by R. Alexander Pilmer and Mark T. Cramer

Swindlers' LIST

Formal dissolution proceedings are usually necessary to sort through the wreckage of failed Ponzi schemes

Until the collapse of Bernard Madoff's reported $65 billion investment scheme late last year, many people had never heard the term "Ponzi scheme"—and those who had would have been hard-pressed to define it. Thanks to Madoff, Ponzi schemes are now part of the mainstream lexicon and are no longer solely the obscure subjects of court opinions and law review articles. Indeed, talk of Ponzi schemes seems to dominate not only the headlines but also late-night talk shows, cocktail parties, and weekend soccer games.

Despite all the recent notoriety, most people (including many attorneys) still have no idea what happens when Ponzi schemes collapse. For law enforcement, attorneys, accountants, and other professionals, that is when the real work begins. Given the prevalence of these schemes and the rate at which they are being discovered, the legal and logistical issues involved in excavating the financial ruins of a collapsed Ponzi scheme will remain for years to come.

Operators of Ponzi schemes typically represent them as legitimate investment opportunities providing substantial returns, but those returns are not supported by any type of underlying, legitimate business. Instead, investors are paid profits from the principal sums paid by newer investors. The initial investors usually receive the promised returns, which attracts additional investors. To keep the scheme going, Ponzi operators must garner more new investors in order to continue paying earlier investors.

Ponzi schemes are a species of pyramid scheme. In essence, Ponzi schemes are upside-down pyramids that inevitably collapse because

R. Alexander Pilmer and Mark T. Cramer are partners at Kirkland & Ellis LLP in Los Angeles, where they are members of the firm's litigation department. Pilmer and Cramer handled hundreds of cases arising out of a failed Ponzi scheme operated by Reed Slatkin, including *In re Slatkin* and *Neilson v. Union Bank of California, N.A.* They are currently counseling a number of investors in the Bernard Madoff Ponzi scheme.

RON OVERMYER

OVER
MYER

they are structurally unsound from their inception. While Ponzi schemes can last for years, eventually—and inevitably—their operators are unable to recruit enough new investors to fund the withdrawal requests and returns of the earlier investors. Thus, like death and taxes, the ultimate failure of a Ponzi scheme is certain.

The Ponzi scheme's namesake, Carlo "Charles" Ponzi,[1] was an Italian immigrant who, in the 1920s, solicited other immigrants to invest their life savings with him.[2] Ponzi falsely claimed that his investors' money would be used to buy international postal coupons that he could resell for a 100 percent profit. Ponzi convinced his investors that he was able to earn substantial profits by exploiting differences in international currency exchange rates. In fact, the only thing Ponzi exploited was his investors' trust because he was not actually using their money to purchase postal coupons and, therefore, would not earn any return on their investments. Instead, he used the money he received from new investors to pay the returns he had promised to earlier investors. Although Ponzi convinced more than 20,000 people to invest more than $10 million, an audit of Ponzi's assets after the scheme collapsed turned up less than $100 worth of postal coupons.

Many Ponzi operators target specific religious or ethnic groups to get their schemes off the ground. They exploit the built-in trust of these so-called affinity investors or affinity groups to establish their credibility, to identify potential investors, and to promote their schemes. There are countless examples of this sort of affinity fraud in the context of Ponzi schemes. Ponzi himself targeted his fellow Italian immigrants. More recently, Madoff preyed on members of the Jewish community, including numerous Jewish charities. A large percentage of the investors in Reed Slatkin's $600 million Ponzi scheme—one of the largest Ponzi schemes in U.S. history—were followers of L. Ron Hubbard's Church of Scientology. Other recent schemes have targeted Baptists, Mormons, and members of the Saddleback Church, as well as African Americans, Koreans, and Latinos. In recent years, hardly any religious or ethnic group has been spared from some sort of affinity fraud.[3]

As Ponzi schemes progress, some investors—typically those who were recruited early in the scheme—withdraw more money from the scheme than they invested. In essence, these early investors receive fictitious profits on their principal investments, while other investors receive either less than they invested or nothing. Whether an investor receives more or less than the principal investment looms large in determining the investor's status in future litigation.

Liquidation, Mitigation, and Litigation

Failed Ponzi schemes often end up in bankruptcy, SEC receivership, Securities Investor Protection Corporation (SIPC) liquidation, or other formal dissolution proceedings. Any number of business entities created in connection with the schemes, in addition to the personal estates of the Ponzi operators, may need to be liquidated as well. Depending on the circumstances, the personal estates of Ponzi operators and related business entities may file for liquidation in a bankruptcy or through a receiver appointed pursuant to securities laws and regulations.

The bankruptcy trustee or the receiver may pursue claims against coconspirators, financial institutions, and certain investors. The recoveries based on these claims often are among the largest assets the trustee or receiver has available to pay creditors' claims, including the claims of investors who lost money in the scheme. Trustees and receivers share the same objective—namely, to return as much money as possible to the victims of the scheme.

While trustees and receivers have many of the same rights and abilities to pursue money from potential defendants, the Bankruptcy Code provides trustees with some additional powers that are not available to receivers. For example, bankruptcy trustees are empowered under the Bankruptcy Code to undo many financial transactions conducted by Ponzi operators in the 90 days leading up to the bankruptcy filing.[4] The purpose of undoing these "preferences," as these transactions are known, is to spread the effect of the bankruptcy across a greater number of creditors and prevent earlier-paid creditors who received money immediately prior to the bankruptcy from receiving a windfall.

Another tool available to trustees that would not be available outside the bankruptcy context is the ability to obtain documents and testimony pursuant to Federal Rule of Bankruptcy Procedure 2004.[5] At any time after a bankruptcy petition is filed, the trustee may seek an order from the bankruptcy court to conduct an examination under oath of "any entity"[6] and compel the production of documents.[7] Consistent with the rule's purpose to discover information regarding the assets of the bankruptcy estate, a permissible "2004 examination" is broad in scope.[8] To that end, and distinct from depositions and other standard discovery devices, a trustee can obtain information through 2004 examinations without initiating litigation.

Separate from and independent of the claims brought by the trustee or receiver, certain aggrieved investors in a Ponzi scheme may have standing to pursue various claims of their own. These can be pursued individually or on a classwide basis on behalf of all similarly situated investors. These claims, however, are likely to have no value because a Ponzi operator will almost always be the subject of a receivership or bankruptcy case. The investors also may have claims against third parties who had some connection with or facilitated the Ponzi scheme.

Upon appointment, a trustee or receiver must investigate, assess, and account for the finances of the Ponzi operator's personal estate and any business entities associated with the scheme.[9] Because fraud artists rarely maintain complete (much less accurate) books and records, this process can be painstaking, time consuming, and complicated.[10] The trustee or receiver typically will rely on bank records to re-create the activity predating his or her appointment. In most cases, the trustee or receiver will need to retain forensic accounting experts not only to complete the process reliably but also to provide expert testimony to support the methodology used and the conclusions reached.[11] Armed with that data, the trustee or receiver will then 1) identify creditors (those who are owed money), 2) identify debtors (those who owe money to the estate), 3) initiate litigation against the debtors to recover the sums owed, and 4) ultimately distribute the proceeds to the creditors.

The first two steps involve a calculation of cash in and cash out: comparing each investor's payments to and withdrawals from the Ponzi operator. The "net winners" in the scheme are those investors who received more payments from the scheme than they paid to it. The "net losers" are those who received less in return than they invested in the scheme. Depending on when the net winners received their payments (relative to the date the Ponzi scheme collapsed or the date a bankruptcy petition was filed), they may be legally required to pay back some or all of their fictitious profits.

Given this reality, it is critical for Ponzi scheme investors—especially those unaware of the fraud before the collapse—to immediately identify how much money they invested with the Ponzi operator compared to their actual returns. Investors who made money will likely face litigation by a trustee or receiver seeking to claw back the overpayments.

Nearly all investors in Ponzi schemes consider themselves innocent victims. Whether they were net winners or net losers in the scheme, most investors will feel betrayed by the Ponzi operator—someone they considered a trusted adviser, if not a friend. Beyond that, even the net winners who made money in the scheme often feel victimized because they thought they still had money legitimately invested with the Ponzi operator, only to find that it was an elaborate hoax. Indeed,

these investors likely will have used the proceeds from the scheme to pay various expenses, such as capital gains and income taxes related to the investments, or unrelated and unrecoverable expenses such as college tuitions and property taxes. Moreover, most investors will have received periodic "account statements" in which the Ponzi operator reported the supposed value of the investments. But these fraudulent statements typically have no weight or relevance for purposes of determining whether a particular investor is a creditor or a debtor of the estate. All that ultimately matters is the calculation of cash in versus cash out—not the phony amounts the Ponzi operator reported to investors based on fictitious profits.

Given the necessarily increasing complexity and size of their schemes, Ponzi operators rarely act by themselves. Those who participated in the scheme with a Ponzi operator are likely to be the targets of claims by the receiver or trustee; they may also be targeted by law enforcement.

In addition to the receiver's or trustee's claims, individual investors also may pursue claims against third parties. The targets of these claims can, and commonly do, include the Ponzi operator's banks, accountants, and lawyers. The Ponzi operator also is likely to have taken at least some of the proceeds of the scheme and invested them in any number of different businesses, including real estate ventures, shares in publicly traded companies, or closely held enterprises. The receiver or trustee will closely scrutinize all aspects of the Ponzi operator's prior dealings, many of which will also end up in litigation.

Avoidance of Fraudulent Transfers

Trustees and receivers both have a powerful tool at their disposal—namely, the ability to avoid fraudulent transfers. Many states, including California, have adopted some version of the Uniform Fraudulent Transfer Act.[12]

There are two basic types of fraudulent transfers: actual (or intentionally) fraudulent transfers, and constructively fraudulent transfers.[13] An intentionally fraudulent transfer is a transfer made with the "actual intent to hinder, delay, or defraud" any creditor.[14] A constructively fraudulent transfer is a transfer made without receiving reasonably equivalent value when the transferor: 1) was insolvent when the transfer was made or became insolvent as a result of the transfer,[15] 2) was engaged in or was about to engage in a business or a transaction for which his or her remaining assets were unreasonably small in relation to the business or transaction,[16] or 3) intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.[17]

The Bankruptcy Code gives bankruptcy trustees the avoidance rights of a creditor under state law, thus empowering the trustee to bring state law fraudulent transfer claims.[18] In addition to fraudulent transfers under state law, the Bankruptcy Code contains its own fraudulent transfer provisions.[19]

The test for determining whether a Ponzi operator made a transfer with the "actual intent to hinder, delay, or defraud any creditor of the debtor" generally requires an inquiry into the Ponzi operator's subjective state of mind.[20] To establish an intentionally fraudulent transfer claim, only the subjective mental state of the Ponzi operator is relevant. The investors' intent is irrelevant to the analysis and is considered, if at all, only to determine whether a potential "good faith" defense applies.[21]

To establish a Ponzi operator's subjective intent, the trustee or receiver will often rely on affirmative evidence—such as admissions or a plea agreement—from the operator. Courts have consistently held the guilty pleas and other admissions of Ponzi operators to be admissible and binding on the issue of actual intent to defraud.[22] Similarly, actual intent to defraud can be established if the court finds that the operator was in fact running a Ponzi scheme.[23]

If the trustee or receiver is unable to demonstrate actual fraud, net winners may still be liable based on a constructively fraudulent transfer claim. In constructively fraudulent transfer cases, the key issues are whether the transfers were made at a time of insolvency, and whether the recipient provided reasonably equivalent value. Insolvency is rarely an issue in Ponzi scheme litigation; given their fraudulent nature, Ponzi schemes are consistently held to be insolvent from their inception.[24]

A recipient of a fraudulent transfer—even a transfer made by a Ponzi operator with the actual intent to defraud his or her creditors—may establish a defense (and keep the money or property transferred) if the recipient provided reasonably equivalent value and received the payment in good faith. Whether the recipient provided reasonably equivalent value turns on the nature of the payments received. Some courts have held that no reasonably equivalent value can be given for the fictitious profits of a Ponzi scheme.[25] In contrast, most courts will allow innocent investors to retain the payments they received, up to the amount of their principal investment. Critical to this analysis is whether the investor received the payments in good faith.[26]

In fraudulent transfer litigation, however, "good faith" has a different meaning than it does in other areas of the law. Courts apply an objective standard in determining what the recipient "knew or should have known"; the recipient's subjective good faith is irrelevant.[27] Moreover, the burden to establish good faith falls on the recipient of the fraudulent transfer.

HELP WANTED

Is your career in need of assistance?

The Los Angeles County Bar Association has created two new electronic services to assist attorneys whose careers have been disrupted by the current economic crisis

ATTORNEY CAREER SUPPORT LIST SERVE FORUM

This forum allows participants to share information and assistance about topics such as

- Job availability
- Job-seeking guidance (including resume development and interview skills)
- Changing to or opening a new practice

Plus the myriad personal and family issues arising from economic dislocation

The forum is open to LACBA members, attorney nonmembers, and nonattorneys who are able to provide guidance and assistance to attorneys seeking career support. For more information and to sign up, go to **www.lacba.org/careersupport.**

LACBA JOBS BULLETIN BOARD

This bulletin board lists Jobs Offered and Jobs Wanted, both for attorneys and for other legal professionals, in an easily searchable format. The bulletin board also provides instructions on how to post a listing. **Available at www.lacba.org/jobs.**

To find out more, visit www.lacba.org/careersupport

LOS ANGELES COUNTY BAR ASSOCIATION
INCORPORATED IN CALIFORNIA 1953
ORGANIZED 1878

Another key issue in Ponzi scheme litigation involves how far the trustee or receiver can "reach back" to avoid the fictitious profits distributed to net winners. Federal bankruptcy law provides a two-year reach-back period for fraudulent transfer claims.[28] But federal bankruptcy law also empowers a bankruptcy trustee to bring fraudulent transfer claims under applicable state law.[29]

State law claims to recover fraudulent transfers vary and can exceed the Bankruptcy Code's two-year reach-back period. California law provides a seven-year statute of repose for intentionally fraudulent transfer claims.[30] Certain claims for transfers beyond four years must be brought under California law within one year after the fraudulent transfers could reasonably have been discovered by the claimant.[31] Thus, depending on the jurisdiction, and whether the claims are brought by a receiver or a trustee, investors could be faced with disgorging all payments that they received between one to seven years before the scheme collapsed.

Potential Claims against Third Parties

Just about any third party who conducted business with a Ponzi operator faces some litigation risk. The Ponzi operator's attorneys, accountants, banks, and even certain investors may find themselves the target of litigation after the scheme collapses. Class actions brought by investors who have suffered damages are fairly common in the context of Ponzi scheme litigation.

A Ponzi operator's coconspirators, including individuals and business entities, can face direct liability for damages if they independently committed torts against investors or other parties suffering harm. Among other claims, coconspirators may have engaged in fraud, negligent misrepresentation, breach of fiduciary duty, or other torts, depending on the coconspirator's relationship with the plaintiff.

Aggrieved investors also may pursue vicarious liability theories against third parties, including financial institutions. The most common of these theories are conspiracy and aiding and abetting. Under basic tort principles in many states, including California, a claim for conspiracy is proper if there is an agreement to commit a tort and the plaintiff suffers damage as a result of an act committed in furtherance of the agreement.[32]

As for aiding and abetting, "liability may…be imposed on one who aids and abets the commission of an intentional tort if the person (a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortious result and the person's own conduct, separately considered, constitutes a breach of duty to the other person."[33] A plaintiff must plead and prove the existence of an underlying tort, such as fraud or breach of fiduciary duty, and an intent to aid or abet the commission of the tort.[34]

Aiding and abetting claims do not require that the defendant owe the plaintiff an independent duty or that the defendant financially gain from the tort.[35] The two critical elements are whether the third party actually knew of the Ponzi operator's breach of duty, and whether the third party substantially assisted in that breach of duty. "Constructive knowledge" will not support an aiding and abetting claim. The "substantial assistance" element "requires the plaintiff to allege that the actions of the aider/abettor proximately caused the harm on which the primary liability is predicated."[36]

Ponzi schemes inflict a significant financial and emotional toll on the innocent victims who are tricked into investing their money in the fraud. In any failed Ponzi scheme, stories abound of hardship and tragedy, with ripple effects that go far beyond monetary losses. Although the legal system can never put the victims' lives back together, victims do have rights under the law that can provide some measure of redress. Of course, in an ideal world, investors would be vigilant about too-good-to-be-true investment opportunities. The silver lining in the cloud of recent investment scams is that their widespread publicity will encourage investors to be more wary of, and therefore less vulnerable to, future schemers. Unfortunately, even though all Ponzi schemes are certain to fail from their inception, it is just as certain that future schemers will devise new frauds and find new victims, if only until those frauds inevitably collapse. ■

---

1 Charles Ponzi is often credited with being the first to mastermind the type of scheme that was eventually named for him. Although Ponzi was perhaps the most famous fraudster to carry out such a scheme, he was not the first. Just before the start of the twentieth century, a man named William Miller engineered a scheme in which he cheated investors out of more than $1 million by promising 10 percent investment returns per week. For that, he was nicknamed "520 Percent" Miller. Miller's fraud was widely publicized and, notwithstanding its failure, probably inspired Ponzi to devise his own scheme.

2 *See generally* Cunningham v. Brown, 265 U.S. 1 (1924).

3 *See, e.g.*, Securities & Exchange Commission Client Alert, Affinity Fraud: How to Avoid Investment Scams That Target Groups, *available at* http://www.sec.gov/investor/pubs/affinity.htm.

4 *See* 11 U.S.C. §547.

5 *See* FED. R. BANKR. P. 2004. Because these examinations are authorized pursuant to the rule, they are often referred to as "2004 examinations."

6 *See* FED. R. BANKR. P. 2004(a). The right to take 2004 examinations is not limited to trustees. The rule permits "any party in interest" to seek an order from

the Bankruptcy Court to take this type of examination. *See id*.

[7] *See* Fed. R. Bankr. P. 2004(c).

[8] Courts have consistently held that the scope of a 2004 examination is "unfettered and broad." *See*, *e.g.*, In re Table Talk, Inc., 51 B.R. 143, 145 (Bankr. D. Mass. 1985).

[9] *See*, *e.g.*, 11 U.S.C. §1106(a)(3) (The trustee shall "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business…and any other matter relative to the case….").

[10] *See*, *e.g.*, In re Bonham, 251 B.R. 113, 116 (Bankr. D. Alaska) (concluding that "the trustee has established the existence of a Ponzi scheme through a meticulous reconstruction of the debtors' disarrayed records").

[11] *See id*. at 118-25; *see also* In re Bayou Group, LLC, 396 B.R. 810, 831-33 (S.D. N.Y. 2008).

[12] Civ. Code §§3439 *et seq*.

[13] Civ. Code §§3439.04, 3439.05.

[14] 11 U.S.C. §548(a)(1)(a); Civ. Code §3439.04(a)(1).

[15] 11 U.S.C. §548(a)(1)(B)(ii)(I).

[16] 11 U.S.C. §548(a)(1)(B)(ii)(II); Civ. Code §3439.04(a)(2)(A).

[17] 11 U.S.C. §548(a)(1)(B)(ii)(III); Civ. Code §3439.04(a)(2)(B).

[18] 11 U.S.C. §544(b); *see also* In re United Energy Corp., 944 F. 2d 589, 593 (9th Cir. 1991) ("A bankruptcy trustee has the power to avoid fraudulent transfers pursuant to state law and/or the provisions of the Bankruptcy Code.").

[19] 11 U.S.C. §548(a)(1).

[20] *See* In re Cohen, 199 B.R. 709, 716 (B.A.P. 9th Cir. 1996).

[21] Under the good faith defense, a fraudulent transfer cannot be avoided to the extent the transferee received the transfer in good faith and provided value in exchange for the transfer. 11 U.S.C. §548(c); Civ. Code §3439.08(a). In the context of Ponzi scheme litigation, this defense typically insulates a good faith investor's principal investment but not the investor's fictitious profits.

[22] *See*, *e.g.*, In re Slatkin, 525 F. 3d 805, 811-15 (9th Cir. 2008) (affirming partial summary judgment regarding actual intent to defraud as a matter of law based on the Ponzi operator's plea agreement); In re AFI Holding, Inc., 525 F. 3d 700, 704 (9th Cir. 2008); *see also* Scholes v. Lehmann, 56 F. 3d 750, 762 (7th Cir. 1995); In re Bayou Group, LLC, 396 B.R. 810, 835 (S.D. N.Y. 2008) ("Courts have consistently found that criminal proceeding admissions of a fraudulent scheme to defraud investors made in guilty pleas and plea allocutions are admissible as evidence of 'actual intent' to defraud creditors.").

[23] *See* Cohen, 199 B.R. at 717 ("Proof of a Ponzi scheme is sufficient to establish the Ponzi operator's actual intent to hinder, delay, or defraud creditors for purposes of actually fraudulent transfers…."); In re Agricultural Research & Tech. Group, Inc., 916 F. 2d 528, 535 (9th Cir. 1990) ("The mere existence of a Ponzi scheme…has been found to fulfill the requirement of actual intent on the part of the debtor."). California's fraudulent transfer statute lists 11 factors that also can be considered in assessing a Ponzi operator's actual intent. Civ. Code §3439.04.

[24] *See*, *e.g.*, Scholes v. Lehmann, 56 F. 3d 750, 755 (7th Cir. 1995) (Investors' claims made a Ponzi scheme insolvent from inception.); In re Randy, 189 B.R. 425, 441 (N.D. Ill. 1995) ("Having been convicted of a Ponzi scheme, Randy was insolvent from its inception as a matter of law."); In re Independent Clearing House, 77 B.R. 843, 871 (D. Utah 1987) ("By definition, an enterprise engaged in a Ponzi scheme is insolvent from day one.").

[25] *See*, *e.g.*, In re United Energy Corp., 944 F. 2d 589, 595 n.6 (9th Cir. 1991) ("[S]uch excess amounts [like the fictitious profits the trustee seeks to avoid here] would be avoidable because the debtor would not have received reasonably equivalent value for them."); Independent Clearing House, 77 B.R. at 857, 859 ("If the use of the [investors'] money was of value to the debtors, it was only because it allowed them to defraud more people of more money….In such a situation, the use of the defendant's money cannot objectively be called 'reasonably equivalent value.'").

[26] 11 U.S.C. §548(c); Civ. Code §3439.08(a).

[27] *See* In re Bayou Group, LLC, 396 B.R. 810, 844 (S.D. N.Y. 2008); *see also* In re Agricultural Research & Tech. Group, Inc., 916 F. 2d 528 (9th Cir. 1990).

[28] 11 U.S.C. §548(a)(1)(A) (actual fraud); 11 U.S.C. §548(a)(1)(B) (constructive fraud).

[29] 11 U.S.C. §544(b).

[30] Civ. Code §3439.09(c).

[31] Civ. Code §3439.09(a).

[32] *See*, *e.g.*, Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 7 Cal. 4th 503, 511 (1994).

[33] Fiol v. Doellstedt, 50 Cal. App. 4th 1318, 1325-26 (1997).

[34] Gonzales v. Lloyds TSB Bank, PLC, 532 F. Supp. 2d 1200, 1206 (C.D. Cal. 2006); Casey v. United States Bank Nat'l Ass'n, 127 Cal. App. 4th 1138, 1145-47 (2005) (and cases cited therein).

[35] *See* Neilson v. Union Bank of Cal., N.A., 290 F. Supp. 2d 1101, 1127 (C.D. Cal. 2003) ("[S]uch a cause of action does not require that the aider and abettor owe plaintiff a duty so long as it knows the primary wrongdoer's conduct constitutes a breach of duty, and it substantially assists that breach of duty.").

[36] *See* Mitchell v. Gonzales, 54 Cal. 3d 1041, 1052-53 (1991).