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Coordination Agreements in Parallel Forfeiture and Bankruptcy Proceedings

By Hon. Steven W. Rhodes

When a Ponzi scheme collapses, the result is often two or three parallel proceedings—a forfeiture action filed by the Department of Justice, a civil securities enforcement action filed by the Securities and Exchange Commission, and a bankruptcy proceeding. Each has procedures for compensating the victims of the scheme, but the procedures are different and conflicting. Resolving those conflicts through litigation can result in significant expense and delay in compensating victims. Recognizing this, and in an effort to use the more advantageous aspects of each process, the DOJ and bankruptcy trustees often negotiate coordination agreements that divide and assign the responsibilities for recovering and distributing assets.

Competing Processes for Compensating Ponzi Victims

The DOJ initiates the asset forfeiture process, whether civil or criminal, as a part of its prosecution of the crimes that the Ponzi perpetrator has committed, which may include mail fraud, wire fraud, securities fraud, money laundering, and conspiracy, just to name a few. In the forfeiture process, the DOJ seizes the property that the perpetrator used in the commission of these crimes and the proceeds of these crimes, as provided in 18 U.S.C. § 981. The DOJ then uses the forfeited assets to compensate the victims of the perpetrator's fraud through its remission and restoration process under 21 U.S.C. § 853(i)(1) (relating to the disposition of criminal forfeiture proceeds) and 18 U.S.C. § 981(e)(6) (relating to the disposition of civil forfeiture proceeds). Remission is the means by which forfeited property is distributed to crime victims. Restoration is the means by which forfeited property is used to satisfy a criminal restitution order for crime victims. This distribution process is done entirely within the DOJ and in the discretion of the attorney general.

At the same time, the Securities and Exchange Commission may also file a civil enforcement action under 15 U.S.C. § 78u(d). The district court may then immediately appoint a receiver over the perpetrator's property for the benefit of the scheme's victims.

Finally, the perpetrator may also face bankruptcy, which can happen in any of three ways. The perpetrator itself may file a voluntary bankruptcy petition. Or, through an involuntary bankruptcy proceeding under 11 U.S.C. § 303, the victims of the scheme may obtain bankruptcy relief and the appointment of a trustee. Or, the receiver appointed through the SEC civil enforcement action may file a petition for the perpetrator. In any event, under 11 U.S.C. § 541(a), all of the perpetrator's property becomes property of the bankruptcy estate, excepting forfeited property under the "relation back" doctrine, discussed below.

Experience suggests that conflicts between receivership proceedings and forfeiture proceedings are rare, perhaps because receivers may be more inclined than bankruptcy trustees to defer to the government's desire to liquidate and distribute forfeited assets. Whatever the reason, because conflicts between bankruptcy and forfeiture are much more common, this article is limited to those conflicts and their resolution through coordination or cooperation agreements.

It is important to note that the forfeiture proceedings and the bankruptcy proceedings are filed in two different courts, with two different judges presiding. The bankruptcy court hears all matters relating to the bankruptcy case, while the district court presides over the forfeiture proceedings. Each court applies a different set of rules to its respective processes.

Both forfeiture and bankruptcy have procedures for compensating victims by (1) marshaling the perpetrators' assets, (2) liquidating those assets, (3) fixing victims' claims to the proceeds of those assets, and (4) distributing those proceeds to victims. There are, however, significant differences in these four key aspects of these procedures. As a result of these differences, each system has advantages and disadvantages, proponents, and critics.

Those who favor the forfeiture process argue:

- Often the criminal investigation has proceeded for a substantial period of time before the bankruptcy process gets underway, and has uncovered and preserved substantial assets from which victims can be compensated.
- The forfeiture process is more expeditious than the bankruptcy process.
- The forfeiture process is less costly than the bankruptcy process.
- The applicable statutes establish a priority for the forfeiture process over the bankruptcy process that must be respected. This priority results from the "relation back" doctrine by which property is deemed forfeited to the government at the time of the commission of the crime and is therefore not property of a subsequently filed bankruptcy estate. 18 U.S.C. § 981(f); 21 U.S.C. § 853(c).

On the other hand, the proponents of the bankruptcy process argue:

- In bankruptcy, there is judicial review and oversight of the entire process, but in the forfeiture process, there is judicial review of only the asset marshaling process, which is accomplished by the identification of the forfeited property in the forfeiture order.
- In bankruptcy, commercial creditors who were left unpaid when the scheme collapsed are entitled to a *pro rata* distribution on the same priority as the direct victims of the perpetrator's fraud, but in the forfeiture process, they receive no distribution because they are not considered "victims" under 28 C.F.R. § 9.6(a).
- In bankruptcy, the proceeds of avoidance actions such as preference claims under 11 U.S.C. § 547(b) and fraudulent transfer claims under 11 U.S.C. §§ 544 and 548 are available for distribution to creditors, but in the forfeiture process there are no such actions.

In the Ponzi case of *United States v. Frykholm*, 362 F.3d 413, 417 (7th Cir. 2004), the Seventh Circuit agreed with the proponents of the bankruptcy process for compensating victims:

> [An involuntary bankruptcy petition] would have provided a superior way to marshal [the perpetrator's] remaining assets and distribute them to her creditors. Although § 853(n)(1) allows the Attorney General to use forfeited assets for restitution, it does not create a comprehensive means of collecting and distributing assets. Bankruptcy would have made it pellucid that [one victim] cannot enjoy any priority over the other victims and cannot reap a profit while [the perpetrator's] other creditors go begging. Moreover, bankruptcy would have enabled the trustee to recoup the sums distributed to the first generation of investors, who received $5 million or so against $2.5 million paid in. Those payments could have been reclaimed under the trustee's avoiding powers and made available to all of the bilked investors.

The courts came to similar conclusions in *SEC v. Madoff*, 2009 U.S. Dist. LEXIS 30712, at *3 (S.D.N.Y. Apr. 10, 2009), and in *United States v. Petters*, 2010 U.S. Dist. LEXIS 55040, at *14–15 (D. Minn. June 3, 2010).

Coordination Agreements

Fortunately for Ponzi victims, in many recent cases, the DOJ and bankruptcy trustees have been able to negotiate coordination agreements. These agreements recognize that coordination of the parallel proceedings, to whatever extent, better serves the victims and creditors of a Ponzi scheme than litigation or stalemate.

Nevertheless, the flexibility of negotiating coordination agreements on a case-by-case basis carries significant costs. First, because the bankruptcy trustee's attorneys fees for negotiating the agreement are entitled to administrative priority in the bankruptcy case under 11 U.S.C. §§ 503(b)(2) and 507(a)(2), their payment will reduce the proceeds available to creditors. This administrative expense can be significant unless the parties reach an agreement promptly.

Second, the time that the trustee and the DOJ take to conclude an agreement delays the trustee's work in marshaling and liquidating whatever assets the coordination agreement assigns to the trustee. Because of depreciation, this time delay can reduce the value of those assets. In any event, it certainly delays the ultimate distribution to creditors.

Regardless, it is clear that a coordination agreement between the DOJ and a Ponzi scheme bankruptcy case trustee is better for victims and other creditors than either litigating the issues or leaving the process of compensating them to one system or the other.

Recently, parties successfully negotiated coordination agreements in these Ponzi cases:

- *Picard v. Picower* (S.D.N.Y. Case No. 09-1197, Docket Nos. 25 (Dec. 17, 2010) & 43 (Jan. 13, 2011)).
- *United States v. Dreier*, 682 F. Supp. 2d 417 (S.D.N.Y. 2010); *In re Dreier LLP*, 429 B.R. 112, 126 (Bankr. S.D.N.Y. 2010).
- *United States v. Petters*, 2010 WL 4736795 (D. Minn. Nov. 16, 2010); *In re Petters Co. Inc.*, 440 B.R. 805 (Bankr. D. Minn. 2010).
- *United States v. DeMiro* (E.D. Mich. Case No. 10-20594).

The Scott Rothstein Ponzi Case

The "poster case" that should motivate the DOJ and the trustee to negotiate a coordination agreement in every Ponzi case is the Scott Rothstein case. When Rothstein was convicted for his Ponzi scheme crimes, the court entered an order forfeiting all

property involved in his RICO and money laundering conspiracies and all property derived from his mail and wire fraud offenses. Also forfeited were the bank accounts of Rothstein's law firm, Rothstein Rosenfeldt Adler, P.A., (RRA). The DOJ and the trustee of the RRA bankruptcy did not reach a coordination agreement. Unfortunately, as a result, the DOJ and the trustee litigated at some length and cost over who should liquidate what property, as this list of court opinions demonstrates:

- *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 143131 (S.D. Fla. June 11, 2010) (denying the RRA bankruptcy trustee's motion to amend the forfeiture order, seeking the return of the funds in RRA's bank accounts).
- *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 69180 (S.D. Fla. July 9, 2010) (granting in part and denying in part the government's motion to dismiss the trustee's claim, which challenged: (1) the trustee's ownership claim to the RRA accounts; (2) the trustee's constructive trust claim to certain miscellaneous property; and (3) the trustee's claim to certain real property as a bona fide purchaser).
- *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 109311 (S.D. Fla. Oct. 14, 2010) (granting in part and denying in part the government's motion for reconsideration).

The Marc Dreier Ponzi Case

An excellent example of a thoughtful coordination agreement is one that the parties negotiated in the Marc Dreier Ponzi case. Dreier, a practicing attorney, ran a Ponzi scheme between 2004 and 2008, selling bogus promissory notes and depositing approximately $700 million in proceeds into a bank account of his law firm, Dreier LLP. The receiver appointed in the subsequent SEC enforcement action filed an involuntary bankruptcy case against Dreier LLP. The trustee appointed in that bankruptcy case then joined other creditors in filing an involuntary case against Dreier personally and a second bankruptcy trustee was appointed.

As part of Dreier's criminal case, the court ordered the forfeiture of $746,690,000 in cash held in accounts controlled by Dreier, as well as the forfeiture of specific listed properties. In addition, as part of Dreier's sentence, he was ordered to make restitution payments to his victims in the amount of $387,675,303. Thus, the stage was set for the negotiations over a coordination agreement among the government and the two bankruptcy trustees. These negotiations were "lengthy and sometimes acrimonious."

When these parties did achieve a series of agreements, they submitted them to the judges assigned to the criminal and bankruptcy cases for approval.

Before reviewing the agreement, District Judge Jed Rakoff in *United States v. Dreier*, 682 F. Supp. 2d 417 (S.D.N.Y. 2010), astutely observed:

> An under-appreciated evil of substantial frauds like those of Marc Dreier is how they pit their victims against one another. Where, as here, the funds remaining after the fraud is uncovered are insufficient to make whole Dreier's numerous victims and creditors, these unfortunates are left to squabble over who should get what. In this case, moreover, resolution of these competing claims involves consideration of three bodies of law—criminal law, securities law, and bankruptcy law—that cannot always be reconciled without some friction.

Judge Rakoff then stated that he, as the judge presiding over the criminal case against Dreier, along with the judges presiding over the related SEC civil enforcement action and the related bankruptcy action, had concluded, "[T]hese inherent tensions are best addressed through coordination and cooperation by all concerned." As a result, "the three judges convened a joint hearing to urge such a resolution by the affected parties."

One of the agreements was a coordination agreement between the DOJ and the bankruptcy trustee for the Dreier's law firm, Dreier, LLP. Other agreements involved settlements between Dreier's personal bankruptcy trustee and GSO Capital Partners, which had invested in Dreier's fictitious promissory notes and had been paid interest and fees. These agreements provided in substance:

- The government will not seek forfeiture of any recoveries generated through avoidance actions brought by the Dreier LLP trustee.
- The government will release to the Dreier LLP trustee 97 seized artworks that it was unable to trace to the proceeds of Dreier's offenses.
- The Dreier LLP trustee promises not to contest forfeiture of the properties listed in the schedule to the Court's Preliminary Order of Forfeiture.
- The Dreier LLP trustee will not challenge the forfeiture of $30,895,028 that GSO disgorged, representing payments that it received from Dreier.
- GSO will pay $9,250,000 to the Dreier LLP trustee and $250,000 to Dreier's personal bankruptcy trustee in exchange for (1) a release of the trustees' claims against GSO, and (2) the entry of a bar order enjoining creditors and other parties in interest from seeking to recover funds from GSO.
- The government released to Dreier's personal bankruptcy trustee the personal property in three personal residences that Dreier owned.
- The government permitted Dreier's personal bankruptcy trustee to sell the three residences, which had been forfeited, in exchange for which the trustee will retain 10 percent of the proceeds.

Certain investors objected, arguing that the property to be transferred to the trustee under the coordination agreement is indisputably forfeitable such that the agreement will reduce the pool of funds available to victims. But Judge Rakoff

rejected this objection, concluding that litigation over the issues resolved in the agreements "would, at a minimum, have the effect of delaying and diminishing the victims' recoveries." The judge also noted that the agreement would incentivize the trustee to pursue her available avoidance actions, for the potential benefit of the creditors. "Thus, despite the foregoing objections, the Court finds that the Coordination Agreement is reasonable and in the best interests of the victims collectively." 682 F. Supp. 2d at 420–21.

In the two Dreier bankruptcy cases, Bankruptcy Judge Stuart Bernstein also approved the agreements, with the exception of one aspect—the bar order enjoining creditors and other parties in interest from seeking to recover funds from GSO. After reviewing the applicable Second Circuit authority, he held that the court could enter an "bar order enjoining creditors and other parties in interest from seeking to recover funds from GSO, where their claims are based on the debtors' misconduct, and there is no independent basis for an action against GSO other than its receipt of the transfers from LLP." He concluded, however, that the proposed bar order was too broad. "While the Bar Order is limited to creditors and parties in interest in the LLP and Dreier cases, these parties may also have direct claims against GSO relating to the debtors or the Notes that are unrelated to their status as creditors or parties in interest." Accordingly, the court held that it "must be modified."

Additional Opportunities for Coordination

The coordination agreements entered to date have focused largely on dividing and assigning assets and claims for relief against third parties to recover additional funds for victims and other creditors. There are, however, a few other areas where communication and coordination between the government and bankruptcy trustees could lead to more streamlined administration and greater recovery in both proceedings.

First, the government may not have the identities of all of the victims and, therefore, may not be able to give notice to all victims to file claims to the forfeited property. The trustee, on the other hand, may have a more complete list of all of the creditors, including victims, which the government could use for notice purposes in the forfeiture proceeding. More complete noticing and access to the forfeited property could therefore be achieved if the parties shared their lists of victims early in the case.

Second, the timetables for distribution to victims in forfeiture proceedings and distribution to creditors in bankruptcy cases are likely to be different. If the bankruptcy trustee does not know about earlier remission or restitution payments to victims from the forfeiture proceeding, the trustee would not be able to account for those partial or full payments when proposing an additional distribution to the same victims in the bankruptcy case. Communication between those responsible for the distributions in the two proceedings would avoid double recovery by some victims. This would also potentially allow greater recoveries for general creditors in bankruptcy cases who are not otherwise considered to be "victims" in the forfeiture proceeding.

Third, while the government may agree to permit a trustee to administer some of the forfeited property, it may want the trustee to distribute the proceeds of that property only to victims and not to general creditors. Because any such agreement would directly impact the rights of general creditors who are not considered "victims," it would need to be approved by the bankruptcy court, after creditors are given an opportunity to be heard. Therefore, the district and bankruptcy courts presiding over these cases should also coordinate and cooperate in carrying out their responsibilities as well.

Conclusion

The competition between forfeiture and bankruptcy in the process of compensating the victims of a Ponzi scheme is not in the better interest of Ponzi scheme victims. It delays and reduces their recoveries. The willingness of the DOJ and bankruptcy trustees to address this problem by negotiating coordination agreements is therefore a welcome development.

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