

THE BATTLE OVER FORFEITED ASSETS WHEN A BANKRUPTCY CASE IS PENDING

Hon. Steven Rhodes
United States Bankruptcy Judge
Eastern District of Michigan

These materials are updated from previous materials prepared jointly with:

Kathy Bazoian Phelps
Danning, Gill, Diamond & Kollitz, LLP
1900 Avenue of the Stars, 11th Floor
Los Angeles, CA 90067
(310) 277 0077
www.dgdk.com

These materials are condensed and adapted from

The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes
By Kathy Bazoian Phelps and Hon. Steven Rhodes
LexisNexis 2012
For more information, go to:
www.ThePonziBook.com

When the government has seized the assets of a fraudster in a civil or criminal forfeiture proceeding, defrauded victims turn to the government for compensation from those assets, while third parties may assert interests in those same assets. These materials address the rights of bankruptcy trustees and third party to assert an interest in property subject to a criminal or civil forfeiture proceeding.

Additionally, many issues arise when forfeiture proceedings run parallel to civil and bankruptcy Ponzi cases. To facilitate coordination between the government's criminal proceedings and civil Ponzi proceedings, cooperation agreements are becoming more common.

I. Criminal and Civil Forfeiture Proceedings

Criminal forfeiture is an *in personam* action against the defendant, by which the government takes property as a punishment for a criminal act.¹ The property that is subject to forfeiture includes proceeds traceable to the criminal act.²

Procedures are in place for third parties to claim an interest in property subject to criminal forfeiture. In summary, a third party cannot contest a criminal forfeiture allegation in the forfeiture proceeding itself and may not commence an ancillary proceeding to assert an interest until entry of a preliminary order of forfeiture is entered in the proceeding as between the criminal defendant and the government. Such a preliminary order will become final if there is

¹ *United States v. Bajakajian*, 524 U.S. 321, 330, 118 S. Ct. 2028, 2030 (1998); *Libretti v. United States*, 516 U.S. 29, 41, 116 S. Ct. 356, 364 (1995).

² 18 U.S.C. § 981(a)(1)(C). *See, e.g., United States v. Rothstein (In re Rothstein Rosenfeldt, Adler, P.A.)*, 717 F.3d 1205, 1211 (11th Cir. 2103):

While the plea agreement and preliminary order of forfeiture both equivocate on the point, it seems to us from the surrounding documents that, in seeking the forfeiture of the law firm's bank accounts, the Government proceeded under the theory that the accounts comprised the proceeds of Rothstein's Ponzi scheme. We have said that proceeds of crime constitute a defendant's "interest" in property, *United States v. Conner*, 752 F.2d 566, 575–76 (11th Cir. 1985); for this reason, they can be forfeited in an *in personam* proceeding in a criminal case.

not a successful ancillary challenge.

Civil forfeiture is an *in rem* action against the property sought to be forfeited.³ The effect of a civil forfeiture is that the government takes the “guilty property” because the property was used in the crime.⁴ The government bears the initial burden of showing probable cause that the property sought to be forfeited is “involved in” or “traceable to” certain fraudulent activity.⁵ If a party asserts ownership of the property, the burden then shifts to that party to prove that the property is not subject to forfeiture.⁶

II. Impact of Bankruptcy Filing on Forfeiture Proceeding

A. Exception to Automatic Stay in Bankruptcy for Forfeiture Action

Forfeiture actions brought by the government are excepted from the automatic stay in bankruptcy.⁷ Section 362(b)(4) of the Bankruptcy Code excepts from the automatic stay in bankruptcy any forfeiture action against the property of a Ponzi debtor. That section creates an exception to the automatic stay for “the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit’s police or regulatory power[.]”⁸

³ *United States v. Usery*, 518 U.S. 267, 116 S. Ct. 2135 (1996).

⁴ *Bajakajian*, 524 U.S. at 329-30, 118 S. Ct. 2034.

⁵ 18 U.S.C. § 981(b)(2).

⁶ *United States v. Contents of Account Numbers 208-06070 and 208-06068-1-2*, 847 F. Supp. 329, 335 (S.D.N.Y. 1994).

⁷ See also *In re James*, 940 F.2d 46, 50 (3d Cir. 1991); *United States v. Klein (In re Chapman)*, 264 B.R. 565, 571 (B.A.P. 9th Cir. 2001); *In re Hann*, 2009 U.S. Dist. LEXIS 79201, at *6-7 (E.D. Mich. Sept. 2, 2009); *Boricua Motors Leasing Corp. v. Puerto Rico*, 154 B.R. 834, 835 (D.P.R. 1993); *Jahn v. United States (In re WinPar Hospitality Chattanooga, LLC)*, 404 B.R. 291, 297 (Bankr. E.D. Tenn. 2009); *Brewer v. United States (In re Brewer)*, 209 B.R. 575, 575 (Bankr. S.D. Fla. 1996); *Smith v. Alabama (In re Smith)*, 176 B.R. 221, 222 (Bankr. N.D. Ala. 1995); but see *Georgia v. Bell (In re Bell)*, 215 B.R. 266, 274 (Bankr. N.D. Ga. 1997) (“[T]he State of Georgia’s pending civil forfeiture action against property of the Debtors’ estate remains stayed, notwithstanding Bankruptcy Code section 362(b).”); *Sachs v. Ryan (In re Ryan)*, 15 B.R. 514, 519 (Bankr. D. Md. 1981).

⁸ *Id.*

B. Forfeited Property Is Not Property of the Bankruptcy Estate - The Relation Back Doctrine

Ordinarily, when a Ponzi perpetrator files a bankruptcy case, all of the perpetrator's property on the date of filing becomes property of the bankruptcy estate.⁹ Accordingly, it is clear that if a forfeiture order is entered before a bankruptcy case is filed, the forfeited property does not become property of the estate.¹⁰

However, a judgment of forfeiture relates back to the date of the offense.¹¹ Accordingly, the prevailing view is that property that becomes the subject of a forfeiture order that is entered after a bankruptcy petition is excluded from the bankruptcy estate.¹²

C. Transfer Made Before Forfeiture Is Subject to Avoidance Powers

An order forfeiting the funds in a bank account does not forfeit the funds that the debtor had previously paid from that account to investors and that the trustee subsequently recovers from those investors as fraudulent transfers, and it is also clear that the forfeiture order does not divest the trustee of such claims.¹³

D. Bankruptcy Discharge Does Not Preclude Civil Forfeiture

⁹ 11 U.S.C. § 541(a).

¹⁰ *Thaler v. Cnty. of Nassau Dist. Attorney (In re Wolfson)*, 261 B.R. 369, 375 (Bankr. E.D.N.Y. 2001).

¹¹ 18 U.S.C. § 981(f); 21 U.S.C. § 853(c) ("All right, title, and interest in property described in subsection (a) [of this section] vests in the United States upon the commission of the act giving rise to forfeiture under this section."); *see also* *United States v. Monsanto*, 491 U.S. 600, 607, 109 S. Ct. 2657, 2662 (1989); *Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617, 625 n.4, 109 S. Ct. 2646, 2652 n.4 (1989); *Rothstein*, 717 F.3d at 1212.

¹² *United States v. Erpenbeck*, 682 F.3d 472, 477 (6th Cir. 2012); *United States v. Pelullo*, 178 F.3d 196, 203 (3d Cir. 1999); *see also* *United States v. Klein (In re Chapman)*, 264 B.R. 565, 572 (B.A.P. 9th Cir. 2001); *Jahn v. United States (In re Winpar Hospitality Chattanooga, LLC)*, 401 B.R. 289, 293 (E.D. Tenn. 2009); *United States v. One Silicon Valley Bank Account 3300355711*, 549 F. Supp. 2d 940, 958 (W.D. Mich. 2008); *United States v. Foley*, 2006 U.S. Dist. LEXIS 98651, at *3-4 (S.D. Fla. Apr. 24, 2006), *aff'd*, 258 Fed. App'x 246 (11th Cir. 2007); *United States v. Zaccagnino*, 2006 WL 1005042, at *4 (C.D. Ill. Apr. 18, 2006); *Diversified Fiber Prods., Inc. v. United States (In re Thena, Inc.)*, 190 B.R. 407, 411 (D. Or. 1995); *Drummond v. Cnty. of Chouteau (In re Kurth Ranch)*, 122 B.R. 759, 763 (Bankr. D. Mont. 1991).

¹³ *Gowan v. The Patriot Grp., LLC (In re Dreier, LLP)*, 452 B.R. 391,409-14 (Bankr. S.D.N.Y. 2011); *see also* *Kapila v. Bible Baptist Coll. of Pa. (In re ATM Fin. Servs., LLC)*, 2011 Bankr. LEXIS 2421, at *2 (M.D. Fla. June 21, 2011).

Even though a debtor has obtained a discharge in a bankruptcy case, property held by that debtor may still be subject to civil forfeiture.¹⁴

III. Interests of Third Party Claimants in Forfeited Property

Once the government has commenced a civil or criminal forfeiture proceeding, a trustee, receiver, or an individual victim of the fraudulent scheme may seek to assert an interest in the forfeited property. Generally, there are two ways in which a claimant can assert an interest in property that is subject to forfeiture.¹⁵ The first way is that the claimant can assert a legal interest in the property. The second is to assert a constructive trust in the property. There are no provisions for a third party to challenge the criminal allegations in the first instance or to challenge whether the property was used in connection with the criminal activity, so a third party's rights are limited to proving an interest in the property itself.

A. Asserting a Legal Interest in Property Subject to Criminal Forfeiture

1. The Process

The process by which a claimant can assert a legal interest in forfeited property winds its way from a provision in the drug control laws.¹⁶ This path is outlined below.

The forfeiture statute states, “The forfeiture of property under this section, including any seizure and disposition of the property and any related judicial or administrative proceeding, shall be governed by the provisions of section 413 (other than subsection (d) of that section) of the Comprehensive Drug Abuse Prevention and Control Act of 1970 (21 U.S.C. [§] 853).”¹⁷

¹⁴ United States v. One 1988 Prevost Liberty Motor Home, 952 F. Supp. 1180,1211 (S.D. Tex. 1996).

¹⁵ 21 U.S.C. § 853(n).

¹⁶ 21 U.S.C. § 853(n).

¹⁷ 18 U.S.C. § 982(b)(1). Identically, 28 U.S.C. § 2461(c) states, “The procedures in section 413 of the Controlled Substances Act (21 U.S.C. [§] 853) apply to all stages of a criminal forfeiture proceeding[.]”

A claimant asserts a legal interest in forfeited property pursuant to a specific statutory procedure.¹⁸ Under this procedure, the first step is for the government to publish and serve notice of the forfeiture order and of the proposed disposition of the forfeited property.¹⁹ The claimant asserting a legal interest then has 30 days to petition the court for a hearing to adjudicate the validity of the alleged interest.²⁰

It must be noted that claimants are explicitly barred from intervening in a criminal forfeiture action in an attempt to establish that the property is not subject to forfeiture. The statute mandates, “[N]o party claiming an interest in property subject to forfeiture under this section may (1) intervene in a trial or appeal of a criminal case involving the forfeiture of such property under this section”²¹ The ancillary proceedings established in § 853(n) are the only means for a claimant to assert an interest in property subject to criminal forfeiture.²²

2. Vested Legal Title or *Bona Fide* Purchaser for Value

¹⁸ 21 U.S.C. § 853(n).

¹⁹ 21 U.S.C. § 853(n)(1).

²⁰ 21 U.S.C. § 853(n)(2). *See, e.g., Rothstein*, 717 F.3d at 1209-10 (“Before sentencing, on May 24, 2010, the Trustee petitioned the District Court pursuant to the ancillary hearing procedure provided by 21 U.S.C. § 853(n) to order the Government to return the RRA accounts held in Gibraltar Bank and TD Bank.”).

²¹ 21 U.S.C. § 853(k). That section also prohibits a party claiming an interest in property subject to forfeiture from commencing “an action at law or equity against the United States concerning the validity of his alleged interest in the property subsequent to the filing of an indictment or information alleging that the property is subject to forfeiture under this section.” *See also United States v. Cox*, 575 F.3d 352, 358 (4th Cir. 2009); *United States v. Nolasco*, 354 Fed. App’x 676, 678(3d Cir. 2009) (“When an *in personam* criminal forfeiture prosecution is initiated, a third party is barred from intervening in the criminal case”); *United States v. Porchay*, 533 F.3d 704, 710 (8th Cir. 2008).

²² *See* FED. R. CRIM. P. 32.2. Some courts consider an exception to this rule “where the delay between the entry of the property restraint and the criminal trial threatens to deprive a third party of its due process right to have a meaningful hearing at a meaningful time.” *See United States v. Petters*, 2010 U.S. Dist. LEXIS 128694, at *11 (D. Minn. Dec. 6, 2010) (citations and internal quotation marks omitted). In *Petters*, however, the court found no due process violation where the movant’s living expenses had been paid from forfeited funds while her claim was pending and the further delay would not be significant. *Id.* at *11. Addressing a similar request by a different claimant in the *Petters* case, the court came to a different result. *United States v. Petters*, 2011 U.S. Dist. LEXIS 13357 (D. Minn. Feb. 10, 2011). “Based on these circumstances and the possibility that Joan Catain may have an ownership interest in some of the assets frozen in the Catain Receivership, the Court will approve monthly payments of \$891 to Joan Catain during the pendency of the forfeiture proceedings.” *Id.* at *19.

The petitioner then must establish by a preponderance of the evidence that either the title was vested in the petitioner rather than the defendant, or that “the petitioner is a bona fide purchaser for value of the right, title, or interest in the property and was at the time of purchase reasonably without cause to believe that the property was subject to forfeiture under this section”²³

“[T]he statute provides that if a petitioner can prove by a preponderance of the evidence that (1) the petitioner has some interest in forfeited property and (2) that the defendant has an inferior interest (e.g., no interest) in forfeited property at the time of the commission of the acts which gave rise to the forfeiture of the property, then the petition has effectively challenged the forfeiture.”²⁴

In *United States v. Egan*, several claimants asserted superior legal interests in cash seized from the defendant’s vaults. The court denied the government’s motion to dismiss, concluding that the claimants’ petitions adequately stated claims that the defendant’s possession of the cash was merely a bailment for them and that the funds subject to the bailment had not been misappropriated or commingled, and were therefore not the proceeds of the defendant’s fraud.²⁵ The court also rejected the government’s argument that returning the claimants’ funds to them would be inequitable to the defendant’s victims. The court stated:

The Government’s argument in favor of the “equitable” distribution of the property fails because it is without support in the criminal forfeiture statute, which gives third-parties the right to

²³ 21 U.S.C. § 853(n)(6)(A) & (B).

²⁴ *United States v. Rothstein*, 2010 U.S. Dist. LEXIS 69180, at *20 (S.D. Fla. July 9, 2010) (citation omitted), *rev’d on other grounds*, 717 F.3d 1205 (11th Cir. 2013); *see also* *United States v. Egan*, 2011 U.S. Dist. LEXIS 84892, at *19 (S.D.N.Y. Aug. 2, 2011); *United States v. Edwards*, 2011 U.S. Dist. LEXIS 54946, at *14 (N.D. Ga. Apr. 18, 2011), *Mag. report and recommendation adopted*, 2011 U.S. Dist. LEXIS 54943 (May 23, 2011) (rejecting the petitioners’ claim to forfeited property “because they cannot show that the title to any of the properties is vested in them rather than Defendant, or that their title is superior to Defendant’s title, because each of the properties was acquired after the illegal activity with illegally derived proceeds.”).

²⁵ *Egan*, 2011 U.S. Dist. LEXIS 84892, at *20.

recover property in which they have a legal interest. 21 U.S.C. § 853(n)(6)(A)-(B). The statute contains no distinction between those who are victims of fraud and those who are not victims of fraud; under the plain language of the statute, any third party with a legal interest in property superior to the defendant's may recover that property.²⁶

3. Standing to Assert a Claim in a Criminal Forfeiture Proceeding

“Under § 853(n), only a person asserting a ‘legal interest in property which has been ordered forfeited’ may petition the Court for redress. This ‘legal-interest’ requirement ‘impose[s] a statutory-standing requirement on claimants.’”²⁷

A legal interest may be established as set forth in Section 16:05[2][b]. Unsecured general creditors “lack standing as claimants of forfeited assets,” because they “cannot claim an interest in any particular asset.”²⁸

B. Asserting Legal Interest in Property Subject to Civil Forfeiture

1. The Process

A somewhat similar procedure is established for a claimant to assert a legal interest in property subject to civil forfeiture. Within 30 days after service of the government’s civil forfeiture complaint, “any person claiming an interest in the seized property may file a claim asserting such person’s interest in the property in the manner set forth in the Supplemental Rules for Certain Admiralty and Maritime Claims”²⁹ The contents of this claim are set forth in Rule G(5)(A) of Supplemental Rules for Certain Admiralty and Maritime Claims. The claimant

²⁶ *Id.* at 25-26.

²⁷ *United States v. White*, 779 F. Supp. 2d 984, 989 (D. Minn. 2011) (quoting *United States v. Timley*, 507 F.3d 1125, 1129 (8th Cir. 2007)).

²⁸ *DSI Assocs. LLC v. United States*, 496 F.3d 175, 184 (2d Cir. 2007); *White*, 779 F. Supp. 2d, at *989; *United States v. Dempsey*, 55 F. Supp. 2d 990, 993 (E.D. Mo. 1998).

²⁹ 18 U.S.C. § 983(a)(4)(A).

then has 20 days to file an answer to the government's forfeiture complaint.³⁰

2. Innocent Owner Defense

A third party may seek to assert superior interests in the forfeited property under the “innocent owner” defense.”³¹ The statutory basis for the “innocent owner defense is:

An innocent owner's interest in property shall not be forfeited under any civil forfeiture statute. The claimant shall have the burden of proving that the claimant is an innocent owner by a preponderance of the evidence.³²

For a property interest in existence at the time the illegal conduct giving rise to forfeiture took place, an “innocent owner” is an owner who “(i) did not know of the conduct giving rise to forfeiture; or (ii) upon learning of the conduct giving rise to the forfeiture, did all that reasonably could be expected under the circumstances to terminate such use of the property.”³³

For a property interest acquired after the conduct giving rise to the forfeiture has taken place, an “innocent owner” is an owner who “(i) was a bona fide purchaser or seller for value (including a purchaser or seller of goods or services for value); and (ii) did not know and was

³⁰ 18 U.S.C. § 983(a)(4)(B).

³¹ 18 U.S.C. § 983(d)(1).

³² *Id.*

³³ 18 U.S.C. § 983(d)(2)(A); *see also* 18 U.S.C. § 983(d)(2)(B), which states:

(i) For the purposes of this paragraph, ways in which a person may show that such person did all that reasonably could be expected may include demonstrating that such person, to the extent permitted by law—

(I) gave timely notice to an appropriate law enforcement agency of information that led the person to know the conduct giving rise to a forfeiture would occur or has occurred; and

(II) in a timely fashion revoked or made a good faith attempt to revoke permission for those engaging in such conduct to use the property or took reasonable actions in consultation with a law enforcement agency to discourage or prevent the illegal use of the property.

(ii) A person is not required by this subparagraph to take steps that the person reasonably believes would be likely to subject any person (other than the person whose conduct gave rise to the forfeiture) to physical danger.

reasonably without cause to believe that the property was subject to forfeiture.”³⁴ The statute does not contain a requirement that the “innocent owner” establish that it acquired the property for value, which is in contrast to an assertion of rights in a criminal forfeiture proceeding.

To successfully assert the innocent owner defense, however, the owner must demonstrate a lack of any knowledge of the illegal activity; turning a blind eye or willful blindness is equated with knowledge of the illegal activity.³⁵

3. Standing to Assert a Claim in a Civil Forfeiture Proceeding

As in every matter in federal court, a claimant to property in a civil forfeiture action must establish its standing to assert its claim.³⁶ Generally, however, this should not be an onerous burden, because it only requires the claimant to follow the applicable procedures for asserting its claim and to allege an interest in the subject property, such as an ownership, possessory or security interest.³⁷ However, unsecured creditors are specifically excluded from the definition of

³⁴ 18 U.S.C. § 983(d)(3)(A) provides:

(A) With respect to a property interest acquired after the conduct giving rise to the forfeiture has taken place, the term “innocent owner” means a person who, at the time that person acquired the interest in the property –

(i) was a bona fide purchaser or seller for value (including a purchaser or seller of goods or services for value); and

(ii) did not know and was reasonably without cause to believe that the property was subject to forfeiture.

³⁵ *United States v. All Monies (\$4,477,048.62) In Account No. 90-3617-3, Israel Discount Bank, New York, N.Y.*, 754 F. Supp. 1467, 1477 (D. Haw. 1991).

³⁶ *See, e.g., United States v. \$148,840.00 in U.S. Currency*, 521 F.3d 1268, 1273 (10th Cir. 2008) (“As the party seeking to intervene in an in rem forfeiture action, a claimant bears the burden of establishing his own constitutional standing at all stages in the litigation.”).

³⁷ *Id.*; *see also United States v. 8 Gilcrease Lane*, 638 F.3d 297, 299 n.1 (D.C. Cir. 2011) (“Rule C(6) of the Supplemental Rules for Admiralty or Maritime Claims and Asset Forfeiture Actions requires a claimant in a forfeiture proceeding to file a “verified statement of right or interest” in the property at stake . . . This statement is known as a ‘verified claim’ and ‘is essential to confer[ing] statutory standing upon a claimant in a forfeiture action.’”) (quoting *United States v. \$125,938.62*, 370 F.3d 1325, 1328 (11th Cir. 2004) (per curiam) and *United States v. \$175,918.00 in U.S. Currency*, 755 F. Supp. 630, 632 (S.D.N.Y.1991)) (internal quotation marks omitted); *United States v. Real Property Located at 475 Martin Lane*, 545 F.3d 1134, 1140 (9th Cir. 2008) (“[A] claimant must allege that he has an ownership or other interest in the forfeited property. In their pleadings, the Kim Claimants specifically alleged an ownership interest in the May 2004 properties, which was sufficient at the initial

owner.³⁸ “Unlike secured creditors, general creditors cannot claim an interest in any particular asset that makes up the debtors’ estate.”³⁹

The standing of a claimant to assert a legal interest in property subject to civil forfeiture was discussed in depth in the Ponzi case of *United States v. Assets Described in “Attachment A” to the Verified Complaint Forfeiture in Rem.*⁴⁰ In that case, Kinetic filed a claim asserting that its judgment against the Ponzi perpetrators gave it an interest in the assets at issue. The government moved to dismiss Kinetic’s claim. It asserted that Kinetic lacked standing to assert a claim against the property that was not titled to the Ponzi perpetrators, and that as to the property that was titled to them, Kinetic could not show that it was an “innocent owner” under § 983(d).⁴¹

The court denied the government’s motion. First, the court discussed the two distinct types of standing that must be met - “Article III standing, which is at issue in every federal case and requires that there be an actual ‘case’ or ‘controversy,’ and ‘statutory standing,’ which requires that a claimant satisfy statutory requirements.”⁴² Addressing Kinetic’s Article III standing to claim an interest in the untitled assets, the court stated, “a claimant must have a ‘facially colorable interest’ in the property at issue, and courts have repeatedly noted that this

stages of the litigation to establish that they had standing to challenge the civil forfeiture action.”) (citations and quotation marks omitted).

³⁸ 18 U.S.C. § 983(d)(6)(A) (“[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[.]”); *United States v. \$20,193.39 in U.S. Currency*, 16 F.3d 344, 346 (9th Cir. 1994) (“[F]ederal courts have consistently held that unsecured creditors do not have standing to challenge the civil forfeiture of their debtors’ property.”).

³⁹ *United States v. \$20,193.39 in U.S. Currency*, 16 F.3d 344, 346 (9th Cir. 1994); *see also United States v. One-Sixth Share*, 326 F.3d 36, 44 (1st Cir. 2003); *United States v. Watkins*, 320 F.3d 1279, 1283–84 (11th Cir. 2003).

⁴⁰ *United States v. Assets Described in “Attachment A” to the Verified Complaint Forfeiture in Rem*, 799 F. Supp. 2d 1319 (M.D. Fla. 2011).

⁴¹ *Id.*

⁴² *Id.* at 1322 (citing *United States v. \$38,000.00 Dollars in U.S. Currency*, 816 F.2d 1538, 1543-47 (11th Cir. 1987)).

standard is not difficult to satisfy.”⁴³ The court held that Kinetic did have Article III standing because it claimed an interest in whatever property was determined to be the property of the perpetrators, including any property the ownership of which was unresolved due to the perpetrators’ concealment of the true ownership.⁴⁴

On the other hand, in *United States v. \$7,206,157,717 on Deposit at JP Morgan Chase Bank, N.A.*, the court denied a motion by Fox, an investor in the Madoff Ponzi scheme, to intervene in a forfeiture action so that he could challenge a settlement between another investor, the estate of Jeffery Picower, and the government on its forfeiture claim against Picower’s estate.⁴⁵ The court found that Fox “has, at most, a contingent interest in forfeited funds, which is an insufficient interest on which to grant intervention as a matter of right.” The court concluded, “To allow those with, at most, contingent interests in a res to intervene would open the floodgates of intervention in forfeiture actions and thus would not serve the efficient administration of justice.”⁴⁶ The court then suggested, “In any case, the proper avenue for Fox to challenge Picard’s method of compensating Madoff’s victims is not with this case, but with the appeal by other net winners of the Bankruptcy Court’s decision approving of Picard’s method. That appeal is currently pending in the Second Circuit.”⁴⁷

On the issue of statutory standing under § 983, the court in *United States v. Assets Described in “Attachment A”* stated, “[S]tanding’ and ‘ownership’ are distinct concepts in civil forfeiture law. . . . Although the two issues are sometimes blurred in reported decisions, they

⁴³ *Id.* (citing *United States v. One-Sixth Share*, 326 F.3d 36, 41 (1st Cir. 2003), and *United States v. \$557,933.89, More or Less*, 287 F.3d 66, 79 (2d Cir. 2002)).

⁴⁴ *Assets Described in “Attachment A,”* 799 F. Supp. 2d at 1322.

⁴⁵ *United States v. \$7,206,157,717 on Deposit at JP Morgan Chase Bank, N.A.*, 274 F.R.D. 125, 126–27 (S.D.N.Y. 2011).

⁴⁶ *Id.* at 127.

⁴⁷ *Id.*

should properly remain separate because they pertain to different stages of the forfeiture case.”⁴⁸ It concluded, “Kinetic has statutory standing because it has complied with the requirements of 18 U.S.C. § 983(a)(2) and Rule G(5)(a) regarding the filing of a claim. The definition of ‘owner’ and the elements of the ‘innocent owner defense’ set forth in 18 U.S.C. § 983(d) do not relate to the standing inquiry[.]”⁴⁹

Many courts find that standing can be acquired by asserting a constructive trust.

Almost all circuits have recognized that, in appropriate situations, a constructive trust theory can provide at least Article III standing to challenge a forfeiture. *See, e.g., United States v. Shefton*, 548 F.3d 1360, 1365 (11th Cir. 2008) (“We agree with the large majority of courts that have determined (1) that a constructive trust, despite being an equitable remedy, constitutes a ‘legal right, title, or interest in . . . property’ . . . and (2) that a constructive trust can render a forfeiture order invalid[.]”) (citing cases). *Shefton* recognized that “[o]nly one circuit court has concluded that a constructive trust cannot invalidate a forfeiture order.” *Id.* (citing *United States v. BCCI Holdings (Luxembourg), S.A.*, 46 F.3d 1185, 1190-91 (D.C. Cir. 1995)).⁵⁰

C. Asserting a Constructive Trust

Outside of the Ponzi context, some courts find 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. These courts hold that, therefore, the property impressed with the trust is not subject to forfeiture.⁵¹ The Eleventh Circuit held in *United States v. Shefton* that a constructive trust is a cognizable “legal interest” sufficient to assert an interest under the forfeiture statutes.⁵²

⁴⁸ *Assets Described in “Attachment A,”* 799 F. Supp. 2d at 1322 (citations omitted).

⁴⁹ *Id.*

⁵⁰ *United States v. One Hundred Thirty Three (133) United States Postal Service Money Orders*, 780 F. Supp. 2d 1084, 1096 (D. Haw. 2011).

⁵¹ *See, e.g., United States v. Shefton*, 548 F.3d 1360, 1366 (11th Cir. 2008); *United States v. \$4,224,958.57*, 392 F.3d 1002, 1004-05 (9th Cir. 2004); *Schwimmer*, 968 F.2d at 1574, 1582; *United States v. Marx*, 844 F.2d 1303, 1308 (7th Cir. 1988); *United States v. Campos*, 859 F.2d 1233, 1238-39 (6th Cir. 1988).

⁵² *Shefton*, 548 F.3d at 1366.

Several other circuits have similarly found that where property was taken from a third party by fraud, a constructive trust is imposed over the property held by the criminal defendant and the property is therefore not subject to forfeiture.⁵³

However, in *United States v. BCCI Holdings (Luxembourg)*, the court held, “[A] constructive trust may not be used to defeat the government’s forfeiture claim.”⁵⁴ The *Shefton* court, however, rejected the *BCCI* court’s holding that a constructive trust does not arise until determined by a court.⁵⁵ The *Shefton* court further criticized the *BCCI* court’s conclusion that the third party must establish that its interest is superior to the government’s, as opposed to superior to the criminal defendant’s.⁵⁶

When imposing such a trust impairs the recovery of other victims from limited forfeiture assets, courts are more likely to conclude that the remedy is inequitable and therefore to refuse it.⁵⁷

In the Ponzi context, for the same reason, investors’ attempts to use the constructive trust theory to protect against forfeiture are generally not successful. “[E]quity demands that no victim be given priority over any other similarly situated victim[.]”⁵⁸

⁵³ See, e.g., *United States v. \$4,224,958.57*, 392 F.3d 1002, 1004-05 (9th Cir. 2004); *United States v. Marx*, 844 F.2d 1303, 1308 (7th Cir. 1988); *United States v. Campos*, 859 F.2d 1233, 1238-39 (6th Cir. 1988); *United States v. Schwimmer*, 968 F.2d 1570, 1574 (2d Cir. 1992).

⁵⁴ *United States v. BCCI Holdings (Luxembourg), S.A.*, 46 F.3d 1185, 1190-91 (D.C. Cir. 1995).

⁵⁵ *Shefton*, 548 F.3d at 1366.

⁵⁶ *Id.*; see also 21 U.S.C. § 853(n)(6)(A) (criminal forfeiture order may be vacated if “the petitioner has a legal right, title, or interest in the property . . . [that] was superior to any right, title, or interest of the defendant at the time of the commission of the acts which gave rise to the forfeiture”).

⁵⁷ See, e.g., *United States v. Andrews*, 530 F.3d 1232, 1238-39 (10th Cir. 2008); *United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996).

⁵⁸ *United States v. Ramunno*, 599 F.3d 1269, 1275 (11th Cir. 2010); see also *United States v. Dreier*, 682 F. Supp. 2d 417, 422 (S.D.N.Y. 2010) (rejecting the equitable claim of one victim to a priority in restitution); *Cunningham v. Brown*, 265 U.S. 1, 12-13, 44 S. Ct. 424, 427 (1924); *Liberte Capital Grp., LLC v. Capwill*, 148 Fed. App’x 426, 436 (6th Cir. 2005) (“[T]he district court was not obliged to impose a constructive trust if it determined that one would be inequitable.”); *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002) (“[T]he use of a pro rata distribution has been deemed especially appropriate for fraud victims of a ‘Ponzi scheme[.]’”);

The *Ramunno* court summarized the issue as applied in a Ponzi scheme as follows:

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.⁵⁹

III. Competition Between Parallel Forfeiture Proceedings and Civil Insolvency Proceedings to Compensate Ponzi Victims

Bankruptcy and receivership proceedings can be used to compensate victims as well as other general unsecured creditors for their losses in Ponzi schemes. In parallel criminal proceedings, the government has been utilizing civil and criminal forfeiture proceedings with increasing regularity to distribute assets to victims. Although there are advantages and disadvantages to both types of proceedings, many outside of the government have criticized forfeiture remission and restoration proceedings as a process for compensating victims, as well as the criminal restitution process. The criticisms focus on the following issues:

First, there is no judicial review of the government's distribution of forfeited assets in the remission process, causing those outside the government concern regarding the handling and ultimate disposition of forfeited assets. To the contrary, there is close judicial review of distributions made to creditors in bankruptcy cases and equity receiverships. The Department of Justice website, however, endeavors to provide publically available data regarding the disposition of forfeited assets in pending cases.⁶⁰

United States v. Durham, 86 F.3d 70, 73 (5th Cir. 1996); *SEC v. Elliott*, 953 F.2d 1560, 1569-70 (11th Cir. 1992); *Rollins v. Neilson (In re Cedar Funding, Inc.)*, 408 B.R. 299, 315 (Bankr. N.D. Cal. 2009) (holding that the bankruptcy principle of ratable distribution outweighs a victim's right to a constructive trust); *In re Schneider*, 2008 Bankr. LEXIS 2744, at *8 (Bankr. N.D. Cal. Sept. 26, 2008) (“[T]he committee was in breach of its fiduciary duties by pursuing a constructive trust theory since it appeared that the remedy would benefit the defrauded investors solely to the derogation of the interests of other unsecured creditors of the estate.”).

⁵⁹ *Ramunno*, 599 F.3d at 1275.

⁶⁰ See

<http://www.justice.gov/jmd/afp/01programaudit/fy2010-afs-rpt.pdf>;

Second, there does not appear to be a time limit to complete the administration of forfeited property and no oversight over that process, whereas the Office of the United States Trustee oversees bankruptcy trustees, and the courts presiding over the receivership cases oversee the receivers that they appoint, both seeking to ensure that the insolvency proceedings do not linger indefinitely and that distributions are made to creditors.

Third, because the definition of “victim” under the criminal statutes is significantly narrower than the classification of general unsecured creditors under the Bankruptcy Code, creditors affected by a Ponzi scheme that are not classified as a “victim” for forfeiture purposes will not receive distributions from forfeited assets. On the other hand, the Bankruptcy Code contains a priority scheme for distributions to all creditors, and the distribution scheme that a receiver proposes is subject to the approval of the court after all interested parties have an opportunity to be heard.

The competing objectives of the government to pay “victims,” on the one hand, and trustees and receivers to pay “creditors,” on the other hand, leads to tension regarding the distribution of recovered funds. Forfeiture and restitution exclude the claims of commercial creditors whose claims remain unpaid when a Ponzi scheme collapses. The government’s forfeiture action has as some of its primary goals punishment of the wrongdoer and restitution to the defrauded victims. The Bankruptcy Code, on the other hand, seeks equitable distribution to all creditors.⁶¹ There is no provision in the forfeiture statutes for payment to non-victims, including general unsecured creditors who have also been harmed by a Ponzi scheme, and there

<http://www.justice.gov/jmd/afp/01programaudit/index.htm>;

<http://www.justice.gov/jmd/afp/02fundreport/2010affr/index.html>

⁶¹ *Howard Delivery Serv. v. Zurich Am. Ins. Co.*, 547 U.S. 651 (2006) (“The Bankruptcy Code aims, in the main, to secure equal distribution among creditors. Preferential treatment of a class of creditors is in order only when authorized by Congress.”).

is no provision in the Bankruptcy Code for priority payment to defrauded victims.

Fourth, trustees in bankruptcy generally feel that they are better equipped to marshal the tangible assets of the Ponzi perpetrator by engaging brokers, conducting auctions, or otherwise maximizing the value of the assets. The government, on the other hand, feels that it may be better situated to seize the assets in a quick forfeiture proceeding and thereafter liquidate those assets more affordably than a trustee.

Fifth, the criminal statutes provide that the government can choose to distribute forfeited assets to its own law enforcement agencies,⁶² causing concern that the forfeited assets might not actually be returned to victims. In contrast, bankruptcy and receivership proceedings are subject to statutory distribution guidelines and court review and supervision, and all funds are returned to creditors after payment of administrative costs.

Sixth, by focusing on the perpetrator's tangible assets, forfeiture and restitution exclude the proceeds of actions against other insiders and third parties. Trustees and receivers, on the other hand, can seek to avoid certain types of transfers pursuant to the Bankruptcy Code or applicable state law, and may also seek recovery for damages on various legal theories where the assets themselves have already disappeared. As the Seventh Circuit observed in addressing forfeiture issues in the Ponzi case of *United States v. Frykholm*:

[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

⁶² 21 U.S.C. § 881(e).

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.⁶³

This issue was also addressed in *SEC v. Madoff*.⁶⁴ In that case, several of Madoff's victims asked for a modification of the preliminary injunction to permit them to file an involuntary bankruptcy petition.⁶⁵ The court rejected the objections asserted by the SEC, the United States Attorney, and the SIPA trustee, concluding:

No opponent to the relief sought by the motion offers as familiar, comprehensive, and experienced a regime as does the Bankruptcy Code for staying the proliferation of individual lawsuits against Mr. Madoff individually, marshaling his personal assets other than those criminally forfeitable, and distributing those assets among his creditors according to an established hierarchy of claims.

A Bankruptcy Trustee has direct rights to Mr. Madoff's individual property, with the ability to maximize the size of the estate available to Mr. Madoff's creditors through his statutory authority to locate assets, avoid fraudulent transfers, and preserve or increase the value of assets through investment or sale, as well as provide notice to creditors, process claims, and make distributions in a transparent manner under the procedures and preferences established by Congress, all under the supervision of the Bankruptcy Court.⁶⁶

These tensions were also addressed in *United States v. Dreier*:

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

⁶³ *United States v. Frykholm*, 362 F.3d 413, 417 (7th Cir. 2004).

⁶⁴ *SEC v. Madoff*, 2009 U.S. Dist. LEXIS 30712 (S.D.N.Y. Apr. 10, 2009).

⁶⁵ *Id.* at *3.

⁶⁶ *Id.* at *3-4.

law, securities law, and bankruptcy law – that cannot always be reconciled without some friction.⁶⁷

V. Cooperation Agreements

By entering into cooperation agreements, trustees, receivers, and the government have begun to address the conflicts between the differing distribution schemes and the conflicting interests in the forfeited property.

In *Ritchie Special Credit Investments, Ltd. v. United States Trustee*, which addressed the Petters Ponzi scheme, the Eighth Circuit noted that “the district court’s receivership order requires [the receiver] to coordinate with representatives of the United States Attorney’s office and Court personnel as needed to ensure that any assets subject to the terms of this Order are available for criminal restitution, forfeiture, or other legal remedies.”⁶⁸

In *United States v. Petters*, the court on its own motion chose to utilize the bankruptcy process over restitution proceedings to redress the claims of victims.⁶⁹ The court noted, “it would be a waste of resources to order restitution of pennies on the dollar (at best) when most victims have filed, or will be filing, parallel claims in bankruptcy proceedings.”⁷⁰

A coordination agreement and several other agreements were also reached and approved in the Dreier Ponzi case.⁷¹ Those agreements provided:

1. The government released to the chapter 11 trustee its forfeiture claim to 97 pieces of

⁶⁷ *United States v. Dreier*, 682 F. Supp. 2d 417, 418 (S.D.N.Y. 2010); see also *United States v. Guidant LLC*, 708 F. Supp. 2d 903, 920 (D. Minn. 2010) (“The forfeiture remission process can be, to say the least, cumbersome”); Mary Jo Heston, et al., *Bankruptcy Fraud: A Roundtable Discussion*, 6 AM. BANKR. INST. L. REV. 275 (1998); Myron M. Sheinfeld, et al., *Civil Forfeiture and Bankruptcy: The Conflicting Interests of the Debtors, Its Creditors and the Government*, 69 AM. BANKR. L.J. 87, 101 (1995).

⁶⁸ *Ritchie Special Credit Investments, Ltd. v. United States Trustee*, 620 F.3d 847, 854 (8th Cir. 2010) (citation and internal quotation marks omitted).

⁶⁹ *United States v. Petters*, 2010 U.S. Dist. LEXIS 55040 (D. Minn. June 3, 2010).

⁷⁰ *Id.* at *14-15.

⁷¹ *United States v. Dreier*, 682 F. Supp. 2d 417 (S.D.N.Y. 2010).

artwork that it could not trace to proceeds of Dreier's fraud.

2. The government will not seek to forfeit the proceeds of the trustee's avoidance actions.

3. The trustee agrees not to contest the government's forfeiture of the properties in the preliminary forfeiture order.

4. The trustee will not challenge the forfeiture of over \$30 million to be disgorged by CGO Capital Partners.

5. GSO will pay the chapter 11 trustee \$9.25 million and the chapter 7 trustee \$250,000, in exchange for the trustees' promises not to sue GSO and the entry of an order to bar other parties from suing GSO.

6. Upon the sale of three real properties by the chapter 7 trustee, the trustee may retain 10% of the proceeds; and

7. The government agrees not to seek forfeiture of funds paid to Fortress Investment Group LLC, which had invested in Dreier's fictitious notes and lost \$84 million.⁷²

The government also cooperated with a parallel receivership proceeding in *United States v. Moreland*.⁷³ "At the prosecution's request, the district court also deferred the issue of restitution pending a determination by a receiver in a related civil case, brought by the U.S. Securities and Exchange Commission, of the identities of victims and the amounts of their losses."⁷⁴

The Business Law Section of the American Bar Association has under consideration a proposed a resolution to encourage these cooperation agreements, entitled, "Resolution to

⁷² *Id.* at 418-19.

⁷³ *United States v. Moreland*, 622 F.3d 1147, 1154 (9th Cir. 2010).

⁷⁴ *Id.*

Encourage Inter-Court and Inter-Party Cooperation and Education in Matters Involving Asset Forfeiture and Bankruptcy.” It is attached.

Much more information is found in the United States Attorneys Bulletin, Vol. 61, No. 5, September 2013, and especially in the chapter entitled, “Interplay Between the Forfeiture and Bankruptcy Proceedings” by Alice W. Dery. This Bulletin is also attached.