SUPPLEMENTING THE TOOLS IN THE TRUSTEE'S TOOLBOX

by

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Our new book, *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes,*[3] although focused on the legal issues that Ponzi schemes spawn, is of significant value outside that narrow world. Chapter 7 trustees and their attorneys will find that the book is a significant resource in fulfilling their duty to maximize the estate's assets for the creditors in their cases. In this article, we present three brief, slightly modified excerpts from our book discussing powerful tools that trustees can use:

- Obtaining the release of documents from the government as an important discovery tool;
- Bringing alter ego claims to broaden the pool of target defendants; and
- Freeing up equity in secured property through the use of equitable subordination.

I. Obtaining the Release of Documents From the Government[4]

Although evidence that a trustee has developed in a Ponzi case can and should be made available to law enforcement authorities upon request, the evidence that law enforcement authorities obtain through the grand jury process is generally secret.[5] The Supreme Court has stated, "We consistently have recognized that the proper functioning of our grand jury system

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[3] Published by LexisNexis (2012). For more information, go to: **www.ThePonziBook.com**.

[4] Part I is excerpted from Chapter 15, Section 15.04[2] of THE PONZI BOOK: A LEGAL RESOURCE FOR UNRAVELING PONZI SCHEMES.

[5] FED. R. CRIM. P. 6(e).

depends upon the secrecy of grand jury proceedings."[6]

There is, however, a mechanism for the release of grand jury information, which can provide a wealth of evidence to a trustee investigating potential estate assets. Federal Rule of Criminal Procedure 6(e)(3)(E) provides, "The court may authorize disclosure - at a time, in a manner, and subject to any other conditions that it directs - of a grand-jury matter: (i) preliminarily to or in connection with a judicial proceeding . . . ."[7] Significantly, the case law distinguishes between the release of testimony and the release of documents.

Addressing the disclosure of testimony, the Supreme Court applied this standard:

> Parties seeking grand jury transcripts under Rule 6(e) must show that the material they seek is needed to avoid a possible injustice in another judicial proceeding, that the need for disclosure is greater than the need for continued secrecy, and that their request is structured to cover only material so needed.[8]

On the other hand, "A request for grand jury documents evokes different, and less exacting, considerations than a request for transcripts of grand jury testimony."[9] In *SEC v. Everest Management Corp.*, the court noted, "Disclosure is appropriate where documents are sought to further legitimate purposes in connection with lawful investigations or judicial proceedings."[10]

As a result, in several cases, bankruptcy trustees have successfully obtained documents that had been submitted to a grand jury. For example, in *In re Grand Jury Proceedings*, the

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[6] *Douglas Oil Co. of Cal. v. Petrol Stops Nw*., 441 U.S. 211, 218, 99 S. Ct. 1667, 1672 (1979).

[7] FED. R. CRIM. P. 6(e)(3)(E).

[8] *Douglas Oil Co. of Cal*., 441 U.S. at 222; *see also McAninch v. Wintermute*, 491 F.3d 759, 767 (8th Cir. 2007) (applying *Douglas Oil* and denying motion for disclosure where "[Movant] failed to make any showing of a particularized need for the requested materials because he admitted that the 'exact same testimony' could probably be obtained from the witness through deposition.").

[9] *SEC v. Everest Mgmt. Corp*., 87 F.R.D. 100, 105 (S.D.N.Y. 1980).

[10] *Id*.; *Alexander v. FBI*, 186 F.R.D. 102, 108 (D.D.C. 1998) (citations omitted) ("[D]ocuments are not cloaked with secrecy merely because they are presented to a grand jury.").

court granted the bankruptcy trustee's motion for release of grand jury subpoenaed documents as well as documents seized pursuant to a search warrant.[11]

Beyond that, the court also concluded that other documents that the trustee sought from the government were not protected at all by the secrecy requirement of Rule 6(e). These were identified as "all public records or documents held by the grand jury and all documents voluntarily provided to that body."[12] In so concluding, the court applied this test from *In re Grand Jury Proceedings*:[13]

> [C]onfidential documentary information not otherwise public obtained by the grand jury by coercive means is presumed to be "matters occurring before the grand jury" just as much as testimony before the grand jury. The moving party may seek to rebut that presumption by showing that the information is public or was not obtained through coercive means or that disclosure would be otherwise available by civil discovery and would not reveal the nature, scope, or direction of the grand jury inquiry, but it must bear the burden of making that showing . . . .[14]

Similarly, in *United States v. Theron*, the court allowed a trustee to obtain the debtor's books and records that the grand jury had subpoenaed.[15] The court determined that the records were not subject to Rule 6(e) and, in the alternative, if the records were subject to the rule, the trustee had met the standard for the release of the records.[16] In *In re Butcher*, the court authorized the release to the trustee of the debtor's papers that had been seized by the government pursuant to a search warrant.[17]

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[11] *In re Grand Jury Proceedings*, 196 F.R.D. 57, 63 (S.D. Ohio 2000); *see also In re Grand Jury Empanelled Mar. 8, 1983*, 1988 U.S. App. LEXIS 19426, at *1 (6th Cir. Aug., 30, 1988).

[12] *Grand Jury Proceedings*, 196 F.R.D. 57, 63 (internal quotation marks omitted).

[13] *In re Grand Jury Proceedings*, 851 F.2d 860, 866-867 (6th Cir. 1988).

[14] *Grand Jury Proceedings*, 196 F.R.D. at 62-63.

[15] *United States v. Theron*, 116 F.R.D. 58, 62 (D. Kan. 1987).

[16] *Id*.

[17] *In re Butcher*, 38 B.R. 796, 801-02 (Bankr. E.D. Tenn. 1984).

In *Application of Executive Services Corp.*, the Second Circuit granted a SIPA liquidating trustee release of grand jury testimony where the witness had waived his right to object to the release of his testimony, finding that there was minimal harm and that the trustee's application was attempting to vindicate substantial public interests.[18]

Most recently, in *United States v. DeMiro*, the district court granted the chapter 7 trustee's motion to obtain access to bank and financial records obtained in connection with the grand jury proceedings relating to the debtor's criminal case.[19] The court applied this standard: "(1) the material sought is needed to avoid a possible injustice in another judicial proceeding; (2) the need is greater than the need for continued secrecy; and (3) the request is structured to obtain only the material needed."[20] The court held that the trustee had demonstrated adequate need because the bankruptcy case had been filed as an involuntary case, the debtor had not provided any financial information, and because the evidence that the trustee sought was necessary to administer the bankruptcy case.[21] The court further found that the need for these documents was greater than the need for the continued secrecy of the grand jury proceedings, because the trustee sought only documents and not grand jury testimony, and because the grand jury proceedings had concluded.[22]

This case law can provide a powerful basis for a trustee, a receiver or any party in a Ponzi case to obtain documents and records that the government has in its possession from its investigation of the scheme.

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[18] *Application of Executive Servs. Corp.*, 702 F.2d 406, 409-10 (2d Cir. 1983).

[19] *United States v. DeMiro*, 2011 U.S. Dist. LEXIS 143548 (E.D. Mich. Dec. 14, 2011).

[20] *Id.* at *3-4 (quoting *In re Antitrust Grand Jury*, 805 F.2d 155, 161 (6th Cir. 1986)).

[21] *Id.* at *4-5.

[22] *Id.* at *5-6.

II. Pursuing Third Parties Through the Use of Alter Ego Claims[23]

The doctrine of alter ego can permit a trustee to bring third parties into litigation, providing an additional potential source of recovery for the estate.

"The alter ego doctrine arises when a plaintiff comes into court claiming that an opposing party is using the corporate form unjustly and in derogation of the plaintiff's interests. In certain circumstances the court will disregard the corporate entity and will hold the individual shareholders liable for the actions of the corporation."[24]

Courts have announced different elements that a claimant must establish to obtain alter ego relief.

"Under Delaware law, in order to pierce the corporate veil on an alter-ego theory, traditionally a plaintiff must prove: (1) the parent and subsidiary operated as a single economic entity; and (2) an overall element of injustice or unfairness is present."[25] "'First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone.'"[26]

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[23] Part II is excerpted from Chapter 7, Sections 7.18[1], [2] and [4] of THE PONZI BOOK: A LEGAL RESOURCE FOR UNRAVELING PONZI SCHEMES.

[24] *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1115 (N.D. Cal. 2003) (citing *Mesler v. Bragg Mgmt. Co*., 39 Cal.3d 290, 300 (1985)).

[25] *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 317 (S.D. Tex. 2008) (citing *In re Foxmeye*r *Corp*., 290 B.R. 229, 235 (Bankr. D. Del. 2003)).

[26] *Neilson v. Union Bank*, 290 F. Supp. 2d at 1115 (quoting *Sonora Diamond Corp. v. Superior Court*, 99 Cal. Rptr. 2d 824 (2000)); *see also Rosen v. Kore Holdings, Inc.* (*In re Rood*), 448 B.R. 149, 158 (D. Md. 2011) (holding that under Maryland law, the corporate entity may be disregarded when "the corporation is used as a mere shield for the perpetration of a fraud"; "in order to prevent evasion of legal obligations"; or if the stockholders "fail to observe the corporate entity, operating the business or dealing with the corporation's property as if it were their own.") (emphasis omitted); *The Ward Family Found. v. Arnette* (*In re Arnette*), 2011 Bankr. LEXIS 2255, at *70 (Bankr. N.D. Tex. June 7, 2011) ("Under this theory, liability follows if there exists such unity between the corporation and the individual that the corporation ceases to be separate, and holding only the corporation liable would promote injustice."); *Oginsky v. Paragon Props. of Costa Rica LLC*, 784 F Supp. 2d 1353 (S.D. Fla. 2011);

"In New York, a party seeking to pierce the corporate veil must generally establish that (1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury."[27]

Under Texas law, according to *SEC v. Resource Development International, LLC*, alter ego is only one possible ground to pierce the corporate veil:

> Alter ego is not however, the only basis for piercing the corporate veil, although many cases "have blurred the distinction between alter ego and the other bases for disregarding the corporate fiction and treated alter ego as a synonym for the entire doctrine of disregarding the corporate fiction." *Id*. There are "three broad theories of corporate disregard" under Texas law. *Fidelity & Deposit Co. of Maryland v. Com. Casualty Consultants, Inc.*, 976 F.2d 272, 274 (5th Cir. 1992). "The corporate veil is pierced when: (1) the corporation is the alter ego of its owners or shareholders; (2) the corporation is used for an illegal purpose, and (3) the corporation is used as a sham to perpetrate a fraud." *Id*. at 274-75.[28]

In *Skidmore, Owings & Merrill v. Canada Life Assurance Co.*, the Tenth Circuit applied a more exhaustive list of factors in determining whether to disregard the corporate form:

> (1) The parent corporation owns all or majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business

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Walls v. Centurion Asset Mgmt., Inc. (*In re Bolze*), 2009 Bankr. LEXIS 2273, at *27 (Bankr. E.D. July 23, Tenn. 2009) (applying Nevada law, holding, "There are three general requirements for application of the alter ego doctrine: (1) the corporation must be influenced and governed by the person asserted to be the alter ego; (2) there must be such unity of interest and ownership that one is inseparable from the other; and (3) the facts must be such that adherence to the corporate fiction of a separate entity would, under the circumstances, sanction fraud or promote injustice.");

[27] *In re Optimal U.S. Litig*., 2011 U.S. Dist. LEXIS 119141, at *10 (S.D.N.Y. Oct. 13, 2011) (footnote omitted).

[28] *SEC v. Res. Dev. Int'l, LLC*, 487 F.3d 295, 302 (5th Cir. 2007).

> except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, 'the subsidiary' is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.[29]

In *Freeland v. Enodis Corp.*, the court noted the following factors under Indiana case law: (1) undercapitalization; (2) absence of corporate records; (3) fraudulent representation by the corporation's shareholders or directors; (4) use of the corporation to promote fraud, injustice, or illegal activities; (5) payment by the corporation of individual obligations; (6) commingling of assets or affairs; (7) failure to observe required formalities; or (8) other shareholder acts or conduct ignoring, controlling or manipulating the corporate form.[30]

"[S]tate law determines whether a claim belongs to the trustee or to the creditor."[31] "If under governing state law the debtor could have asserted an alter ego claim to pierce its own corporate veil, that claim constitutes property of the bankrupt estate and can only be asserted by the trustee or the debtor-in-possession."[32]

The most common context in which standing to assert an alter ego claim is raised is when a trustee seeks to include in an individual's bankruptcy estate the assets of the corporations controlled by the debtor. The issue arises because under the Supreme Court decision in C*aplin v. Marine Midland Grace Trust Co.*, the trustee may assert only the debtor's claims and not those

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[29] *Skidmore, Owings & Merrill v. Canada Life Assurance Co*., 907 F.2d 1026, 1027 (10th Cir. 1990).

[30] *Freeland v. Enodis Corp*., 540 F.3d 721, 739 (7th Cir. 2008).

[31] *Ahcom, Ltd. v. Smeding*, 623 F.3d 1248, 1250 (9th Cir. 2010); *see also Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993).

[32] *Derivium Capital*, 437 B.R. 798, 814 n.5; *see also Krasny v. Bagga* (*In re Jamuna Real Estate LLC*), 365 B.R. 540, 562 (Bankr. E.D. Pa. 2007).

of creditors.[33] Accordingly, the issue turns on whether, under applicable state law, the debtor may pierce the corporate veil of the corporation that he controls. The cases are split on this issue. "Although several circuits have examined this same issue, not all circuits have arrived at the same result."[34]

In an important case on this issue, *Ahcom, Ltd. v. Smeding*, the Ninth Circuit held, "California law does not recognize an alter ego claim or cause of action that will allow a corporation and its shareholders to be treated as alter egos for purposes of all the corporation's debts."[35] As a result, the court held that the trustee does not have standing to pursue an alter ego claim, and that an individual creditor may pursue an alter ego claim.[36]

Other courts have held that a trustee may bring an alter ego claim against the debtor's insiders.[37]

III. Freeing Up Equity in Property Through Doctrine of Equitable Subordination[38]

The significance of equitable subordination for a trustee is that the doctrine can

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[33] *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 92 S. Ct. 1678 (1972).

[34] *Baillie Lumber Co., LP v. Thompson* (*In re Icarus Holding, LLC*), 391 F.3d 1315, 1319 (11th Cir. 2004).

[35] *Ahcom, Ltd. v. Smeding*, 623 F. 3d 1248 (9th Cir. 2010); *see also In re RCS Engineered Prods. Co*., 102 F.3d 223 (6th Cir. 1996); *Levey v. Sys. Div., Inc*. (*In re Teknek, LLC*), 563 F.3d 639 (7th Cir 2009); *Mixon v. Anderson* (*In re Ozark Rest. Equip. Co*.), 816 F.2d 1222, 1228 (8th Cir. 1987).

[36] This decision effectively overruled two lower court decisions to the contrary. *In re Davey Roofing, Inc.*, 167 B.R. 604 (Bankr. C.D. Cal. 1994), and *CBS, Inc. v. Folks* (*In re Folks*), 211 B.R. 378, 387 (B.A.P. 9th Cir. 1997).

[37] *See, e.g.*, *Morley v. Ontos, Inc*. (*In re* Ontos, Inc.), 478 F.3d 427 (1st Cir. 2007); *Baillie Lumber Co., LP v. Thompson*, 413 F.3d 1293 (11th Cir. 2005) (relying on the Georgia Supreme Court's response to a certified question, 279 Ga. 288, 612 S.E.2d 296 (2005)); *Kalb, Voorhis & Co. v. Am. Fin. Corp*., 8 F.3d 130, 132-34 (2d Cir. 1993); *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132 (4th Cir. 1988); *SI Acquisition, Inc. v. Eastway Delivery Serv. Inc.* (*In re S.I. Acquisition, Inc.)*, 817 F.2d 1142 (5th Cir. 1987); *see also Francisco v. Bowman*, 109 Fed. App'x 24 (6th Cir. 2004), which appears to contradict, but does not mention, *In re RCS Engineered Prods. Co*., 102 F.3d 223 (6th Cir. 1996). Regardless, the Sixth Circuit has held that the trustee has standing to assert an alter ego claim to avoid a fraudulent transfer made by the debtor's corporation. *Fisher v. Slone* (*In re Fisher*), 296 Fed. App'x 494 (6th Cir. 2008).

[38] Part III is excerpted from Chapter 11, Sections 11.01 and 11.02 of THE PONZI BOOK: A LEGAL RESOURCE FOR UNRAVELING PONZI SCHEMES.

potentially create value in an otherwise fully secured asset. The court may subordinate a fully secured claim, which would otherwise be paid in full, such that the subordinated creditor might receiver nothing or pennies on the dollar, and the equity in the otherwise secured property can become available for distribution to unsecured creditors.

The doctrine of equitable subordination has the effect of reprioritizing claims based on the wrongful conduct of a claimant. Equitable subordination permits a bankruptcy court to subordinate all or a part of a claim to all or part of another allowed claim, or to transfer to the estate a lien which secures a subordinated claim. Equitable subordination may be considered by a court "notwithstanding the apparent legal validity of a particular claim [where] the conduct of the claimant in relation to other creditors is or was such that it would be unjust or unfair to permit the claimant to share *pro rata* with the other claimants of equal status."[39] "Equitable subordination allows the bankruptcy court to reprioritize a claim if it determines that the claimant is guilty of misconduct that injures other creditors or confers an unfair advantage on the claimant."[40]

Equitable subordination has been codified in § 510(c) of the Bankruptcy Code, which provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may–
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> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all of part of another allowed interest; or
> >
> > (2) order than any lien securing such a subordinated

[39] *Comm. of Unsecured Creditors of Adelphia Commc'ns Corp. v. Bank of Am.* (*In re Adelphia Commc'ns Corp*), 365 B.R. 24, 68 (Bankr. S.D.N.Y. 2007) (footnote omitted).

[40] *See In re Kriesler*, 546 F.3d 863, 865-66 (7th Cir. 2008).

claim be transferred to the estate.

Courts initially created the doctrine of equitable subordination to apply when one creditor, usually an insider, abused its position to the detriment of other creditors. The Supreme Court has held that the bankruptcy court has equitable powers to subordinate an allowed claim in order to assure "that fraud will not prevail, that substance will not give way to form, that technical consideration will not prevent substantial justice from being done."[41]

Courts have fairly uniformly applied the standards established by the Fifth Circuit in *Benjamin v. Diamond* (*In re Mobile Steel Corp.*), and hold that, to be subordinated: "(i) [t]he claimant must have engaged in some type of inequitable conduct[;] (ii) [t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant[;] (iii) [e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act."[42] "The courts have actually confined equitable subordination of claims to three general categories of cases: those in which a fiduciary of the debtor misuses his position to the disadvantage of other creditors; those in which a third party, in effect, controls the debtor to the disadvantage of others; and those in which a third party defrauds other creditors."[43]

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[41] *Pepper v. Litton*, 308 U.S. 295, 305, 60 S. Ct. 238, 244 (1935). Some courts have also read § 510(c) and *Pepper* to support a claim for equitable disallowance. *See, e.g., Comm. of Unsecured Creditors of Adelphia Commc'ns Corp. v. Bank of Am.* (*In re Adelphia Commc'ns Corp.*), 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007) ("In *Pepper*, an order disallowing-not just subordinating-a claim was affirmed. And as the quoted language from Pepper makes clear, subordination and disallowance, which were linked by an "or" no less than five times, were perceived by that court as separate remedies, each of which was available. That does not mean to this Court that they are equally appropriate alternatives, but it tells this Court that disallowance would be permissible in those extreme instances-perhaps very rare-where it is necessary as a remedy.").

[42] *Benjamin v. Diamond* (*In re Mobile Steel Corp.*), 563 F.2d 692, 700 (5th Cir. 1977) (citation omitted); *see also In re Kriesler*, 546 F.3d 863, 865-66 (7th Cir. 2008); *Henry v. Lehman Commercial Paper, Inc.* (*In re First Alliance Mortg. Co.*), 471 F.3d 977, 1006 (9th Cir. 2006); *Picard v. Katz*, 2011 U.S. Dist. LEXIS 109595, at *24-25 (S.D.N.Y. Sept. 27, 2011); *Picard v. Madoff* (*In re Bernard L. Madoff Inv. Sec. LLC*), 2011 Bankr. LEXIS 3578, at *66-67 (Bankr. S.D.N.Y. Sept. 22, 2011).

[43] *Holt v. FDIC* (*In re CTS Truss, Inc.*), 868 F.2d 146, 148-49 (5th Cir. 1989) (footnotes omitted).