Ponzi Schemes, Securities Fraud and other Fraudulent Enterprises:

From "A" to "B" to "C"

***A**sset forfeiture*

***A**voiding powers*

***B**ankruptcy*

***C**oordinating multiple court proceedings*

Presenters

- Hon. David H. Coar
  - JAMS Mediator, Chicago IL
  - Formerly USDCt ND Il, USBankrCt ND Il, USTrustee ND Il
- Professor Jessica D. Gabel
  - Georgia State University School of Law, Atlanta GA
- Lawrence G. McMichael
  - Partner, Dilworth Paxton LLP, Philadelphia PA
- Kathy Bazoian Phelps
  - Partner, Danning Gill Diamond & Kollitz, Los Angeles CA

Moderator: Professor Karen M. Gebbia

Golden Gate University School of Law, San Francisco CA

Program overview

- Bankruptcy and forfeiture intersections: securities fraud and Ponzi schemes
- Asset forfeiture: criminal and civil
- Competing claims in the wake of collapse
- Coordinating multiple court proceedings
- Avoiding powers: emerging trends and tactics

Communication with the panel during the program

- Submit to chat box on your screen
- Very short questions only please
- Thank you

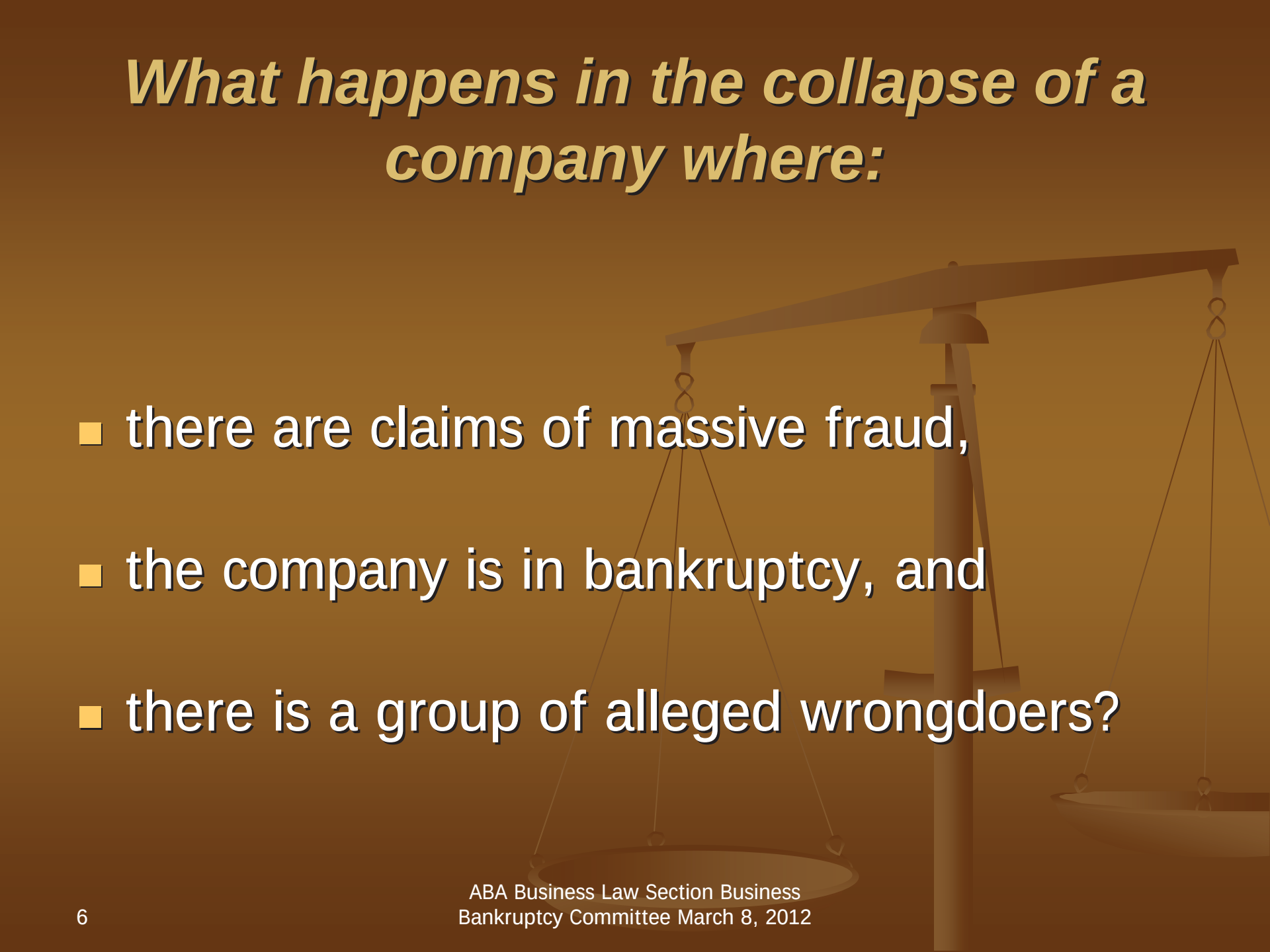
Professor Karen M. Gebbia

Bankruptcy and Forfeiture Intersections: securities fraud and Ponzi schemes

Presented by Lawrence G. McMichael

Dilworth Paxton

What happens in the collapse of a company where:



- there are claims of massive fraud,
- the company is in bankruptcy, and
- there is a group of alleged wrongdoers?

Limited assets become subject to competing claims

- *Trustee in Bankruptcy/Debtor in Possession*
  - Pursues wrongdoers and causes of action to bring assets back into bankruptcy estate
- *Government*
  - Asserts claims against wrongdoers and seeks civil (SEC) and criminal (DOJ) forfeiture
- *Individual Claimants*
  - Creditors and equity holders assert claims and interests

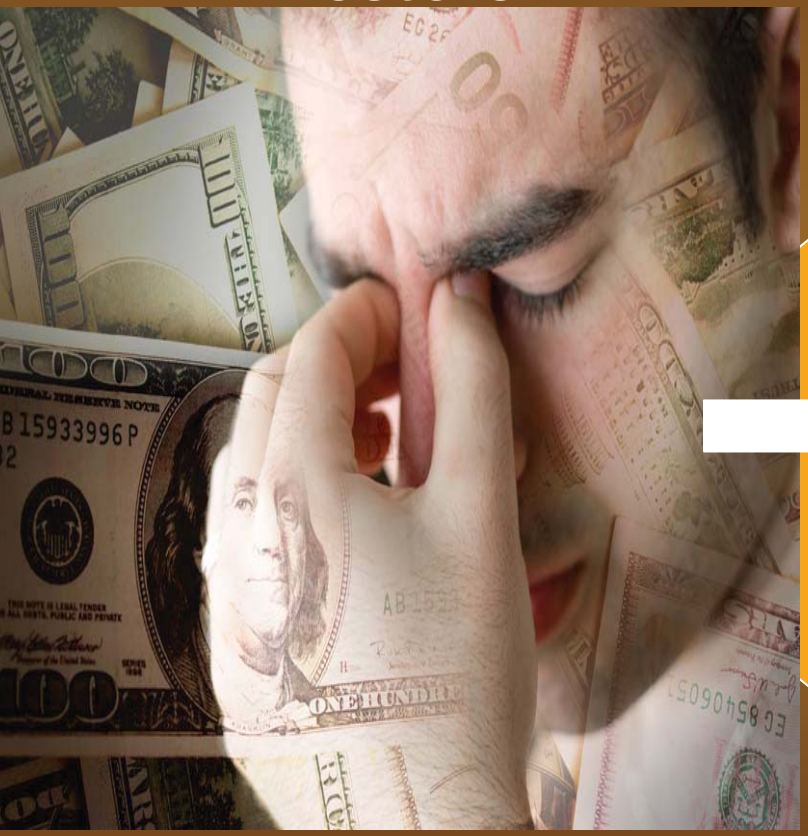
Simple Case #1
Isn’t it a crime . . . (forfeiture and restitution)

Simple Case #2
business bankruptcy (receivership, etc)

AT THE INTERSECTION: CASE 3

Ponzi collapse

Investors



The “assets” have been acquired by fraud

Creditors?
Victims?
Investors?

Bankruptcy (receivership)

Forfeiture

AT THE INTERSECTION: CASE 4

"legitimate" business collapse

Investors

creditors

Securities law violation;
+/or some "assets" have been acquired by fraud;
+/or internal corruption

Forfeiture

Bankruptcy (receivership)

Recoveries for Claimants

Bankruptcy vs. Forfeiture

	Bankruptcy	Forfeiture
Stockholder	0	+
Bondholder	+	+
Trade Creditor	+	0

FORFEITURE: Civil and Criminal

Presented by Kathy Bazoian Phelps

Danning Gill Diamond & Kollitz LLP

Co-Author with Hon. Steven W. Rhodes:

THE PONZI BOOK: A Legal Resource for Unraveling Ponzi Schemes (2012)

Kathy Bazoian Phelps

Danning Gill Diamond & Kollitz LLP

Civil vs. Criminal Forfeiture Proceedings

- Underlying policy rationale
- Goals:
  - punishment
  - deterrence
  - restitution
- Compare to bankruptcy goals

Civil Forfeiture Proceedings

18 USC § 981 (983-987)

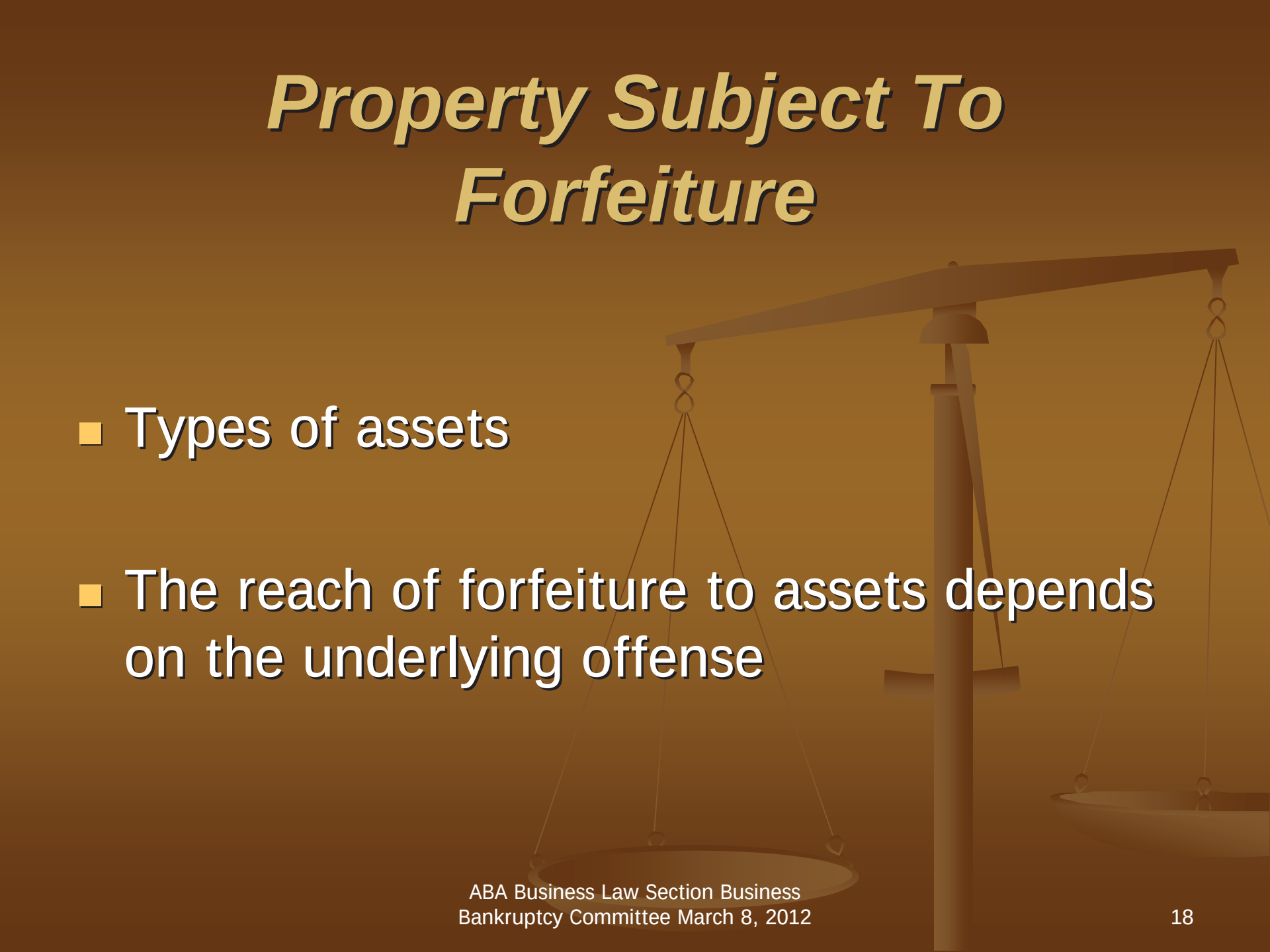
- *In rem* action against "guilty property"
- Property is "involved in" or "traceable to" certain fraudulent activity
- Procedure for third party claims to forfeited assets

Criminal Forfeiture Proceedings

18 USC § 982

- *In personam* action against criminal defendant
- Property used to commit or facilitate the crime
- Procedure for third party claims to forfeited assets: ancillary proceedings

Property Subject To Forfeiture



- Types of assets
- The reach of forfeiture to assets depends on the underlying offense

Substitute Assets

21 U.S.C. § 853(p)(1): When property subject to forfeiture:

- Cannot be located upon the exercise of due diligence
- Has been transferred or sold to, or deposited with, a third party
- Has been placed beyond the jurisdiction of the court
- Has been substantially diminished in value; or
- Has been commingled with other property that cannot be divided without difficulty

Relation Back Doctrine

- Property deemed vested in government as of date illegal activity commenced
- If forfeiture order entered before bankruptcy, forfeited property never becomes property of estate
- If forfeiture order entered after bankruptcy, property is subject of forfeiture order and excluded from the bankruptcy estate
- Application of relation-back doctrine to substitute assets

Third Party Rights To Forfeited Assets: Civil Forfeiture

- Property not involved in, or traceable to, unlawful activity
- Innocent owner defense
  - Ownership interest in property
  - Innocence regarding property's forfeitability

Third Party Rights To Forfeited Assets: Criminal Forfeiture

- Legal interest (holds superior interest) in property
- Pre-existing interest
- Impossible as to proceeds of crime

Constructive Trust: Elements

- Ability to trace
- Lack of adequate remedy at law
- Confidential relationship
- Fairness to others similarly situated
- “Clean” hands

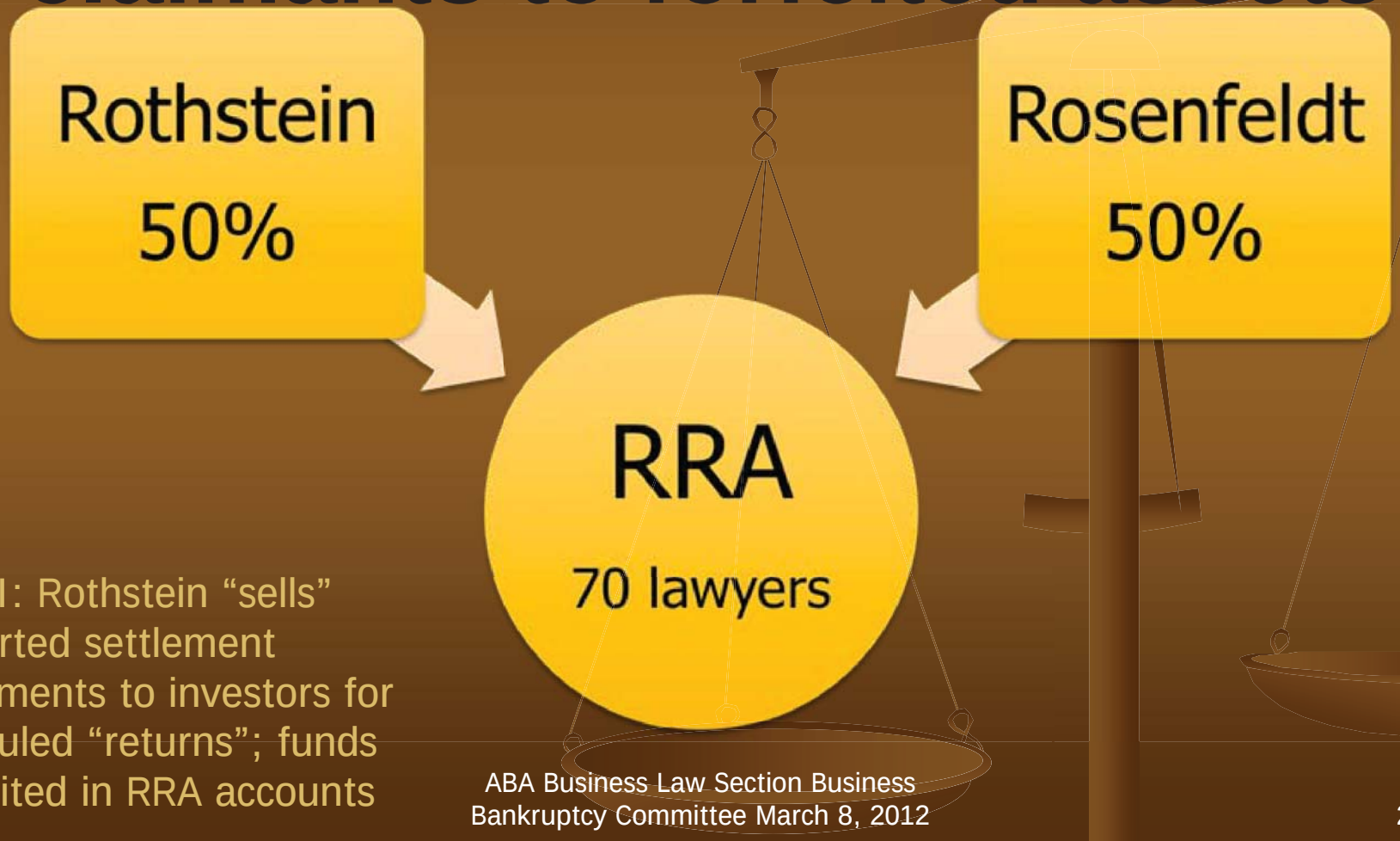
Constructive Trust: Timing

- *U.S. v. BCCI Holdings* (*Luxembourg*), S.A., 46 F.3d 1185 (D.C. Cir. 1995)
- *U.S. v. Shefton,* 548 F.3d 1360, 1366 (11th Cir. 2008)
- *U.S. v. Ramunno,* 599 F.3d 1269, 1275 (11th Cir. 2010)
- *U.S. v. Wilson,* 659 F.3d 947 (9th Cir. 2011)

Bona Fide Purchase For Value: Criminal Forfeiture Proceeding

- Arms-length transaction
- Exchange for value
- No cause to believe property subject to forfeiture
- Not a fraudulent conveyance
- No giftees, donees or creditors

ROTHSTEIN: a Ponzi scheme case study of competing claimants to forfeited assets

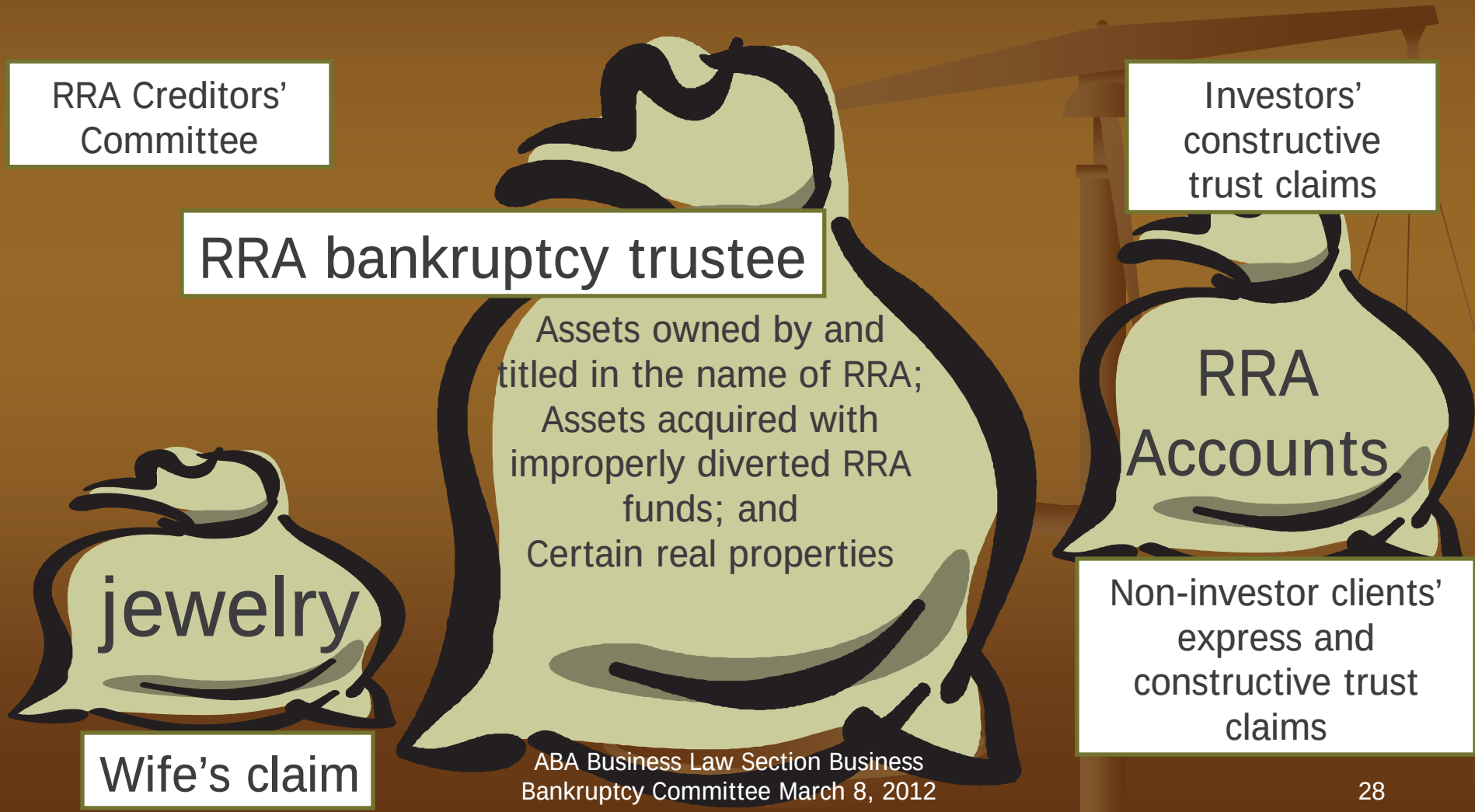


PONZI: Rothstein "sells" purported settlement agreements to investors for scheduled "returns"; funds deposited in RRA accounts

ROTHSTEIN: a Ponzi case study

- Government charges Rothstein with criminal activity relating to the Ponzi scheme
- Rothstein pleads guilty
- Rothstein stipulates that all of the property the government seized could properly be forfeited

ROTHSTEIN: competing claimants to forfeited assets



Select additional resources regarding forfeiture

- *ABA Criminal Justice Section Publication*

  ASSET FORFEITURE: Practice and Procedure in State and Federal Courts (2d ed. 2008, Edgeworth)

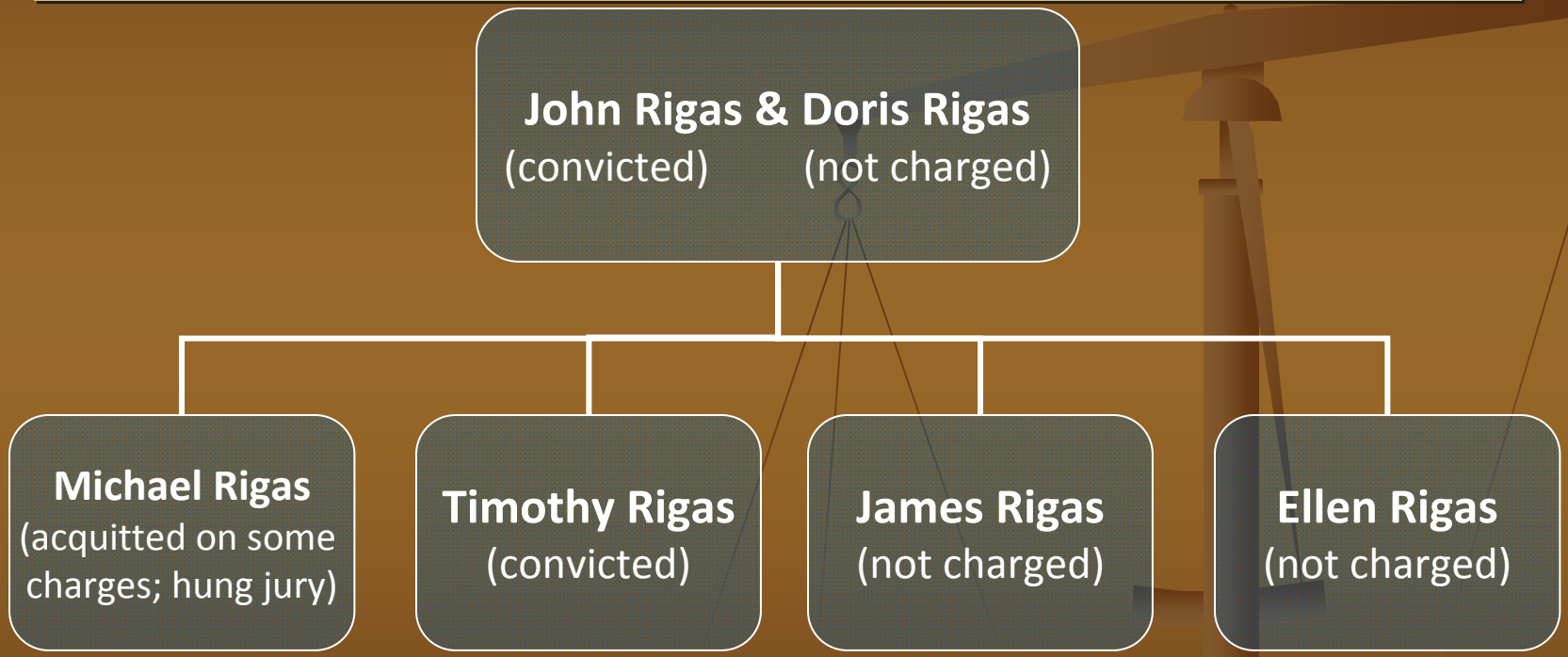
- *US DOJ educational materials (AFMLS)*
  - Returning Forfeited Assets to Crime Victims: An Overview of Remission and Restoration

Competing Claims in the Wake of Collapse

Presented by Lawrence G. McMichael

Dilworth Paxton

Securities Case Study: The Rigas Family

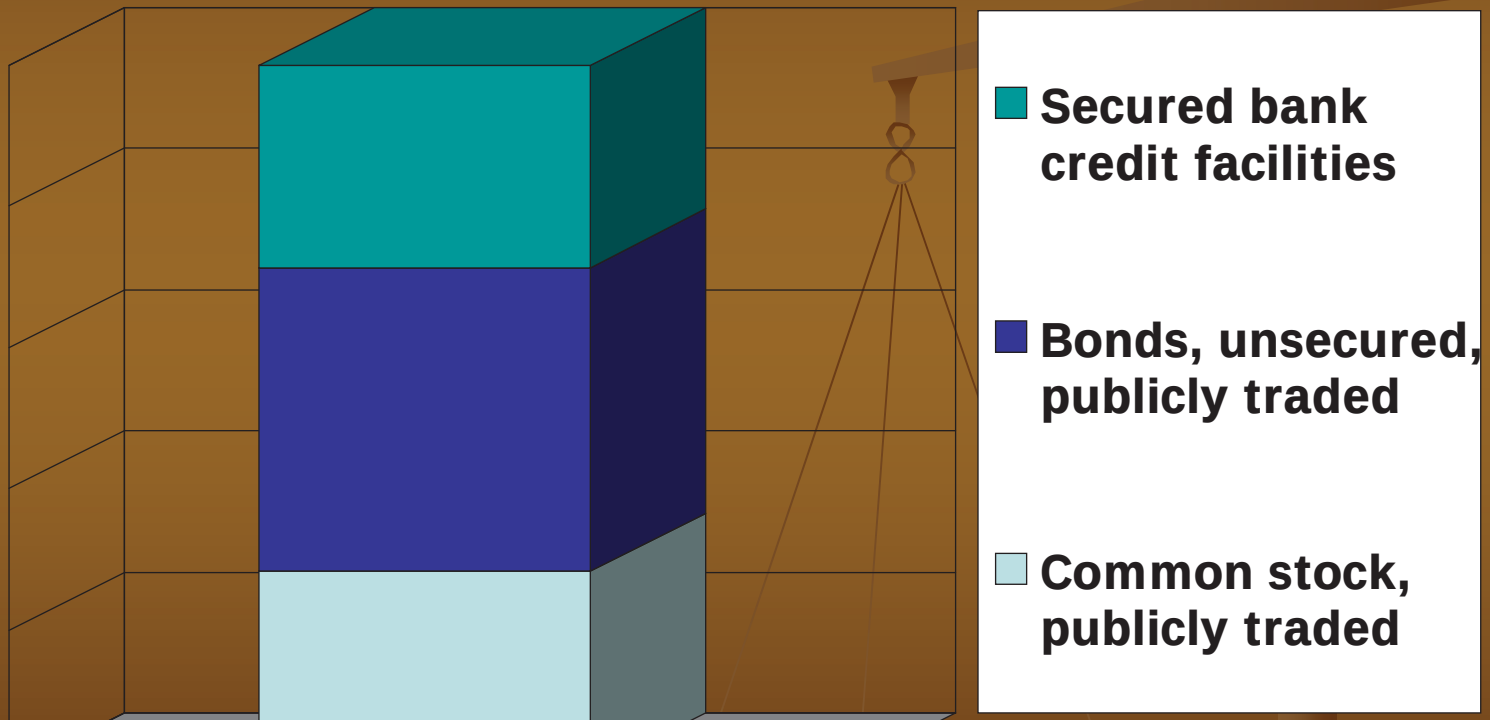


*Pre-Forfeiture Rigas Property Ownership**

- Adelphia Stock
  - Owned by John Rigas and by Highland Holdings GP (owned by John Rigas, his children and various partnerships owned by John Rigas and his children)
- Adelphia Bonds
  - Owned by Highland Holdings GP
- Private Cable TV Companies
  - Owned ultimately by all members of the Rigas Family
- Real Estate
  - Owned by John and Doris Rigas

* Simplified for presentation purposes

Adelphia Communications Corp. Capital Structure*



* Simplified for presentation purposes

Government Forfeiture Claims

- Adelphia defrauded public bondholders and stockholders
- John and Timothy Rigas defrauded public bondholders and stockholders
- John and Timothy Rigas defrauded Adelphia

*Forfeiture Settlement**

- John and Timothy Rigas forfeit all assets
- Other members of the Rigas Family forfeit some assets
- Forfeiture settlement results in the forfeiture of:
  - All Adelphia stock
  - All Adelphia bonds
  - Most of the private cable TV companies, and
  - Some real estate
- Forfeited assets deposited by the Government into a Victim Fund for the benefit of Adelphia stockholders and bondholders
- Adelphia purchases private cable TV companies from the Victim Fund for $715 Million

* Simplified for presentation purposes

Objections to Forfeiture Settlement

- Adelphia, as debtor-in-possession, has senior claim to Rigas forfeited assets
- Distribution of forfeited assets to holders of Adelphia common stock violates the absolute priority rule in bankruptcy

Coordinating Multiple Court Proceedings: When Bankruptcy and Forfeiture Clash

Presented by Hon. David H. Coar

JAMS Mediator

Formerly, in the Northern District of Il

United States District Judge

United States Bankruptcy Judge

United States Trustee

Hon. David H. Coar (ret.)

What the Courts Want From You

- Education: history and facts concerning all of the proceedings in both (all) courts
- Coordination:
  - procedurally between (among) the courts
  - between the government (forfeiture) and trustee (bankruptcy)

Case Management Orders: possible coverage

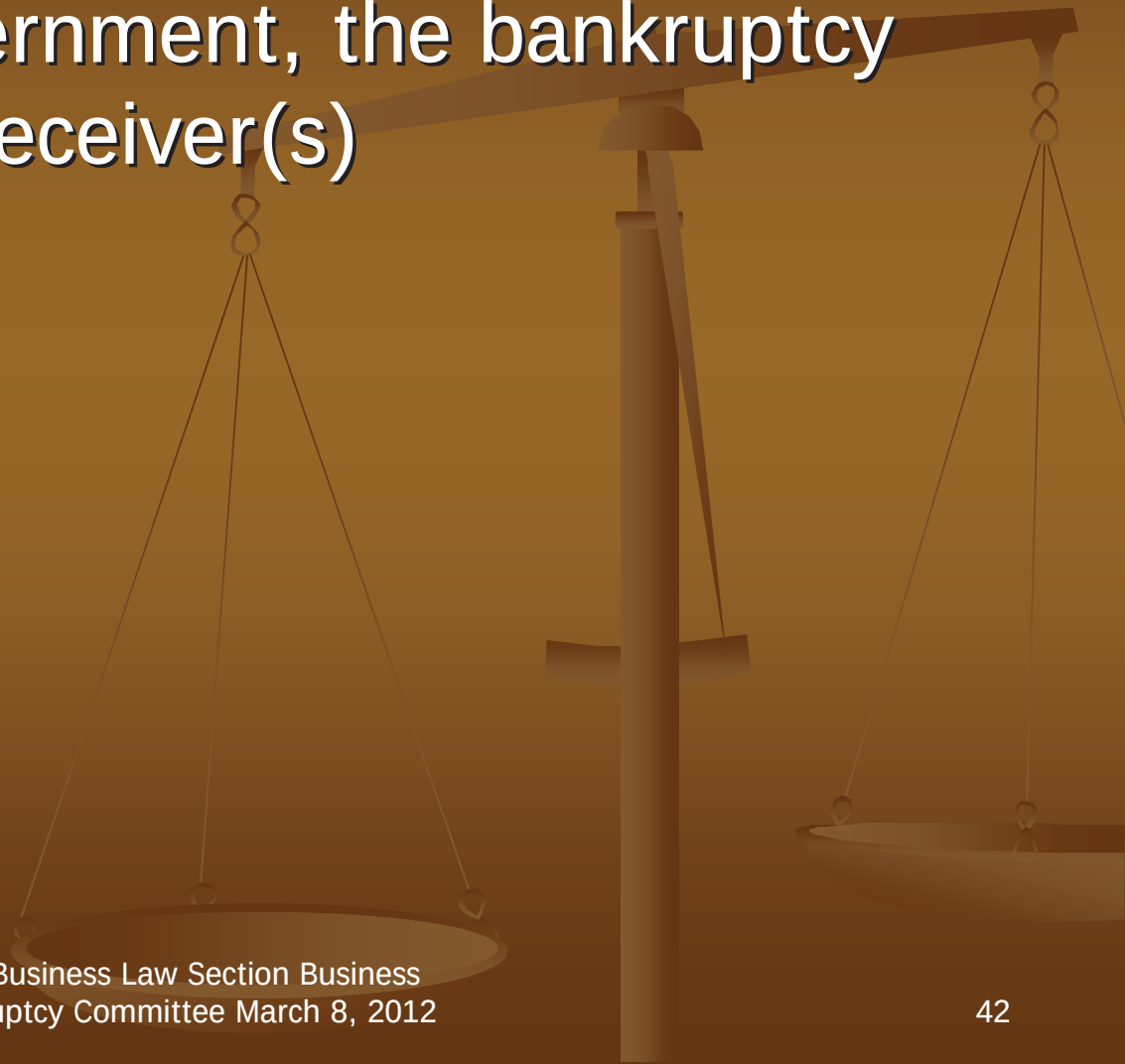
- Procedural
  - Examples: mediation and litigation management procedures, withdrawal and/or stay, consolidation of issues
- Evidentiary
  - Example: preservation release and sharing of evidence, protective orders
- Administrative
  - Example: communication among the courts, joint hearings or conferences
- Substantive
  - Example: allocation of causes of action, recoveries and expenses; substantive consolidation; releases

EG: Petters Case Management

- Order for Joint Mediation
  - Avoidance actions in Polaroid bankruptcy, Petters bankruptcy, and Receiver in criminal case against Petters
- Order on consolidated issues
  - Issues common to dismissal motions in avoidance actions
- Case management procedures order
  - Regarding avoiding powers actions

Cooperation Agreements

Between the government, the bankruptcy trustee(s) and receiver(s)



EG: Petters coordination agreement: parties

- Chapter 11 trustee of Petters Company Inc. entities
- United States
- Receiver (placed entities in chapter 11 to preserve assets and avoiding powers)
- Chapter 7 trustee of Polaroid

EG: Petters Coordination agreement: Scope

- Allocates assets and causes of action among the four entities
- Resolves threatened forfeiture re same
- Allocates expenses incurred among the bankruptcy estates
- Resolves criminal liability of two corporate entities, and thereby potential forfeiture consequence of corporate criminal liability
- Material wind-down of individuals' receiverships

AVOIDING POWERS: emerging trends and tactics

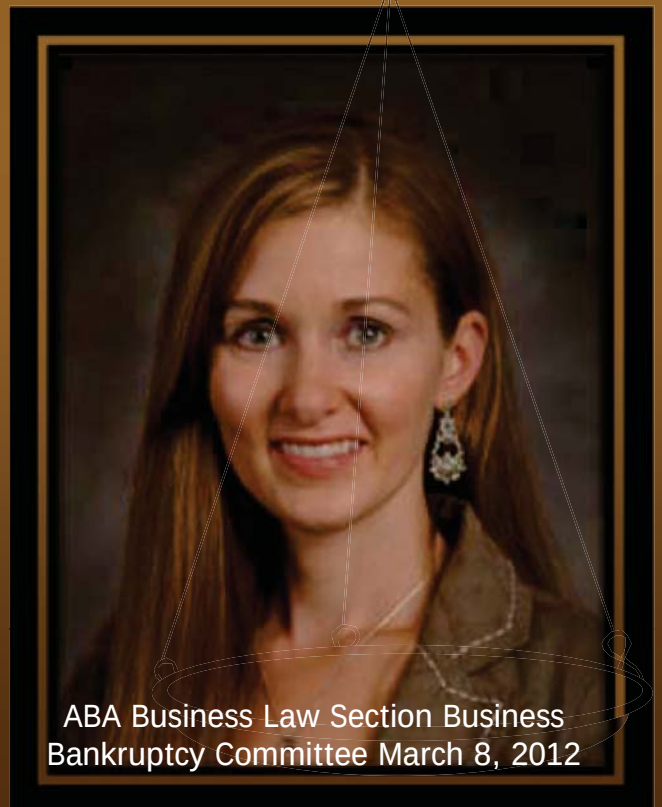
Presented by Professor Jessica Gabel

Georgia State University College of Law

The Claw Back Clique

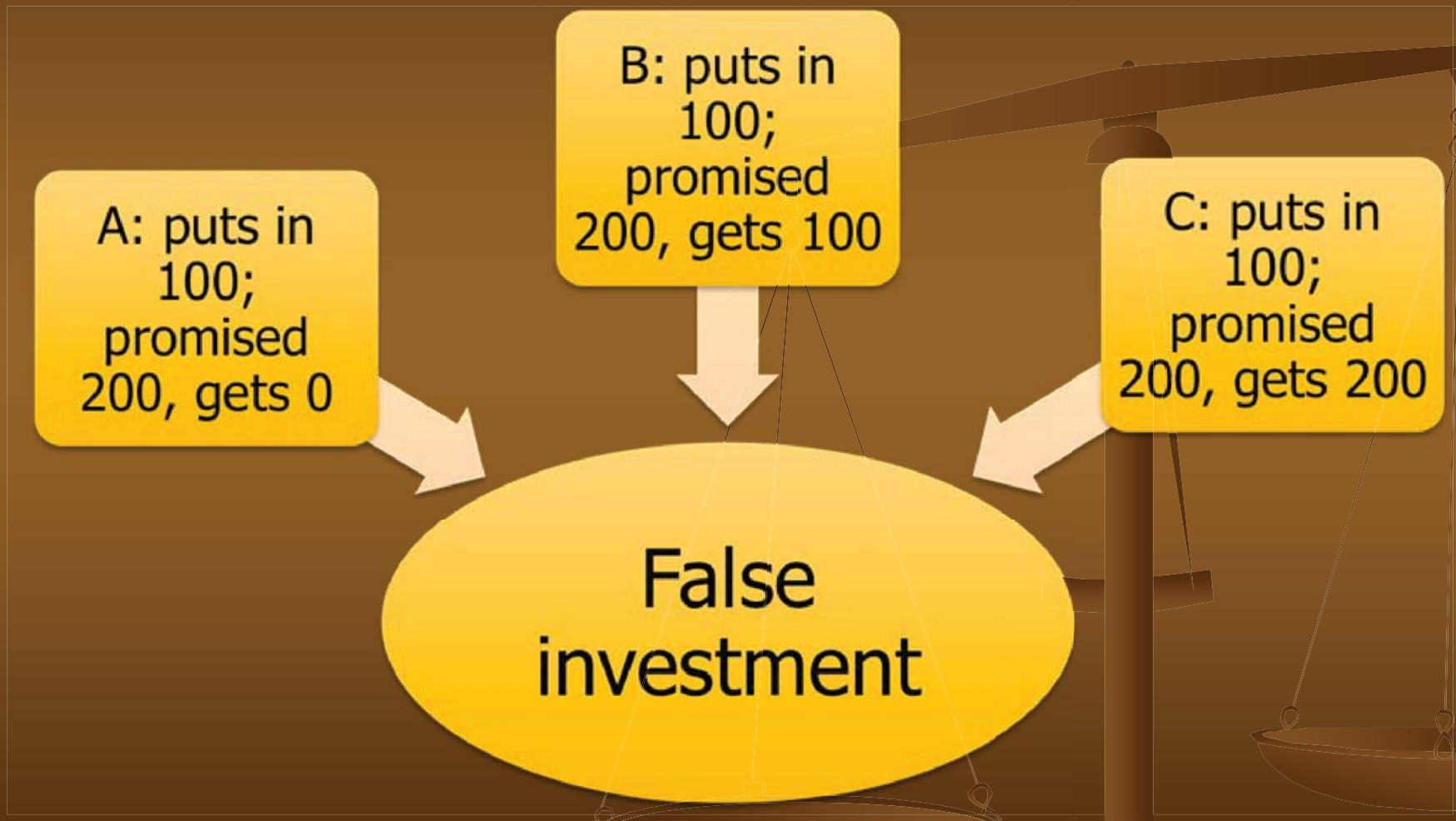
Opportunities and Obstacles in 547 and 548 Cases

Jessica Gabel
Georgia State University Collage of Law



ABA Business Law Section Business Bankruptcy Committee March 8, 2012

A classic pure Ponzi scheme



Ponzi Scheme Collapse

- Competing claims of Trustee, Government, and Individual Claimants feature prominently
- Bankruptcy may expose non-wrongdoer participants (net winners) to claims
  - Trustee may pursue preference and fraudulent transfer claims

Overview: Fraudulent Transfer Cases

- In Ponzi scheme cases, the trustee may recover transfers received by a defendant within two years before the petition date under § 548(a)(1)(A) (Actual Intent)

- If the transferor made a transfer with fraudulent intent, section § 548(a)(1)(A) is satisfied. The intent or understanding of the transferee is not relevant. *See In re Bayou Group, LLC,* 439 B.R. 284, 304 (S.D.N.Y. 2010) *("Bayou III")*

Overview: Fraudulent Transfer Cases

- Many Circuits have held that the fraudulent intent of the transferor (i.e., Ponzi operator) is presumed in cases where the debtor operated a Ponzi scheme because transfers made during the course of the scheme are made for no purpose other than to hinder, delay or defraud creditors.
- After the trustee establishes the transferor's actual fraud, all of the two year transfers are recoverable unless the transferee can prove that it received the transfers "for value" and in "good faith." 11 U.S.C. § 548 (c).

Fictitious Profits v. Principal Payments

- 11 U.S.C. § 548(c) is an affirmative defense
  - Transferee bears the burden of proving that it took both
    - for value. and
    - in good faith
- Defendants (i.e., investors) who receive fictitious profits do not have a § 548(c) defense
  - Cannot reap what was not planted
  - Ponzi scheme investors cannot provide value for transfers above the amount invested

Fictitious Profits v. Principal Payments

- Some courts have noted that principal investments typically do not, strictly speaking, provide “value” because that money furthered the fraud

- A good faith investor generally would, nonetheless, be entitled to a claim of rescission to recover the full amount of the principal investment

Winners, Losers, and Net Equity

In re Bernard L. Madoff Inv. Securities LLC, 654 F.3d 229 (2d Cir. 2011)

- Second Circuit affirmed the use of the "Net Investment Method" for determining customer claims by the Madoff estate trustee
- Court held that the Securities Investment Protection Act permits a SIPA-appointed trustee to employ his or her sound judgment in determining the appropriate methodology for calculating customer claims in a broker-dealer liquidations
- The decision emphasized that there is no "one size fits all" formula applicable to all cases, but Net Investment was appropriate in something as massive and complex as the *Madoff* case

Winners, Losers, and Net Equity

- *Madoff* trustee used the "Net Investment Method," which credited "the amount of cash deposited by the customer into his or her . . . account, less any amounts withdrawn from it"

- Under the Net Investment Method, only customers who had deposited more cash into their investment accounts than they had withdrawn would have allowable claims against the customer property fund

Winners, Losers, and Net Equity

- Certain customers objected to the trustee's approach and argued before the bankruptcy court that their net equity should be determined by the market value of the securities reflected on their most recent customer statements
  - "Last Statement Method"
- Finding that the most recent customer statements were unreliable, "entirely fictitious" and did not "reflect actual securities positions that could be liquidated," the bankruptcy court upheld Trustee Picard's methodology and certified the issue to the Second Circuit

Winners, Losers, and Net Equity

The bankruptcy court determined that the definition of “net equity value” had to be read along with other provisions of SIPA that require a trustee to discharge net equity claims only if such obligations are

(1) ascertainable from the books and records of the debtors. or

(2) otherwise established to the satisfaction of the trustee

Winners, Losers, and Net Equity

- Because the debtor's books and records revealed a fraud in which "no securities were ever owed, paid for or acquired" and use of the Last Statement Method would "legitimize" the fraudulent scheme, Picard's use of the Net Investment Method was appropriate

Good Faith Litigation

- "Good Faith" not defined in the Bankruptcy Code

- Importantly, a lack of good faith can be found when the transferee knows, or has reason to know, of the debtor's insolvency

Good Faith Litigation

Some courts have said that good faith requires:

(i) an arm's length transaction;

(ii) an honest belief by the transferee in the propriety of the activities in question;

(iii) no intent by the transferee to take unconscionable advantage of others;

(iv) no intent by the transferee to hinder, delay or defraud others; and

(v) no knowledge by the transferee of the fact that the activities will hinder, delay or defraud others.

Good Faith Litigation

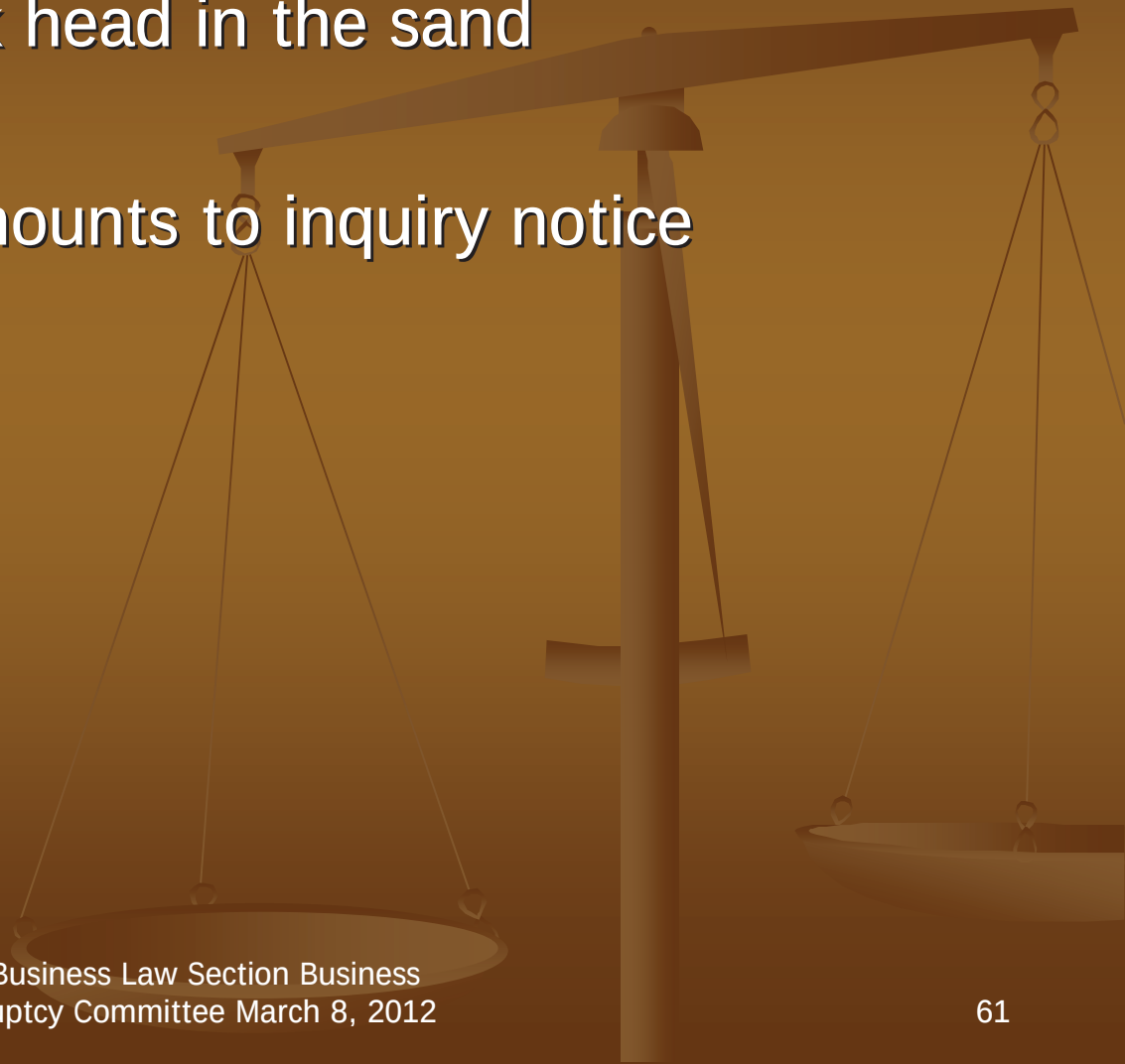
- In Ponzi cases, the majority view is that a transferee must demonstrate
  - (1) whether the transferee was on inquiry notice of the debtor's fraud; and if so, then
  - (2) whether the transferee was diligent in its investigation

- The test for good faith is objective:

"An objective, reasonable investor standard applies to both the inquiry notice and the diligent investigation components of the good faith test."

Good Faith Litigation

- Not allowed to stick head in the sand
- Willful blindness amounts to inquiry notice



Good Faith Litigation

- After an investor is on inquiry notice, a transferee must satisfy the "diligent investigation" requirement to establish good faith
- Need to do more than simply inquire with the Ponzi operator (or company)
- If the transfer defendant was on inquiry notice and did not conduct a diligent investigation, the defendant is not protected by a good faith defense

Good Faith Litigation

- If the transferee does conduct a diligent investigation and that investigation "aggravates, rather than allays, the concerns placing the transferee on inquiry notice, then no 'good faith' defense is supported." *Bayou II,* 396 B.R. at 846

- The transferee's own reactions (e.g., information spurs action) may support a finding that the transferee was on inquiry notice
  - Brings subjectivity into the good faith defense

Good Faith Litigation

- The *Bayou* case provides an extensive discussion of the "good faith" component of Bankruptcy Code § 548(c)
  - *Bayou* shows a shift in the courts – a softer stance on inquiry notice in light of increased complexity and deception of Ponzi schemes
- The *Bayou* case does not, however, give much instruction on the "value" requirement

Good Faith Litigation

- But unlike "good faith," the term "value" is defined in Bankruptcy Code § 548(d)(2)(A)

- "'[V]alue' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor" 11 U.S.C. § 548(d)(2)(A)

Perkins v. Haines, 661 F.3d 623 (11th Cir. 2011)

- Trustee brought an adversary proceeding seeking to avoid and recover certain fraudulent transfers made to **equity investors** who had invested in the underlying Ponzi scheme
- The defendant-investors alleged that they acted in good faith and that the transfers were made to them "for value" (like any other investor of principal)
- The question became whether "for value" entitles investors in a Ponzi scheme to keep all of the payments made to them by the debtor in connection with the scheme

For Value

- Eleventh Circuit (*Perkins*) held that the *form* of the investment— either as a direct payment giving rise to a debt claim, or an equity investment — is irrelevant to application of the rule

- Where the *substance* of the transaction reveals an investor who was defrauded into participating in a Ponzi scheme, the initial investment will be considered made "for value," and will be immune from recovery by the trustee

A Preference for Ponzi Schemes

- Preference claims can be difficult to bring because of the lag time between the withdrawal of funds and the filing of the bankruptcy case
- Preference claims under Bankruptcy Code § 547 require an antecedent debt as a predicate fact
- A prior investment in the Ponzi scheme is considered an antecedent debt up to the amount of that investment
- Thus, the trustee may generally only bring a preference claim to recover transfers that constituted the return of an investor's principal, and not to recover fictitious profits

A Preference for Ponzi Schemes

- There is no good faith defense to preference claims
- Trustee is not required to plead or prove that the investor was on inquiry notice to recover preference monies (cheaper to pursue preference action)
- In Ponzi scheme cases, debtor is presumed to be insolvent from day 1 of the scheme

A Preference for Ponzi Schemes

- A trustee can rely on the Ponzi scheme insolvency presumption seen in fraudulent transfers to meet his or her burden in a preference action
- As such, establishing a preference action in the context of a Ponzi scheme is usually a very easy process with none of the defenses really measuring up to defeat the claim

How Much Did They Know and When Did They Know It?

- The bulk of *Madoff* cases are "clawback" lawsuits against former Madoff customers alleged to have received false profits (output > input)

- Other lawsuits are against large banks and financial institutions alleged to be "feeder funds" that steered client money to Madoff
  - Trustee accused the defendants of ignoring red flags about Madoff's fraud, and such willful blindness led to more fees or commissions

How Much Did They Know and When Did They Know It?

- Feeder Funds have largely defended their actions by arguing that the trustee failed to show that anyone at the bank had ***actual knowledge*** of Madoff's crimes, or ***deliberately collaborated*** with Madoff to win banking fees

Recent Developments in Madoff Feeder Fund Cases

Picard v. Merkin, *(In re Bernard L. Madoff Inv. Securities, LLC), SIPA Liquidation Case No. 08-01789 (BRL), Adv. Proc. No. 09-1182 (BRL) (S.D.N.Y. Aug. 31, 2011)*

Picard v. Katz, *No. 11 Civ. 3605 (JSR), 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011)*

Picard v. JPMorgan Chase, et al., *No. 11 Civ. 00913 (CM) (S.D.N.Y. Nov. 1, 2011)*

Picard v. UBS S.A., *No. 11 Civ. 04213 (S.D.N.Y. Nov. 1, 2011)*

Unsafe Waters

- *Picard v. Merkin (In re Bernard L. Madoff Investment Securities, LLC)*: District court ruled that the complaint filed by Madoff trustee alleging fraudulent transfers based on both actual and constructive fraud, could survive a motion to dismiss
  - Both NY Law and Bankruptcy Code put focus on the intent of the debtor-transferor that matters, not the intent of the transferee
    - Noted that New York law poses a closer question.
  - Section 546(e) safe harbor defense isn't a free pass because bankruptcy court had yet to rule on application of safe harbor

Safe at the Base

- *Picard v. Katz:* district court dismissed all of Picard's claims except the actual fraud and equitable subordination claims, in part by finding that Madoff's firm "was a registered securities brokerage firm, a fact that directly invokes certain 'safe harbor' provisions of the Bankruptcy Code . . . ."

- Judge Rakoff decided as a matter of law that bankruptcy Code § 546(e) had kicked in, thereby eliminating Picard's preference and constructive fraud claims

Safe at the Base

- *Katz* also held that investors' principal was safe from recovery absent any actual bad faith by an investor, but that the fictional profits might be recovered by trustee

- The court then explained that mere inquiry notice that fraud was afoot was not sufficient to defeat good faith defense

- Only willful blindness to the fraud would "constitute a lack of good faith"

Following Rakoff's Lead

- SDNY Judge McMahon threw out most of a $19.9 billion lawsuit against JPMorgan Chase and a $2 billion case against UBS S.A.
- Held that trustee had no power to pursue common law claims against the banks
  - Such claims properly belong to former Madoff customers
  - Judge returned what is left of the cases to the bankruptcy court

Following Rakoff's Lead

- Judge McMahon followed the earlier decision by Judge Rakoff
- Likened trustee's argument to a garage owner trying to sue on behalf of a customer whose car got scratched while stuck in traffic, before it was parked in the garage
- "What interest could the garage possibly have in going after the stranger?…The garage would have no legal standing to vindicate that injury."