

BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

What Do You Do When the Feds Come For Your Assets? Third-Party Claims in Forfeiture Proceedings

By [Kathy Bazoian Phelps](#)

Bank accounts, real property, jewelry, yachts, cars, and other personal property are the low hanging fruit that defrauded investors and bankruptcy trustees hope to grab when a Ponzi scheme lands in bankruptcy. In the recent Ponzi case of Scott Rothstein and his law firm, Rothstein, Rosenfeldt & Adler, P.A., there were many such assets just within reach when Rothstein pleaded guilty to running a \$1.2 billion Ponzi scheme.

Easy pickings for the trustee and creditors, right? Not if the government comes along and swallows the assets in one fell swoop in a forfeiture action. And not if third parties claim that those very same assets belong to them and not to the government, the trustee, or the defrauded investors.

The matter of third-party claims to forfeited assets has become an issue of great significance in the administration of assets in a fraudulent scheme, particularly where a parallel bankruptcy or receivership action is pending regarding the same fraud and the same assets. Conflicts arise when the government enforces the criminal and drug control laws containing provisions for asset forfeiture, while bankruptcy trustees and regulatory receivers seek to fulfill their mandate by marshaling and liquidating assets for the benefit of the creditors of the estate. When you add to that the individual

defrauded investors who want to pursue direct claims to the assets, along with other unrelated third parties who claim an ownership interest in an asset that they believe to be superior to everyone else's interests, a complicated mess of litigation ensues. This article will discuss these competing claims to forfeited assets and the range of potential outcomes.

Forfeited Assets in the Rothstein Case

The Scott Rothstein Ponzi case is a good example of how many different people can make claim to the very same assets, each with compelling arguments, and how, in the absence of cooperation and coordination between the government and parallel bankruptcy proceedings, significant litigation costs can deplete the value available for everyone. Scott Rothstein stipulated with the government to an order for forfeiture of Rothstein's right, title, and interest in all property involved in the RICO and money-laundering activities and all property derived from the mail and wire fraud offenses. Once the government took the assets, everyone wanted a piece of them, and the fighting began. In other cases, such as the Bernard Madoff and Marc Dreier Ponzi cases, the government and trustee found ways to cooperate and coordinate on various contentious issues.

Rothstein may be an anomaly; however, it presents a cautionary tale.

Here is what happened in the Rothstein case.

- The government forfeited all of the assets of Rothstein and his law firm.
- The trustee of the Rothstein law firm made claim to all of the funds in the law firm bank accounts and all assets that had been purchased with those funds.
- Some of the defrauded investors asserted a constructive trust over the funds in the Rothstein law firm's bank accounts.
- Non-investor clients of the Rothstein law firm asserted express and constructive trust claims over funds in some of the Rothstein law firm bank accounts on the theory that they had retained the firm to represent them in personal injury actions and the proceeds of the settlements of those claims were in client trust accounts held for their benefit.
- Rothstein's wife claimed that Rothstein had given her gifts of jewelry based on their relationship, some of which was gifted before the criminal acts so she should be able to retain those gifts.

- The creditors committee in the law firm's bankruptcy case also tried to make claim to the forfeited property on behalf of all of the victims and creditors of the law firm.

Criminal or Civil Forfeiture Proceeding?

As a preliminary matter, whether the government has forfeited assets in a criminal or civil forfeiture proceeding may make all the difference for a third party asserting rights to forfeited assets.

A civil forfeiture proceeding is an *in rem* proceeding where the government is taking guilty property because the property was used in a crime, without regard to culpability of the owners of the property. Such a forfeiture does not depend on a criminal conviction or whether or not there has been an indictment.

A criminal forfeiture proceeding, on the other hand, is an *in personam* action against the criminal defendant, where the government takes property as punishment for a criminal act.

Because of these fundamental differences at the outset, the procedures for third parties to assert interests in forfeited property in criminal and civil forfeiture proceedings vary significantly. In a civil forfeiture proceeding, the government files a complaint for forfeiture and serves notice to victims pursuant to the remission regulations. The government must establish probable cause to the court, without a jury, that the forfeiture is appropriate. A third-party claimant must file a claim to the property and answer the government's complaint. The case is then presented to a jury and the government's burden of proof is a preponderance of the evidence. These procedures are set forth in 18 U.S.C. § 983(a).

In criminal forfeiture, the government must establish that the property sought to be forfeited was used in, or to facilitate, the crime. Alternatively, the government may establish that property is forfeitable because it constitutes or is derived from any proceeds that the person obtained from the crime. A third party seeking to assert an interest in those assets may not

contest the criminal forfeiture allegation in the forfeiture proceeding itself, as only the criminal defendant can do that. Nevertheless, after a preliminary order of forfeiture is entered in the proceeding as between the criminal defendant and the government, a third party can commence an ancillary proceeding to establish an interest in the forfeited property. These procedures are set forth in 21 U.S.C. § 853(n).

Third-party Standing

Before addressing the merits of what must be established to make a successful claim to forfeited assets in either a civil or criminal forfeiture proceeding, a third party must demonstrate that it has standing even to make a claim. To do so, a third party must establish an ownership or legal interest in the property. Being a run-of-the-mill general unsecured creditor or defrauded investor does not meet the test of standing in these types of proceedings; a more direct interest in the forfeited property must be established. "[T]he term 'owner' . . . does not include . . . a person with only a general unsecured interest in, or claim against, the property or estate of another[.]" 18 U.S.C. § 983(d)(6)(A).

Third-party Rights in Civil Forfeiture Proceedings

A third party asserting a superior interest in the forfeited property must demonstrate one of two things:

1. The property is not involved in or traceable to the specified unlawful activity; or
2. The "Innocent Owner Defense" applies.

These are factual matters that must be determined by the trier of fact. In a civil forfeiture proceeding, the innocence of the third party making the claim is of utmost importance, because the innocent owner defense is designed to protect the interests of the truly innocent owner. On a basic level, the third party must establish an ownership interest in the forfeited property and his or her innocence regarding the property's forfeitability. The application of

this defense, however, differs depending on when the innocent owner acquired an interest in the property.

If the third party's property interest was in existence at the time the illegal conduct giving rise to the forfeiture took place, the third party is considered an innocent owner if he or she either did not know of the conduct giving rise to the forfeiture, or upon learning of that conduct, did all that reasonably could be expected under the circumstances to terminate the criminal use of the property. For example, the third party could have given timely notice of the criminal conduct to law enforcement or could have attempted to revoke permission for the use of its property or otherwise tried to prevent the illegal use of its property.

If the third party's property interest was acquired after the conduct giving rise to the forfeiture had taken place, the third party is considered an innocent owner if he or she was a bona fide purchaser or seller for value and did not know, and was reasonably without cause to believe, that the property was subject to forfeiture.

In the context of the innocent owner defense, a lack of knowledge of the criminal conduct and the forfeitability of the property is key. The courts have held that turning a blind eye or willful blindness is equated with knowledge of the illegal activity.

Third-party Rights in Criminal Forfeiture Proceedings

In contrast to a civil forfeiture proceeding, a third party seeking to establish a superior interest to forfeited property in a criminal forfeiture proceeding need not be innocent. Here, the third party needs to establish superior ownership rights by demonstrating that he or she has a legal right or interest in the property superior to that of the criminal defendant's interest. Alternatively, the third party can demonstrate that he or she is a bona fide purchaser for value.

Bona Fide Purchase for Value

One way that a third party can establish a superior interest in the forfeited property in a criminal forfeiture proceeding is by

demonstrating that he or she is a bona fide purchaser for value. The claimant must demonstrate that an actual purchase was made and that the property was obtained in an arm's-length transaction. The claimant must be without cause to believe that the property is subject to forfeiture. General creditors and victims are not bona fide purchasers (they would not have standing in any event), nor are donees, judgment lien creditors, creditors receiving property as payment on a debt, or creditors exercising set-off rights.

Use of Constructive Trust

Issues relating to the establishment of a superior legal interest in the forfeited assets most often relate to the timing of the vesting of the third party's interest in the property. The claimant must establish a legal interest in the forfeited property that was superior to the defendant's interest at the time of the criminal offense. While it seems that this would be impossible as to proceeds of a crime (which do not exist until after the crime occurs), a third party may be able to present other theories to establish a superior interest.

The most frequently litigated theory asserted by third-party claimants is that of constructive trust. Some courts have found that property is not forfeitable where it was taken from a third party by fraud and the criminal defendant therefore only held it in constructive trust. Such property impressed with a trust is not subject to forfeiture. The Eleventh Circuit held in *United States v. Shefton*, 548 F.3d 1360, 1366 (11th Cir. 2008), that a constructive trust is a cognizable "legal interest" sufficient to assert an interest under the forfeiture statutes. Until *Shefton*, the government had been relying heavily on an early decision holding that "a constructive trust may not be used to defeat the government's forfeiture claim." *United States v. BCCI Holdings (Luxembourg), S.A.*, 46 F.3d 1185, 1190–91 (D.C. Cir. 1995).

An interest in property may be demonstrated by establishing a constructive trust over property that one party holds in equity for another. Under state law, a constructive trust can generally be shown

where property has been obtained by another through means by which it would be unconscionable for the holder of legal title to retain a beneficial interest. Although the law varies by state, generally, a claimant establishing a constructive trust must satisfy principles of equity and needs to demonstrate the following:

- The ability to trace an interest to the particular asset
- The lack of an adequate remedy at law
- A confidential relationship between the claimant and the defendant
- Fairness to others who are similarly situated
- Clean hands
- Unjust enrichment or fraud if no constructive trust is established

State laws may also vary on the timing of when a constructive trust is established, which may make all the difference on whether a constructive trust claim can prevail over the government's forfeiture action. Some jurisdictions find that a constructive trust is created at the time the fraud occurs. Others state that a constructive trust is a remedy and established only at the time that it is judicially imposed.

If a constructive trust is imposed when the crime occurs, some courts find that such an interest cannot be pre-existing and superior because the constructive trust and the government's claim would have arisen at the exact same moment when the crime occurred, so the government wins. The government's interest arises pursuant to the relation back doctrine set forth in 21 U.S.C. § 853(c), where the government's interest in the property is deemed to have vested at the moment the crime occurred.

Other courts, however, relying upon the same doctrines and theories, find that, even though the constructive trust and the government's interests arise at the same time, the third-party constructive trust prevails, and the government's claim is eliminated if the third party has met its burden under the criminal statutes.

If under state law the constructive trust must be judicially imposed rather than es-

tablished as of the time of the crime, courts have held that a constructive trust can never give a third party the right to the forfeited property because the trust can never be pre-existing as the statute requires.

In other words, as a matter of state law, whether or not a constructive trust can be established in the first instance, when that trust is established, and what are the rights vis-à-vis the defendant's and the government's interests, are all issues that are up for grabs. Several circuits have found, however, that the federal question of whether a third party can establish a superior interest in forfeited property through the use of a constructive trust should be answered in the affirmative, so long as the constructive trust has been timely established under state law.

In the case of a fraudulent scheme, the issue of constructive trust can mean the difference between full recovery versus no recovery. Some courts, however, have specifically disallowed the use of constructive trusts in Ponzi or Ponzi-like cases expressly because of the fraudulent nature of the scheme and the inequity that would result in allowing the one defrauded investor whose funds were still located in the account on the last day to be paid back in full while earlier investors receive nothing. For example, in *United States v. Ramunno*, 599 F.3d 1269, 1275 (11th Cir. 2010), the court explained:

If the funds are distributed equitably to all victims, then each victim . . . may recover some fraction of their lost investments. However, if Martin is granted a constructive trust and recovers his entire loss, the other victims would recover less than their pro-rata share of the seized assets.

Details of the Rothstein Battle Over Forfeited Assets

The outcome of the disputes arising in the Rothstein Ponzi case over the forfeited assets took into consideration many of these factors. The results were mixed, after numerous hard fought battles:

- The Rothstein law firm bankruptcy trustee was not allowed to keep most of the law firm bank accounts

because the court concluded that the funds in those accounts were traceable to the crime. The trustee was permitted to keep one client trust account because it was determined that Rothstein, the criminal defendant, had no interest in that account, the trustee did not have to prove a superior interest to the trust beneficiaries, and the trustee had legal title. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 109311 (S.D. Fla. Oct. 14, 2010).

- The trustee did not fare well in his attempts to assert a constructive trust over assets acquired with the funds in the law firm accounts. The court found that a constructive trust was inequitable under the circumstances where the funds should not go to the bankruptcy estate but should be returned directly to the law firm clients and investors. The court also noted that the equitable remedy of constructive trust should not be imposed where the victims had an adequate remedy at law through the restitution process. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 69180 (S.D. Fla. July 9, 2010).
- The trustee's constructive claims over real property purchased with the law firm funds were also rejected, as was his claim that he was a bona fide purchaser for value under Section 544(a)(3) of the Bankruptcy Code. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 109311 (S.D. Fla. Oct. 14, 2010).
- The defrauded investors also asserted constructive trust claims against the funds in the law firm's bank accounts. Given the court's findings denying the trustee's claims because the money should

be returned directly to investors, one would have expected success here by the third parties. But the investor constructive claims were also denied. First, the court held that the investors were required to trace their funds to the forfeited property but were unable to do so. Second, it would be inequitable to the other victims to impose a constructive trust for the benefit of just a few victims. Third, the victims all had an adequate remedy at law, which was the remission process. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 74814 (S.D. Fla. July 26, 2010).

- The non-investor clients of the law firm were somewhat successful in their third-party claims. To the extent that the accounts were held directly for their benefit, the third-party claims prevailed. Nevertheless, the constructive trust did not extend to cover assets that had been purchased with those funds for many of the same reasons that the trustee's and investor's trust claims had failed. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 69794 (S.D. Fla. July 13, 2010).
- Rothstein's wife asserted an ownership claim over certain jewelry she had received prior to the criminal conduct. The government objected on the grounds that she had not adequately described the jewelry, but the court overruled the objection, noting that the government itself had been sufficiently vague in describing the jewelry in its forfeiture order. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 74423 (S.D. Fla. July 22, 2010).
- The creditors' committee of the Rothstein law firm bankruptcy

case made claim to the forfeited property in an attempt to reach assets for the benefit of the law firm's creditors and victims, but the court found that the committee did not have standing in the forfeiture proceeding and that it needed to seek recourse in the bankruptcy case. *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 74814 (S.D. Fla. July 26, 2010).

Conclusion

If appropriate, third-party claims can catapult a party out of the category of general unsecured creditor, where it would share the pot with everyone else, and can lead to a full recovery of that creditor's claim amount. In Ponzi cases and other fraudulent schemes, however, courts are wary of treating the last victim to place money into the scheme differently than earlier investors just because the last victim's funds are still sitting in a bank account. Therefore, even if all the t's are crossed and the i's dotted, a victim or creditor may still not be successful in asserting a third-party claim to forfeited property. Nevertheless, one should not be discouraged from asserting those rights if property rightfully belonging to that party has been forfeited by the government. Importantly, however, all potential claimants—including trustees, receivers, investors, third-party owners, and the government—are encouraged to communicate and work together to divvy up the assets in the most cost-effective manner possible. The multiple pieces of Rothstein litigation certainly led to some winners, yet one cannot help but wonder whether the wins would have been greater and the losses smaller had the government and trustee been able to avoid such costly, lengthy, and bitter litigation.

Kathy Bazoian Phelps is a partner at Danning, Gill, Diamond & Kollitz, LLP, in Los Angeles.