. During their discussion, Patterson sought to learn the identity of those individuals who were attempting to gather information about the apparent overbilling on the Guntersville site. During the meeting, Patterson told the director repeatedly that "Mike Alred needs to be fired."<sup>6</sup>

At Patterson's request, the Bancshares board convened a special meeting on the morning of Saturday, July 15, 2000. Bishop, Childers, and Dewey Hamaker attended the meeting, and each denied that there had been any impropriety in the invoicing of Community Bank. In addition to denying that MCC had billed Community Bank for services performed at HVF, Dewey Hamaker stated that he invoiced Patterson "about every six months" for the work MCC did at HVF.

Alred, Bean, and Barnett recognized that Patterson's involvement in the scheme they uncovered made them targets for retaliation. They began communicating with government authorities; first to banking regulatory agencies and, when that proved unsuccessful, to criminal authorities. As a result of these contacts, while the Bancshares board meeting was ongoing, the Marshall County Sheriff's Department executed a search warrant at MCC's offices. Authorities seized all of the company's time sheets, along with virtually every document and record on site. MCC's computers were also seized.

Patterson convened a separate meeting of the Community Bank board on July 18, 2000. At that meeting, Alred, Bean, and Barnett openly voiced their

concerns about apparent cost overruns on the Guntersville site and pushed for an investigation. Bishop, Childers, and Dewey Hamaker once again appeared and told the bank board that no billing improprieties had occurred.

Soon after that meeting, Patterson called a separate meeting in his office attended by several attorneys, including outside counsel. Patterson expressed his intention to fire Bean, but outside counsel strongly advised against that course of action. Immediately after that meeting concluded, Patterson convened the bank board's Executive Committee and "raised a concern about the ability of Michael Alred and Michael Bean to perform their normal duties during the investigation of the Guntersville overbilling." The Executive Committee considered and approved a request to "reassign" Bean and Alred to work on "special projects" at bank headquarters. Despite receiving flawless performance reviews and substantial performance-based pay increases in each of the previous two years, the two men were stripped of their authority to approve loans and their ability to access financial information.

Shortly thereafter, Bean, Alred, and Barnett were removed from the Community Bank board. On November 10, 2000, then bank president Denny Kelly informed Bean and Alred that they had been fired. Patterson claimed to have no role in that decision, testifying in a subsequent deposition that he was unaware of the reason for their termination, and that he "tried to be completely removed about it, that [he] didn't even want to be in conversations about it."

Shortly after allegations of wrongdoing arose in July 2000, several Bancshares shareholders filed a derivative action against the company ("the Benson Litigation"). The Benson Litigation was premised in part on allegations that Patterson, Bishop, J&M, and MCC, among others, caused harm to Community Bank by fraudulently misappropriating bank funds for non-bank purposes, including construction of Patterson's mansion. The Community Bank and Bancshares boards formed a "special litigation committee" of directors ("the Benson SLC") to investigate the allegations raised in the Benson Litigation, and retained outside counsel to assist in that process.

The Benson SLC sought to investigate the allegations of wrongdoing by gathering documents and interviewing bank employees and contractors. During this process, MCC and J&M provided spreadsheets which purported to validate the amounts they invoiced on the Guntersville project. The spread-

sheets suggested that each of the contractors incurred substantial expenses on the project, including those relating to labor, equipment rental, and other overhead, which nearly equaled the amounts Community Bank was invoiced.

The Benson SLC also interviewed each of the schemers. During his interview, Patterson claimed that he did not pay MCC on an ongoing basis for work performed on the mansion because the parties agreed that MCC would “hold the bill” until completion of the project. Bishop parroted this explanation, as did the Hamakers during their joint interview.

The Benson SLC also discovered a marked change in billing practices after questions were raised. As noted above, MCC invoiced Patterson for a total of only \$47,500 and collected only \$10,000 from him prior to July 15, 2000. After allegations of wrongdoing were raised in July 2000, the Hamakers sent 29 invoices to Patterson over the next five months, totaling over \$460,000.<sup>7</sup> Several of these invoices sought payment for construction services actually performed years earlier. One invoice, dated September 6, 2000, sought \$241,254.00 for the “balance of work completed from 1/1/99 to 7/12/00 at [Patterson’s mansion].” Another, dated August 17, 2000, demanded \$135,754 for “construction work in 1998.” Patterson paid all of these invoices in full, almost immediately after they were issued.

The Hamakers were indicted in May 2002 and convicted in October of that year after a two-week trial. The court sentenced each to 18 months imprisonment.<sup>8</sup> The government spent the next year developing its case against Patterson, and indicted him, along with Bishop and Childers, in October 2003. All three men were convicted in March 2005 after a two-month trial. Patterson was sentenced to five years imprisonment, while Bishop received four years and Childers 21 months.

## THE LESSONS LEARNED

While each bank fraud has its own distinguishing characteristics, the Community Bank scheme arose from a scenario which exists in countless institutions throughout the country, albeit to varying degrees — a powerful chief executive whose demeanor and reputation deters subordinates from questioning his action and a relatively weak board presence which fails to carry out its oversight responsibilities. As a result, there is value to be gained

from reverse engineering the fraud that was carried out at Community Bank, and applying the lessons that emerge.

Those lessons emanate from two sources: (1) the factual environment in which the scheme was conceived and conducted, and (2) the investigations which sought to gather information after the fact. The first category is populated by the variety of red flags and other indicators of questionable conduct which provide insight about the types of gaps in internal controls that allow fraud to germinate and flourish. The second category contains some of the more common hallmarks of efforts to cover up fraudulent activity, knowledge of which aids in making an informed assessment about whether identified irregularities represent isolated, innocuous deviations from the mean or are the product of systemic, calculated efforts to defraud. Once identified and understood, formulating a strategy to prevent, detect and remedy fraudulent activity becomes infinitely easier.

### **Lessons from the Circumstances That Gave Rise to the Scheme**

Even a cursory review of the Community Bank scenario lays bare the main failure which caused the scheme to flourish — poor internal controls. While the majority of the deficiencies that existed at the bank resulted from Patterson's carefully orchestrated plan to loot the institution, some arose and developed naturally as the bank expanded over the years. Regardless of how these gaps were created, recognizing their existence helps identify the root causes of the problem.

The primary failure of internal controls at Community Bank was the purposefully lax oversight of Bishop. He was empowered to commit millions of dollars of bank funds without any real supervision. That level of authority, coupled with a willingness to abuse it, made him the cog in the scheme, absolutely essential to its formation and execution.

Bishop's breach of trust began with the selection of contractors. Without any system or guidelines in place to govern which contracts were awarded, Bishop was free to create his own criteria. In selecting MCC and J&M, Bishop looked for small, financially unstable entities who would quickly and easily become beholden to Community Bank for work and were therefore more likely to engage in fraudulent conduct. In selecting the non-complicit contractors,

Bishop again typically sought out smaller entities; those who would be unlikely either to suspect his nefarious motives or question his directives about invoicing practices, or seek clarification on such matters with others at the bank.

Of equal concern was Bishop's absolute authority to approve construction invoices. While delegation of invoice approval authority is a necessary component of any business, staggered internal controls are not difficult to install or monitor. Clearly, sole authority was appropriate up to some level depending on the nature and amount of the services being provided. Even in a scenario where an individual is given sole authority below a threshold level, however, appropriate oversight can and should be exercised through the periodic monitoring and random testing of the approval process. Community Bank failed to employ either technique, and Bishop exploited that failure repeatedly over the life of the scheme by approving literally hundreds of fraudulent invoices.

Bishop's ability to secure payment of generic invoices also advanced the scheme. Without any itemization requirement, complicit contractors like MCC and J&M were able to perform thousands of hours of construction services at Patterson's mansion — extracting millions from the bank in return — via fraudulent invoices submitted to the bank with nothing more than the most basic descriptions of services supposedly performed. No one at the bank other than Bishop or Patterson had either the authority to question or the ability to ascertain whether the contractors were invoicing for services which were properly payable, had already been invoiced and paid for or, worse yet, were never performed at all.

Bishop's malfeasance also flourished because there were no benchmarks in place to gauge cost overruns on bank construction projects. Because the bank did not estimate the costs of construction or solicit bids on any of the projects, no yardsticks existed to allow the board or the bank's accounting units to measure estimated versus actual costs and thus potentially discover the scheme in its infancy. The fact that the bank had multiple projects in progress during the pendency of the scheme further aided Bishop's efforts to conceal its existence. He spread the costs incurred on the construction of Patterson's mansion around, tucking the amounts misappropriated in invoices relating to many different projects.<sup>9</sup> Because no system existed to detect the ever-widening negative correlation between amounts paid and progress

achieved on those sites, Bishop's concealment was tremendously effective.

Bishop's refusal to execute — and the bank's failure to require — written contracts which memorialized the nature and scope of the construction projects in progress also served to shroud the scheme. While some at the bank knew the general nature of the services provided by various contractors (e.g., framing, excavation, engineering), failing to identify the contours of the individual contractors' involvement on each of the several projects ongoing at any given time also furthered the scheme by hindering the bank's ability to identify and investigate billing irregularities.

Requiring written contracts would have potentially enhanced the institution's ability to protect its interests in other ways. Banks can and should seek to secure anti-fraud and anti-corruption representations and warranties from contractors. Properly drafted, these provisions allow the institution to conduct audits of the contractor's books and records and reserve the bank's rights to: (1) "claw back" any payments subsequently determined to be improper, (2) terminate the agreement without cause upon minimal (e.g., 30 days) notice, and (3) terminate the agreement immediately and suspend payments if improper activity occurs.

To recap, the following measures serve to substantially impede fraudulent activity by insiders similar to that carried out in the Community Bank scheme:

- Implementing and adhering to written guidelines governing the selection of contractors on bank projects;
- Demanding details on invoices regarding the nature and volume of services provided, along with breakdowns for overhead and profit;
- Conducting random auditing of approved invoices to ensure that services listed were actually provided and that payment was appropriate, especially where the invoicing party is a major vendor;
- Insisting that preliminary cost estimates be conducted, especially for those contracts that fall below the bid threshold; and
- Requiring that significant contracts be bid, and that multiple bids be solicited;
- Mandating that significant contracts be reduced to writing, ideally containing anti-fraud and anti-corruption representations and warranties.

The failure of internal controls at Community Bank was not limited to Bishop's activity. Patterson as well operated without meaningful oversight, wielding the power he held to prevent detection of the scheme. The Bancshares and Community Bank boards, which should have kept watch over Patterson's activities, instead allowed him to operate with virtual impunity.<sup>10</sup> In fact, several board members acknowledged that until the denial of Patterson's request that the bank pay the Hamakers' legal fees after they were indicted (a truly astounding prospect), not a single vote was cast against Patterson's proposed choice of action at board meetings.

While the solution to this dilemma should be obvious — requiring the board to operate as an independent entity free from allegiances and constraints, other than to protect the institution — translating that goal into action often proves more difficult. But board independence must always be the paramount concern. For all the Community Bank and Bancshares boards did to challenge Patterson's authority during the scheme, they should have been issued rubber stamps. No evidence ever suggested that any board member was complicit in the scheme to defraud Community Bank, but their collective failure to fulfill their fiduciary obligations to the institution did as much to advance that scheme as any of the devious actions Patterson, Bishop, Childers or the Hamakers ever conjured up and carried out.

Patterson's willingness to abuse his authority revealed itself in different ways, including initiating adverse employment action on bank employees. He actively sought to marginalize Alred and Bean after they raised concerns, eventually orchestrating their terminations from the bank. Before and after those efforts, Patterson routinely sought to sanction those who threatened to uncover the scheme or, more significantly, his role in it. Employees feared incurring his wrath, having witnessed those foolish enough to "cross the boss" or even question his methods sent packing soon thereafter.<sup>11</sup> Recognizing the potential concerns that his direct involvement in such adverse action might trigger, Patterson routinely operated behind the scenes, manipulating others to actually mete out the punishment he decided upon.

Two measures would have frustrated Patterson's efforts in this regard. First, the bank should have created and adhered to a meaningful recusal policy. While Patterson pledged to remove himself from the investigation into the questionable construction expenditures at the Guntersville site, his "recu-

sal” was a charade, silently endorsed by all those board members who failed to object when he routinely inserted himself in the process. Especially where allegations are raised against executive officers, recusal must mean a complete and total lack of involvement, on every level, in any and all decisions regarding the investigation — including adverse action against those who call for, support, or aid in the inquiry.

As a second measure, the board members who went along with the sanctions Patterson imposed from behind the curtain also needed to be better educated about their authority and responsibility. Amazingly, none of the board members seemed to understand that taking adverse action against Alred and Bean — two whistleblowers — created substantial liability for the bank under federal law. By firing Alred and Bean, the bank violated 12 U.S.C. § 1831j, which provides, in pertinent part:

No insured depository institution may discharge or otherwise discriminate against any employee with respect to compensation, terms, conditions, or privileges of employment because the employee (or any person acting pursuant to the request of the employee) provided information to any Federal banking agency or to the Attorney General regarding—

- (A) a possible violation of any law or regulation; or
  - (B) gross mismanagement, a gross waste of funds, an abuse of authority, or a substantial and specific danger to public health or safety;
- by the depository institution or any director, officer, or employee of the institution.

The fact that Alred and Bean fit squarely within this statute did not serve as an impediment to their discharge, mainly because board members were apparently not aware of the statute and did not fully appreciate the impact that adverse action against the two would have on the institution.

In addition to improved education of board members, other relatively simple and inexpensive measures would have dramatically impeded Patterson’s ability to operate the Community Bank fraud behind a cloak of secrecy. Insider-operated bank fraud schemes are conceived, function and prosper most effectively in the shadows, shielded from honest employees who rec-



ognize their ability and obligation to ask tough questions when irregularities appear. Because sunlight is the best disinfectant, the more transparent the relationship between the bank's employees and the individuals who receive its money, the more effectively the institution's interests are protected.

Uncomplicated measures such as requiring employees, especially executive officers and those with authority to commit bank funds, to disclose any relationships — employment, financial, familial, or otherwise — with outside vendors would have drawn attention early on to the fact that the contractors who received the most money on bank construction projects were also performing work on Patterson's mansion. So too would direct communications with vendors about their dealings with Bishop. Random contact to inquire about how and why contractors invoiced as they did might have revealed the clearly and purposely flawed system in place early on, and thus reduced the harm the bank ultimately suffered.

### **Lessons Learned from the Investigations That Followed**

The investigations of the Community Bank scheme, including that conducted by the Benson SLC, offer valuable insight. Reviewing those investigations with the benefit of hindsight allows one to sift through the range of conduct such inquires trigger and thus differentiate those reactions which signal an intent to cover up fraudulent activity. Several guiding principles emerge.

First, where the fraud is carried out by more than one individual, responses to inquiries often generate an identifiable synchronicity of implausible explanations. In the Community Bank case, this factor was revealed though the explanation Patterson, Bishop, and the Hamakers gave about why MCC had performed tens of thousands of hours of work on Patterson's mansion, incurring hundreds of thousands of dollars of direct labor costs as of July 2000, yet had only invoiced for \$47,500 and only received \$10,000. All parties claimed this resulted from a prearranged agreement for MCC to "hold the bill" in order to receive a lump sum payment at the completion of the project. Dewey Hamaker claimed that he viewed the arrangement "as kind of a 401k."

Numerous factors made this claim doubtful, if not absurd. To accept it, one would have to believe that the parties agreed that MCC would construct the entire project (massive by any objective measure) and be paid upon comple-

tion, years later, without any upfront agreement about the estimated cost, any protection for Patterson against overbilling, or any security for MCC to ensure payment. Moreover, one would have to believe that MCC agreed to delay receiving payment on its largest project for years, all the while paying money to its employees for salaries, without any receiving any benefit in return.<sup>12</sup>

When faced with questionable explanations, the best first step is to test the claims from a purely rational perspective. While human behavior is not always sensible, determining whether a proffered explanation makes sense as a matter of pure logic represents the best starting point. While this process should never represent the sum total of the investigation, it represents the most effective and efficient way to focus the inquiry in order to get to the fundamental question every investigation should seek to answer: why did this individual act in an irrational manner?

Especially in those instances where the explanation is implausible, any investigation should attempt to identify or rule out corroboration. Had that approach been employed, the Benson SLC would have learned that MCC carried no receivable on its books for Patterson, despite working on the project for over 2 1/2 years at the time the investigation began. Nor did Patterson record any amount due to MCC as a liability (deferred, contingent or otherwise) on his financial statements prepared during that period. The Benson SLC would have also discovered that MCC lacked the financial wherewithal to carry such a receivable, regardless of whether the company actually recorded an entry in its books.

Demanding corroboration is also the preferred course when faced with “derivative” documents which supposedly exonerate the questioned party. Such documents often purport to validate that party’s conduct, when in reality they represent a wholesale distortion of the underlying data. In some instances, such as Community Bank, the documents are simply constructed from whole cloth.

As detailed above, both MCC and J&M submitted spreadsheets which represented that the respective companies’ billings on the Guntersville site were grounded in fact and reasonable in amount in light of the nature and volume of services supposedly provided. The spreadsheets supposedly summarized other “raw” documents (including invoices and timesheets) which allegedly documented expenses actually incurred. As noted above, the spread-

sheets were almost completely bogus, having been concocted as part of an effort to conceal the absence of any meaningful work performed at the site.

Simple questions about their preparation would have raised red flags or possibly uncovered the fraud. When faced with such documents, the investigation should seek to determine who prepared them and for what purpose. Of greatest importance is the determination of how the document was prepared. By examining the manner in which the document is created, a reviewer can more effectively isolate flaws (unintended or otherwise) in the methodology. More importantly, the reviewer can identify the source of the information used, and begin efforts to independently review that “raw” data.

Had that approach been used in Community Bank, the Benson SLC might have learned that the J&M chart provided by Childers was actually fabricated by one of his employees. Childers had hired the individual just weeks before to manage a planned cement mixing plant. In the interim, Childers provided the employee with a list of dollar amounts (representing the invoices J&M had submitted to Community Bank) and instructed him to create a spreadsheet buttressing those figures with data regarding expenses incurred on the site each week during the time period in question. As Childers well knew, there were no such expenses. As a result, the process of creating the spreadsheet was purely mathematical — the employee simply made up all the underlying data.

Other indicators of fraudulent activity littered the Community Bank investigations. For example, efforts to cover up past activity under scrutiny may reveal consciousness of guilt. Such efforts can take the form of marked changes in behavior — like MCC’s decision send Patterson a virtual blizzard of invoices after questions were raised — and warrant further inquiry.

Patterson’s role in the repeated terminations of bank employees who raised questions established consciousness of guilt in another form. Whether he sought to exact revenge, stifle the inquiry, or deter others from asking such questions, Patterson’s efforts demonstrated his knowledge of and culpability in the scheme. The board should have recognized these signals early on, and asked questions about why Patterson acted as he did. Instead, they sat silent or, in some cases, actively endorsed his efforts.

The mere existence of the investigative process can also serve to illuminate the participants in a fraudulent scheme. Individuals who refuse to

provide requested information likely warrant scrutiny in the absence of any readily identifiable basis for such refusal. Of course, those participants who actively seek to obstruct or undermine the investigation (whether by tampering with witnesses, destroying or altering documents, or other means) necessarily require thorough study.

In a similar vein, those who seek to hinder the investigation in a more subtle fashion — for example, by questioning the need for such an inquiry without legitimate basis, unreasonably attempting to narrow the scope of its reach, or seeking to terminate it prematurely — may also deserve a closer look. Board members who resist the process of making informed determinations about the existence and extent of schemes that defraud the bank should be queried about the basis of those objections. Many times, such opposition is rooted in financial concerns — a fear that the costs incurred in investigating the fraud will dwarf the harm actually realized by the bank. Depending on the context — such as where the fraud causes substantial loss or the circumstances suggest an ongoing or recurring risk of harm — closer analysis may be appropriate.

## **CONCLUSION**

Financial institutions, regardless of size, can and should employ measures calculated to minimize opportunities for insider fraud to occur. While these steps will necessarily vary depending on the structure of an individual institution and its activities, the review above identifies the types of concerns which must be addressed and provides a starting point for fashioning solutions to those problems. Simply installing these controls is insufficient, however. Banks must strive to create and maintain an environment where those affiliated with the institution serve as a backstop to detect fraud. That process begins by encouraging individuals associated with the institution in any fashion, be they employees, officers, directors, or other affiliated parties, to ask difficult questions and demand complete answers about how the institution's funds are being spent.

Although the scope of the moral duty owed by bank insiders can be debated, there is no question that employees, officers and directors owe a legal duty to protect the interests of the institutions they serve. While it is

without question that those who elevate their own personal financial interests above the interests of the institution fail to fulfill these duties, it should also be equally clear that those who either knowingly turn a blind eye toward potential red flags or simply settle for unsupported or incomplete answers to questions are also blameworthy. Ultimately all bank employees, officers and directors fulfill their obligations to the institution the same way — by maintaining a vigilant watch for red flags and asking tough questions when they appear. By creating and maintaining a culture intolerant of fraud in any form, the institution can exponentially increase its ability to monitor internal activities by effectively leveraging the observational abilities of all those associated with the bank.

In the end, no amount of precautionary measures can serve as an absolute deterrent to insider fraud. Banks have been and will continue to be targets of such malfeasance because, in the words often attributed to noted bank robber Willie Sutton, “that’s where the money is.” Nevertheless, those familiar with history stand the best chance to avoid repeating it. Community Bank represents an important chapter in the annals of financial institution fraud, and offers valuable lessons for those who wish to avoid the fate that institution suffered.

## NOTES

<sup>1</sup> The facts reviewed herein are drawn from publicly available sources, including evidence offered during court proceedings and information recounted in media coverage. In addition, this article draws from the opinions issued by the Eleventh Circuit Court of Appeals. See *United States v. Hamaker*, 455 F.3d 1316 (11<sup>th</sup> Cir. 2006) (affirming convictions of MCC and its principals, Dewey and Linda Hamaker); *United States v. Childers*, 254 Fed.Appx. 772 (11<sup>th</sup> Cir. 2007) (affirming convictions of Patterson, Bishop, and Jimmie Childers, J&M’s principal).

<sup>2</sup> In November and December 1998, certain Bancshares stockholders threatened and then filed a derivative suit (“the Towns suit”) alleging, *inter alia*, that Community Bank funds were being spent improperly. Shortly thereafter, Patterson and Bishop agreed to request an invoice from MCC for work on HVE. In late December 1998, MCC sent Patterson an invoice for \$37,500 for work MCC performed on HVE.

<sup>3</sup> Under the parties’ contractual arrangement, MCC was to bill Community Bank on a “cost-plus” basis; billings which used MCC’s labor costs as a benchmark, then allowed

for percentage markups for workers compensation and taxes, overhead, and profit.

<sup>4</sup> To be sure, some of this billing was legitimate. MCC actually performed services at some sites, and billed appropriately for those services. Because MCC was not separately invoicing Patterson for the work its employees performed on HVE, however, the company was required to inflate the amount of its invoices in order to cover expenses and overhead on legitimate and illegitimate work, and to extract a healthy premium for its owners' participation in the scheme.

<sup>5</sup> Perhaps not surprisingly, Patterson did not restrain in his efforts to steal bank funds to the mansion. Using Bishop as an intermediary, he regularly misapplied bank funds for construction services performed on properties owned or occupied by his family members, often using the same contractors who worked on the mansion.

<sup>6</sup> Unbeknownst to the director, and for reasons that were never entirely clear, Patterson recorded the conversation. The government later acquired the recording and it served as a centerpiece of the evidence offered at Patterson's trial.

<sup>7</sup> On July 17, 2000, the Hamakers sent Patterson an invoice for \$50,000 for work on the mansion. Patterson paid the invoice immediately, and the schemers touted the payment to the bank board at the meeting the next day.

<sup>8</sup> The government appealed the Hamakers' sentences, and the Eleventh Circuit agreed that they were premised on an improperly calculated loss figure. *See Hamaker*, 455 F.3d at 1338 (finding district court error in calibrating loss of \$178,500). On remand, the district court conducted a hearing and recalculated the loss figure at the substantially higher amount proposed by the government. Nevertheless, the district court imposed the same 18 month sentence on each defendant. The government again appealed the sentences, and the Eleventh Circuit held that their imposition was a valid exercise of the district court's discretion.

<sup>9</sup> At trial, an MCC administrative employee testified that Bishop would typically call and provide Linda Hamaker (who handled the company's billing) with the amounts and locations MCC should include on its invoices.

<sup>10</sup> There is perhaps no greater evidence of Patterson's control over the bank board — instead of vice versa — than his willingness to accede to his suggestion that Bean and Alred be "reassigned" just moments after they raised substantial questions regarding the Guntersville project.

<sup>11</sup> In addition to Alred and Bean, Patterson also orchestrated the termination of the bank's general counsel after he took action in the summer of 2002 to protect the institution's interests. After Patterson himself was finally terminated in early 2003, the general counsel was restored to his previous position.

<sup>12</sup> Investigators calculated that MCC would have forgone approximately \$240,000 in interest if in fact the company was purposely delaying invoicing for services on Patterson's mansion.