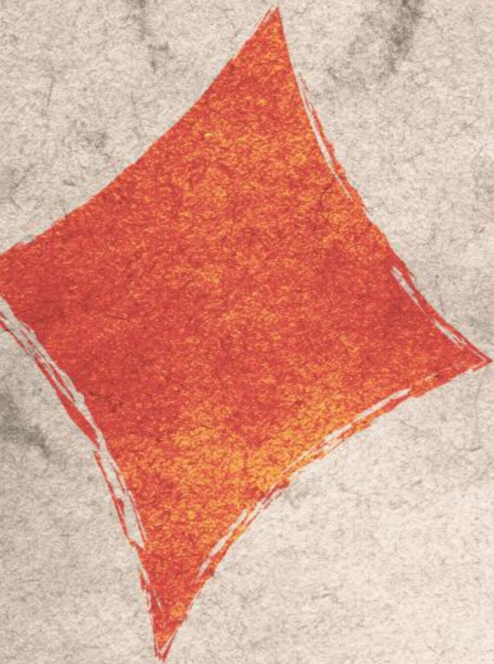
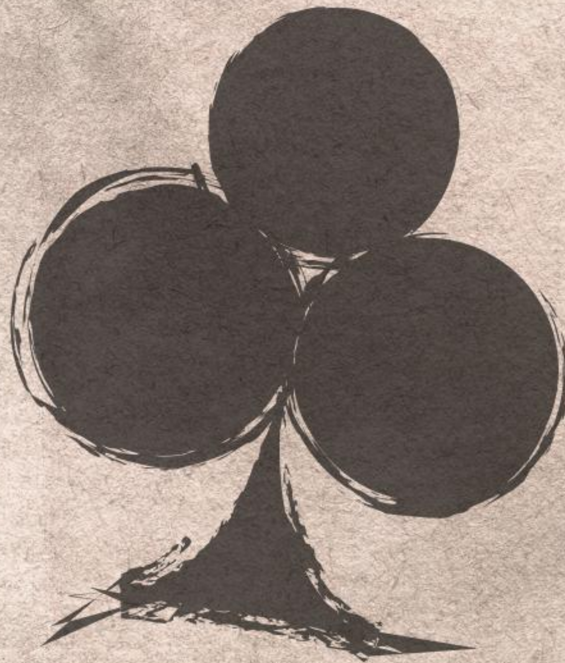
PONZI SCHEMES:

Picking Up the Pieces From a Fallen House of Cards





By Jeff Sonn, Esq.

PONZI SCHEMES - PICKING UP THE PIECES FROM A FALLEN HOUSE OF CARDS

By Jeff Sonn, Esq.[1]

All too often, investors are duped into making an investment that promises extraordinary returns, later discovered to be a "Ponzi Scheme".[2] The term Ponzi Scheme was coined following the discovery that Edward Ponzi, during the 1920's, had duped thousands of investors out of millions of dollars, by paying out very high investment returns to his investors by using later investors' money to pay back earlier investors, all the while taking huge amounts of the investors' money to fund a lavish lifestyle for himself.[3]

A Ponzi scheme is, in essence, a financial fraud that usually induces investment by promising extremely high, risk-free returns, in a short time period, from an allegedly legitimate business venture. "The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment." *In re United Energy Corp.,* 944 F.2d 589, 590 n. 1 (9th Cir.1991). Sometimes a legitimate business later morphs into a Ponzi scheme as well.[4] The purpose of this article is to give the reader a general overview of some of the more famous Ponzi schemes, third parties who may be subject to liability for promoting these schemes, receiverships, collection issues, and some tips on where the investors' attorneys might look to help victims recover their investment.

I. Looking at the Forest of Ponzi Schemes for Common Themes

Ponzi schemes come in many forms, but usually contain the same type of structure. First, the promoter sets up a business that appears to be generating huge returns in a short period of time. Second, the promoter generally pays back his early investors with large returns, on a timely basis, thereby generating an investing frenzy. Third, the Ponzi scheme principal lives a lavish

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[2]. A search of the Westlaw® database for "Ponzi" yielded 2,492 reported cases as of the writing of this article.

[3]. *See generally Cunningham v. Brown,* 265 U.S. 1, 7-9, 44 S.Ct. 424, 68 L.Ed. 873 (1924) (detailing the criminal career of Charles Ponzi). Charles Ponzi was a famous Boston swindler. With a capital of $150, Ponzi began to borrow money on his own promissory notes at a 50% rate of interest payable in 90 days. In the 1920's, Ponzi collected nearly $10 million (a huge sum in those days) in 8 months ... using the funds of new investors to pay off those whose notes had come due.' *United States v. Shelton,* 669 F.2d 446, 449 n. 2 (7th Cir.1982)." *See Sterling Trust Co. v. Adderley,* 168 S.W.3d 835, 838 n.1 (Tex.2005).

[4]. *See Schneider vs. Service Five Investments, dba Loans for Military* (S.D.Fla. 2006).

lifestyle, thus reinforcing his investors' belief that the business is very successful and profitable. Fourth, many Ponzi scheme principals employ investors as promoters or general partners of limited partnerships to raise money, and pay those promoters a significant commission for every investor they bring to the business. Fifth, the Ponzi business has little or no legitimate business, and eventually, the Ponzi principal and his promoters are unable to bring in enough new investors to generate the ever increasing revenues necessary to pay earlier investors, thus causing the Ponzi scheme to implode.

The types of business that Ponzi schemes utilize are as varied as the imagination. They sometimes take the form of a successful commodities trading company,[5] a "wizkid" stocktrader[6], or a Christian church-based gold trading investment meant to "double the blessings" of investors..[7] Sometimes the scheme involves a business that loaned money to others collateralized by auto loans,[8] or the food brokerage business[9]. Others often involve raising "working capital" for established companies.[10] Still others focus on the power of the internet, claiming that huge returns can be made by generating advertising revenue.[11] Still others involve corrupt music or

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[5]. *See Litigation Release No. 19117 / March 3, 2005, Securities and Exchange Commission v. K.L. Group, LLC, et al.,*Case No. 05-80186-CIV-RYSKAMP (S.D.Fla., filed March 2, 2005).

[6]. Reed Slatkin was touted as a uncanny investor, who told investors he had wisely invested in business ventures (for the most part allegedly in publically traded securities), defrauding hundreds of investors of hundreds of millions of dollars., and was famous for donating huge amounts of money to the Scientology Church, thereby attracting Hollywood celebrities who followed scientology. *In re: Reed Slatkin*, Case No. ND 01-11549-RR (Bktcy.N.D.CA 2001).

[7]. *See Greater Ministries International (GMI), www.sptimes.com/News/031301/ TampaBay/Jury_convicts_five_in.shtml*. Their flagship program, the "Double Your Money Gift Exchange," promised to double contributions thanks to GMI's (nonexistent) investments in precious metals. GMI marketed the program to ultraconservative political and religious groups as well as to other communities outside the mainstream, especially the Amish and Mennonite sects. The program, stated Gerald Payne, was based on Luke 6:38:"Give, and it shall be given unto you." Claiming to accept money only from active Christians, Payne said that God had modernized the multiplication of the loaves and fishes and asked him to share the secret.

[8]. *See Securities and Exchange Commission v. Charles Richard Homa et. al.* Case No. 99-cv-06895. (NDIL 1999); SEC Litigation Release No. 17726 / September 16, 2002

[9]. *See SEC vs. Premium Sales Corporation* ("Premium Sales"), Litigation release No. 13668 dated June 9, 1993.

[10] . *SEC v. J.T. Wallenbrock,* 313 F.3d 532 (9th Cir.2002).

[11]. See Litigation Release No. 19579 / February 27, 2006, SEC v. Charis Johnson, Lifeclicks LLC and 12dailypro, Civil Action No. CV 06-01018 NM (PLAx) (C.D. Cal.) The SEC alleged that Johnson raised more than $50 million from more than 300,000 investors by convincing visitors to the Web site that they could earn a 44 percent return on their investments in 12 days by looking at Internet advertisements. The scheme, which the SEC calls

concert agents with connections to famous entertainers such as the Backstreet Boys, 'Nsync, and even the Rolling Stones.[12]

However, many of the Ponzi schemes use common techniques, such as promissory notes, high fixed rates of return greater than an average stock market return, unregistered offerings, lack of audited financial statements, and sales made outside of the traditional channels of brokerage firms, financial planners or insurance companies. Also, because of the internet, victims are often given the appearance of a valid investment account, via access to an online account statement on a website, using an account name and password. This way, the investors are comforted by viewing their investment balance and profits online, thus reinforcing the false belief that their money is safe and profitable.[13] Lastly, Ponzi schemes often target victims in churches, temples or generally through a common affinity (hence the name "affinity fraud.").[14]

Some of the larger or more infamous Ponzi schemes include:

Louis J. Perlman

Lou Perlman, the manager of such singing sensations as the "Backstreet Boys." and 'N Sync, conducted a $500 million dollar Ponzi scheme. In 2006, it was discovered that Pearlman was the head of one of the largest and longest running Ponzi schemes in American history, leaving almost half a billion dollars in debts. Perlman headed up Transcontinental Airlines Travel Services Inc. and Transcontinental Airlines Inc., and the Transcontinental Savings Program (collectively referred to as "Transcontinental"), which existed only on paper. For over 20 years, Perlman raised money from investors in Transcontinental, using falsified FDIC, AIG and Lloyd's of London documents to gain investors' confidence in his business.

Perlman created the "Employee Investment Savings Account" (E.I.S.A.) program and he used fake financial statements created by a fictitious accounting firm "Cohen and Siegel" to secure bank loans. E.I.S.A. investors were falsely led to believe their investment "deposits" were safe, secure and residing in U.S. financial institutions, where FDIC and other insurance

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"paid auto-surf," required users to buy $6 "units" -- up to a maximum of 1,000 units -- and to view advertisements from what were described as paying advertisers.

[12]. Ponzi schemes by music and concert agents include Louis J. Perlman (Backstreet Boys, 'Nsync's former manager, note 12, infra) and Jack Utsick (concert promoter for artists such as the Rolling Stones and Nora Jones).

[13]. *See Harris vs. Heierle*, 07-22279-civ-Moreno (S.D.Fla. 2008).

[14]. From 1993 until 1997 a church named Greater Ministries International in Tampa, Florida, headed by Gerald Payne bilked over 18,000 people out of 500 million dollars. Payne and other church elders promised the church members double their money back, citing Biblical scripture. However, nearly all the money was lost and hidden away. Church leaders received prison sentences ranging from 13 to 27 years.

guaranteed the investment. The existence of FDIC, Lloyd's of London or AIG insurance, however, was simply a fabrication that went hand in hand with the false representations that all E.I.S.A. funds were maintained in U.S. institutions such as Citibank, where above market interest rates were provided to purportedly cash laden companies such as Trans Continental Airlines, Inc.[15]

One of the key findings by state regulators was that the bank records indicated the investors' deposits of approximately $118 million were utilized to pay earlier investors both dividends and cash withdrawals, as is the case in Ponzi schemes, to pay commissions of approximately $7 million to sales agents who marketed the program, and to funnel approximately $50 million to the Pearlman and his companies.[16]

On May 21, 2008, Pearlman was sentenced to 25 years in federal prison, after pleading guilty to charges of conspiracy, money laundering, and making false statements during a bankruptcy proceeding. Perlman was given the chance to cut his prison time, by an offer from the judge to reduce his sentence by one month for every million dollars he helps the bankruptcy trustee recover. [17]

SEC v. J.T. Wallenbrock

Wallenbrock promised investors a 20 percent return in ninety days, by using their money to provide working capital to Malaysian latex glove manufacturers, raiding $250 million dollars in the process. Ordinarily, Wallenbrock claimed, these manufacturers had to wait eighty to ninety days after shipment to collect payments from buyers. Wallenbrock would purchase these manufacturers' accounts receivables at a significant discount, providing the glove manufacturers with immediate access to working capital. Wallenbrock investors, in turn, would enjoy a 20 percent return when Wallenbrock collected the receivables from glove purchasers in due time. In reality, the officers of Wallenbrock took the investors' money and used some of it to pay off earlier investors, some to pay for personal expenses, and some to invest in risky start-up companies.[18]

This type of "accounts receivable factoring" Ponzi scheme is one of the more common types of Ponzi schemes. While Wallenbrock was a "latex glove" account receivable scheme, still others involved the brokerage of food (See Premium Sales, below), or the factoring of receivables for contractors, manufacturers, and wholesalers.[19]

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[15]. *See Complaint, Office of Financial Regulation, State of Florida vs. Transcontinental Airlines, et.al* Case No.: 48-2006-CA-011136-O (Orange Cty, Fl. Cir.Ct. 2006);

[16]. Id.

[17]. Id.; *Lou Pearlman falls from life of glitz to 25-year sentence*, www.orlandosentinel.com news/local/orange/orl-pearlman2208may22,0,5440882.story.

[18]. *SEC v. J.T. Wallenbrock,* 313 F.3d 532 (9th Cir.2002)

[19]. SEC vs. JTL Financial, Lit. Release 19726 and 17237 (2006).

Worldwide Entertainment

Jack Utsick, of Worldwide Entertainment, was considered the third largest independent concert promoter in the world, according to Billboard Magazine.[20] What was unknown to his investors was that he was running a massive Ponzi scheme. The SEC alleged in its 2006 complaint that from at least 1998 through late 2005, Utsick and his partners Donna and Robert Yeager sold unregistered securities in the form of loan agreements or units in special purpose limited liability companies ("LLCs") to raise funds for a variety of entertainment ventures produced and/or promoted by Jack Utsick including Rolling Stone concerts and even a Paris Hilton movie, National Lampoon's Pledge This!.

Utsick, the Yeagers, and others told investors that their investments would earn annual returns ranging from 15% to 25% and, in some cases, an additional 3% of the profits generated by Jack Utsick and his companies. The investments in the LLCs or loan agreements were usually for a term of one year, and many investors rolled over their principal and purported "profits" from project to project. Over the years, defendants raised funds for dozens of projects, including theatrical productions and concerts for well-known artists and groups such as Shania Twain, Elton John, Santana, The Pretenders and Aerosmith.[21]

Utsick paid over $7 million in undisclosed commissions to the Yeagers and others. Utsick also used investor funds inconsistently with the purposes promised to investors. Utsick opened an options trading account at Gunn Allen Securities through which he traded (and lost) nearly $17 million, and he used investor funds to, among other things, pay principal and interest to earlier investors, pay sales commissions, purchase two multimillion condominiums in Miami Beach, Florida, and to fund his lavish lifestyle.

The Worldwide Entertainment case is notable for the fact that it actually had some legitimate, albeit losing, business operations. Some concert venues were profitable, while many others were not. Some investments like Paris Hilton's National Lampoon Pledge This! movie were a flop, while other investments such as concert venue leases were profitable and continue to make money. Still other investments included oil and gas lease partnerships, modeling agencies, and even restaurants. Some of the investments had to be abandoned by the Court-appointed Receiver, Michael Goldberg, and others are still being managed for the benefit of investors to this day.[22]

Mutual Benefit Life

Between 1994 and 2004, Mutual Benefit Life (MBC) operated as a viatical and life settlement provider, raising money from 29,000 investors to purchase viatical and life settlement

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[20]. *Litigation Release No. 19659 / April 17, 2006, SEC v. John P. Utsick et al.*, Case No. 06-20975 (S.D. Fla.)

[21]. Id.

[22]. See Receiver's reports, http://entertainmentgroupinfo.com/trusteereports.htm.

contracts.[23] A viatical or life settlement contract involves the sale of a life insurance policy by a terminally ill person or senior citizen (known within the industry as a "viator") at a price discounted from the face value of the policy. Investors pay the premiums, and receive the face value of the life insurance policy when the insured, or viator, dies. In turn, the viator receives a portion of the proceeds of his life insurance policy as a lump sum.

MBC allocated investor funds to approximately 9,000 life insurance policies with an aggregate anticipated death benefit of approximately $1.451 billion.[24] MBC promised investors guaranteed, fixed rates of return ranging from 12% to 72%, depending upon the term of investment chosen by the investor. The life expectancy of the viator as determined by MBC, in turn, determines the total rate of return. For example, MBC promised investors who selected a policy insuring an individual with a one-year life expectancy a 12% return on the investment, investors who selected a policy insuring an individual with a two-year life expectancy a 28% return, and investors who selected a policy insuring an individual with a three-year life expectancy a 42% return.[25]

MBC sold its investments to 29,000 investors primarily through a national network of independent sales agents, consisting mainly of insurance agents, brokers and financial advisors.[26] The Company also solicits investors directly through its Internet website. MBC, primarily at the direction of Leslie Steinger, oversaw the activities of its sales agents through a staff of in-house sales directors. MBC trained its outside sales force during multi-day training sessions called "MBC University." Steiner participated in these training sessions held at MBC's Fort Lauderdale headquarters, and other sessions held throughout the world. Steiner instructed future sales agents about the viatical industry in general, the humanitarian aspects of viatical settlements, MBC's philanthropic efforts, and MBC's excellent track record in the viatical settlement industry. During these sessions, Steiner did not disclose to future sales agents any information about his brothers' disciplinary history, criminal conviction, or the cease-and-desist orders issued against MBC by state regulators.[27]

For their role in marketing the offering, MBC's sales agents were paid a commission, generally from 6% to 12%, based on the total investment.[28] MBC also offered its agents incentives for reaching sales goals, such as all-expense paid vacations. During their oral sales

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[23]. See Amended Complaint. SEC vs. Mutual Benefit Corp. Et al., Case No. 04-60573 (S.D.FL2004).

[24]. Id.

[25]. Id.

[26]. Id.

[27]. Id.; MBC failed to disclose to investors the fact that at least five states, Alabama, Alaska, Indiana , Pennsylvania and Vermont, have issued cease-and-desist orders against MBC and its principals for securities fraud and registration violations . In addition, the state of Kansas issued a cease-and-desist order against the sales agents who sold the investment opportunity in that state. *See Complaint, Scheck Investments LP vs. MBC et al.* Case no. 04-21160 (S.D. FL 2004).

[28]. Id.

solicitations, MBC's sales agents assured investors that the investment opportunity was "guaranteed."[29] Agents also regularly downplayed the fact that the viator might live beyond his life expectancy.

Life expectancy figures determined, among other things, the rates of return to investors and the amount of funds to be escrowed for payment of future premiums. Approximately 90% of MBC's policies were well beyond their life expectancy estimates and, in a Ponzi-like fashion, new investor funds set aside to pay premiums on specific policies were being used to pay premiums of policies assigned to earlier investors.

Ultimately, the Eleventh Circuit Court of Appeals upheld the trial court's finding that the viatical investments were "securities" and thus sold as unregistered securities to unsuspecting investors.[30]

In re World Vision Entertainment, Inc.

This Ponzi was known as the Nine-Month Promissory Note Sales Program. Jamie Piromalli formed World Vision Entertainment, Inc., as a Florida corporation in 1994, to promote itself as an entertainment investment company. In 1996, World Vision started selling nine-month promissory notes with annualized interest rates varying between 10.9 and 11.9 percent. Investors could collect their interest monthly or at the end of the nine-month term in a lump sum together with their principal investment. Although the notes were unsecured, investors received a certificate of insurance promising full repayment if World Vision defaulted. At the expiration of each nine-month term, World Vision encouraged investors to reinvest their principal for additional nine-month terms. Between June 1996 and September 1999, World Vision sold nine-month notes totaling approximately $62 million in 33 states to approximately 1,200 investors. The investors typically were elderly people living on a fixed income. They lacked financial sophistication and often invested their retirement savings into the note program relying on the advice of their broker.[31]

E-M Management

Edward Paul May was an investment advisor and the managing or controlling member of some 266 corporations. Allegedly, the corporations were not legitimate businesses, but rather were used to facilitate a fraudulent Ponzi scheme. Allegedly, over a period of several years, May solicited and received funds from many parties for purported investments totaling between $200 and $300 million. Contrary to representations made by May, funds received from investors were placed into high risk, rather than low risk, investments. In many cases, funds may not have been invested at all, but rather were used to pay false dividends to earlier investors, or diverted for the personal use of May. May is purportedly under investigation by the Securities and Exchange

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[29]. Id.
[30]. *S.E.C. v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005).
[31]. *In re World Vision Entertainment, Inc.* 275 B.R. 641 (M.D.Fla.,2002).

Commission, the Federal Bureau of Investigation, and possibly other federal or state authorities.[32] Frank Bluestein, a former registered representative with Gunn Allen, allegedly sold investments involving E-M Management, and as a result, Gunn Allen is presently the subject of many arbitration claims by investors for "selling away".

SEC vs. Premium Sales

The SEC's complaint alleged that Premium Sales fraudulently raised over $500,000,000 through a grocery diverting scheme and defrauded investors with promises of up to 60% annualized returns on their investments. The SEC's complaint against Morris and Scott Thenen alleged that they played a major role in the operation of Premium Sales, a Ponzi scheme that operated from North Miami Beach, Florida. Premium Sales, Morris and Scott Thenen told investors they were in the business of grocery "diverting". Grocery diverters take advantage of differences in prices for wholesale grocery products among different regions of the country. In a form of arbitrage, diverters purchase lower-priced groceries in one region and resell them for a small profit in another region where prices are higher. Unfortunately for investors of Premium Sales, most of the diverting transactions made by Premium Sales were fictitious.[33] This author's former law firm represented the unsecured creditor's committee in the Premium Sales bankruptcy case, during which the committee helped uncover the fact that the bank for Premium Sales had aided and abetted the fraud, and uncovered ill-gotten gains of promoters who received "commissions" for bringing investors to the company.

Caritas ("Charity" in Latin)

Caritas was a $450 million dollar Ponzi scheme in Romania which was active between April 1992 and August 1994. It attracted millions of investors from all over Romania who invested more than a trillion lei (between one and five billion USD) before it finally went bankrupt in 1994. Caritas was a self-described "mutual-aid game" (hence the name "Caritas", meaning charity in Latin) which had the purpose to help the impoverished Romanians during the transition to capitalism and promised eight times the money invested in six months. An eightfold return appears ridiculously high in hindsight, but not in 1993, given that Romania was suffering from heavy inflation (over 300% yearly), and Romania's citizens were not used to modern financial instruments, so almost none of the investors suspected a scam during the early stages of the scheme. Caritas was aided by its connections in the nationalist Party of Romanian National Unity (PUNR) and the mayor of Cluj-Napoca, Gheorghe Funar, who welcomed this scheme and even helped it build a credibility by renting space right in the town hall, appearing in public and on television defending Caritas from criticism. The mayor also gave space in the local newspaper to publish a list of the 'winners' who would have to go and claim their money eightfold, a list which at times was as long as 44 pages.

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[32]. *In re Estate of the Assignment for the Ben. of Creditors of Edward May,* 2008 WL 2201977 (E.D.MI.,2008).
[33]. *See SEC vs. Premium Sales, footnote 7, supra.*

Reed Slatkin

Reed Slatkin was a former Scientologist minister and a cofounder of Earthlink, the internet service provider. Slatkin was touted as a wunderkid of stock and business investing. It was verified that he had made $100 million in profit on the internet company Earthlink alone. He and his family lived in a large estate in Santa Barbara and employed an estate manager to tend to the property. They took vacations to Europe and Hawaii, belonged to an elite country club, and their social circle included some of Santa Barbara's wealthiest and most influential people. During the 1990's, Slatkin was investing in a wide array of real estate developments throughout the United States, film and production companies, investment partnerships, and securities in a variety of companies. Most of Slatkin's investments later proved to be financial disasters.[34]

In reality, Slatkin's financial castle was a house of cards. Slatkin began to be exposed in 1999. The total amount invested with Slatkin during a 15-year period was $593 million, of which he disbursed $534 million to investors and the remaining claims, representing actual cash invested but not returned, was approximately $255 million.

His true success, it was later revealed, was limited to his investment in Earthlink. Most of Slatkin's investments went sour, but as far his investors were concerned, Slatkin's was a hugely talented investor, because he sent all of his investors false financial statements showing huge profits, and was able to pay off earlier investors very large returns.[35]

According to Slatkin's bankuptcy trustee, "Slatkin may have been viewed by many as a financial "whiz kid" generating stupendous returns for those investors fortunate enough to entrust their money to him. This reputation seems to have been primarily based on three factors: (1) substantial returns (albeit completely fabricated) as reported on the investor monthly statements provided by Slatkin; (2) the investors' ability, at least until the latter stages, to withdraw money without difficulty from their accounts; (3) Slatkin's appearance of expertise based on his opportune Earthlink investment." With the notable exception of his Earthlink investment, for the most part Slatkin's investments were losers. A review of 37 investments revealed that Slatkin lost $47 million of the $68 million he invested in stocks.[36]

Slatkin's investors included many Scientologists, including Foxnews reporter and Scientologist Greta Van Susteren[37] and her husband John P. Coale. They invested $2.1 million and received $2.7 million in payments according to a report by the court-appointed trustee When being told that even innocent parties (i.e. participants who didn't know it was a Ponzi scheme) are required to return the extra money, Van Susteren's husband, John Coale said: "I'll fight this

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[34]. See Report of Trustee, *In re: Reed Slatkin*, Case No. ND 01-11549-RR (Bktcy.N.D.CA 2001).
[35]. Id.
[36]. Id.
[37].For years, Greta van Susteren was CNN's in-house Scientologist and legal talker and co-hosted the show *Burden of Proof* until December 2001, when the show was cancelled.

thing for 100 years" because "Most of that money went to the IRS."[38] That fight is already over. Van Susteren settled the case by agreeing to pay back $705,000.[39]

Slatkin later claimed he was “brainwashed” by the Church of Scientology, to whom he had donated between $25 and $50 million dollars.[40]

Foundation For New Era Philanthropy

John Bennett scammed hundreds of respected institutions and individuals through a “matching gifts program” that made Bennett's name famous within charity circles. Bennett's “New Era Philanthropy” program provided for a group of anonymous and extremely wealthy donors to match funds raised by non-profit institutions and philanthropists.[41] After being invited to participate in the program, non-profit institutions would raise funds and deposit them with New Era. Similarly, philanthropists would deposit funds earmarked for designated charities.

One major requirement was that New Era hold the funds for six months. During this time, New Era would deposit the funds in a "quasi-escrow" account with Prudential Insurance, where they were to be invested in T-bills. This holding period was designed to give New Era time to collect enough interest to cover administrative expenses and find a matching donor. The anonymous donors would contribute funds to New Era, doubling the original amounts raised by the institutions and donated by the philanthropists. After six months, the deposited funds, plus the matched funds, would be transferred to the appropriate non-profit organization.

Different donors were told different things; over time the waiting period grew from six to nine to ten months. The number of anonymous donors, anonymous benefactors, and anonymous philanthropists also varied, though Bennett eventually settled on claiming to have nine of them. John M. Templeton, Jr., son of John Templeton, Sr., the famous investor and philanthropist, was a friend of Bennett and people believed that he was one of the anonymous. In addition, Prudential Securities was a prominent part of the setup (and became the subject of a $90 million lawsuit accusing them of complicity)[42]. In 1994, Bennett expanded the program to allow "donations" by nonprofit organizations.

Like many modern Ponzi schemes, Bennett's was an 'affinity' scheme, in which he defrauded people of common interest: in this case, local non-profit organizations and Christian charities. Using the swelling funds from these churches, Bennett expanded further, establishing offices in Radnor, Pennsylvania. He had glossy brochures and a staff to process all the money coming in.

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[38]. The Los Angeles Times, December 21, 2001.
[39]. www.skeptictank.org/slatkin/rslat067.htm
[40]. http://www.slatkinfraud.com/index.php
[41] Litigation Release No. 15095 / September 30, 1996 USA v. John G. Bennett (E.D. Pa., Filed September 27, 1996)
[42]. In re: New Era Philanthropy, 2:10-md-01127-SD (E.DPA). The case settled on undisclosed terms.

Bennett increased his sales force by encouraging organizations to take a "finder's fee" from any money they raised. In other words, if a representative could convince donors to give $10,000,000, the agent could keep $1,000,000 for himself, give the remaining $9,000,000 to New Era and get back $18,000,000 for the non-profit in six months.

By and large his donors did not ask many questions. When they wanted proof that the money they donated was not being stolen, he provided evidence that the Foundation owned government bonds. However, he was showing the same bonds to everybody, and they had been pledged as collateral on loans. Bennett told prospects that his anonymous donors met several times a year, in person or by phone. Former U.S. Treasury Secretary William Simon, who ironically lost a lot of money to the scam, asked to be admitted to the donor panel. Bennett never responded to the request and Simon gave him money anyway. With the cash flowing though his hands, Bennett made all sorts of private investments. He bought a share of a travel agency and ran all of New Era's travel business through it. He also purchased a publishing house and other businesses.

On May 15 1995, a skeptical article about the Foundation appeared on the front page of the Wall Street Journal. The same day, the Foundation capitulated in the face of a lawsuit demanding repayment of a $44,000,000 loan and filed for chapter 11 bankruptcy protection. In filing, the foundation stated that its assets were worth $80 million with liabilities of $551 million. A close examination of the documents filed in the subsequent lawsuits reveals that more than $354 million passed through New Era's hands and that Bennett took $8 million of that for himself.

II. Common Remedies and Claims

Theories of liability in Ponzi cases normally include a claim for the sale of unregistered securities.[43] The Securities Act of 1933 and the Securities Exchange Act of 1934 both define the term “security” as including the catch-all term “investment contracts.”[44] The phrase “investment contract” is not defined in either statute. In *Securities & Exchange Commission v. W.J. Howey Co.,*[45] the Supreme Court provided a flexible test for determining whether a particular transaction qualified as an “investment contract.” “[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party ....”[46] The Court stated that this approach “embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promises of profits.”

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[43]. Normally referred to as “Sale of Unregistered Securities in Violation of Sections 5(a) and 5(c) of the Securities Act, ”15 U.S.C. §§ 77e(a) and 77e[c].
[44]. 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10).
[45]. 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946).
[46]. 328 U.S. at 298-99, 66 S.Ct. at 1103.

In *Securities & Exchange Commission v. Edwards,*[47], the Supreme Court reaffirmed the definition enunciated in *Howey.* The Court reiterated that " 'Congress' purpose in enacting the securities laws was to regulate *investments,* in whatever form they are made and by whatever name they are called.' To that end, it enacted a broad definition of 'security,' sufficient 'to encompass virtually any instrument that might be sold as an investment.' "[48]

Courts will normally broadly apply the securities laws under the Security Acts of 1933 and 1934 under *Howey* and reiterated in *Edwards* to all "schemes devised by those who seek the use of the money of others on the promise of profits." [49] As the Supreme Court once commented in *Tcherepnin v. Knight*,[50] "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.".

The second theory common to suits involving Ponzi schemes is a claim for fraud by misrepresentation or omission under Section 10(b)(5).[51] Section 10(b) of the Securities Exchange Act makes it,

"unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[52]

The SEC, pursuant to this section, promulgated Rule 10b-5, which makes it unlawful

"(a) To employ any device, scheme, or artifice to defraud,
"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,"in connection with the purchase or sale of any security.[53]

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[47]. 540 U.S. 389, 124 S.Ct. 892, 157 L.Ed.2d 813 (2004).
[48]. 540 U.S. at 393, 124 S.Ct. at 896 (quoting *Reves v. Ernst & Young,* 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990)).
[49]. S.E.C. v. Mutual Benefits Corp., 408 F.3d 737, (11th Cir.2005); *Howey,* 328 U.S. at 299, 66 S.Ct. at 1103; *see also Tcherepnin v. Knight,* 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967).
[50]. 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967).
[51]. See 15 U .S.C. § 78j(b), and Rul e 10b-5, 17 C .F.R. § 240.10b-5.
[52]. " 15 U.S.C. § 78j.
[53]. " 17 CFR § 240.10b-5.

Rule 10b-5 encompasses only conduct already prohibited by § 10(b).[54]Though the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations, the Courts have found a right of action implied in the words of the statute and its implementing regulation.[55] In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[56]

Unfortunately, in *Central Bank,* the Supreme Court of the United States determined that § 10(b) liability did not extend to aiders and abettors.[57] The Court found the scope of § 10(b) to be limited by the text, which makes no mention of aiding and abetting liability.[58] The Court doubted the implied § 10(b) action should extend to aiders and abettors when none of the express causes of action in the securities Acts included that liability. *Id.,* at 180, 114 S.Ct. 1439.[59]

Another common claim brought in Ponzi scheme cases is liability under the "control person" statute under the Securities and Exchange Act of 1934.[60] The Act imposes liability not only on the person who actually commits a securities law violation, but also on an entity or individual that controls the violator. Section 20(a) provides:

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[54] *United States v. O'Hagan,* 521 U.S. 642, 651, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997).
[55]. *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.,* 404 U.S. 6, 13, n. 9, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971).

[56]. See *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-342, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

[57]. *Central Bank of Denver vs. First Interstate Bank of Denver,* 511 U.S., at 177, 114 S.Ct. 1439 (1994).

[58]. Id.

[59]. The Court added the following:
"Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions. See also *Chiarella* [*v. United States,* 445 U.S. 222, 228, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980)]. Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Ibid.* The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. Then-SEC Chairman Arthur Levitt, testifying before the Senate Securities Subcommittee, cited *Central Bank* and recommended that aiding and abetting liability in private claims be established. S. Hearing No. 103-759, pp. 13-14 (1994). Congress did not follow this course. Instead, in § 104 of the Private Securities Litigation Reform Act of 1995 (PSLRA), 109 Stat. 757, it directed prosecution of aiders and abettors by the SEC. 15 U.S.C. § 78t(e).

[60]. Section 20(a) of the Exchange Act, 15 U .S.C. § 78t(a). Section 15 of the Securities Act of 1933 also imposes liability on controlling persons. *See* 15 U.S.C. § 77o (West 20007).

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable *jointly and severally with and to the same extent* as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
> 15 U.S.C. § 78t(a) (emphasis added).

The text of section 20(a) unambiguously imposes derivative liability on persons that control primary violators of the Act. Under section 20(a), a controlling person is liable to the plaintiff jointly and severally with and to the same extent as a controlled person for the controlled person's acts, unless the controlling person can establish the affirmative defense of good faith and non-inducement.

The legislative purpose in enacting a control person liability provision was to prevent people and entities from using straw parties, subsidiaries, or other agents acting on their behalf to accomplish ends that would be forbidden directly by the securities laws.[61] In congressional hearings preceding the passage of the Act, Congress referred to correcting the "dangerous and unreliable system of depending upon dummy directors" that lacked any accountability or responsibility.[62] The House of Representatives Report accompanying the Act summarized section 20(a) and clarified that Congress intended to achieve its purpose by making "a person *722 who controls a person subject to the act ... liable *to the same extent* as the person controlled unless the controlling person acted in good faith."[63]

Control person liability is essentially a claim for vicarious liability. In the Eleventh Circuit, "a defendant is liable as a controlling person ... if he or she 'had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws ... [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.' "[64]

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[61]. H.R.Rep. No. 73-152, at 12 (1933); *see generally* William O. Douglas, *Directors Who Do Not Direct,* 47 Harv. L.Rev. 1305 (1934); Loftus C. Carson II, The *Liability of Controlling Persons Under the Federal Securities Acts,* 72 Notre Dame L.Rev. 263, 266 (1997).

[62]. S.Rep. No. 73-47, at 5-6 (1933); *see also* H.R.Rep. No. 73-152, at 12 (1933); *Stock Exchange Practices: Hearing on S. Res. 84 (72nd Cong.) and S. Res. 56 and 97 (73rd Cong.) Before the Senate Comm. on Banking and Currency,* 73rd Cong., 1st Sess. 6556 (1934) (remark of Sen. Barkley).

[63]. H.R.Rep. No. 73-1383, at 26 (1934) (emphasis added).

[64]. *Brown v. Enstar Group, Inc*., 84 F.3d 393, 396 (11th Cir.1996) (citations omitted).*See also Hoffend v. Villa (In re Villa)*, 261 F.3d 1148 (11th Cir. 2001)(Under this Court's interpretation of the term "controlling person" under § 20(a), a "controlling person" may include not only partners or principals under agency law, but also any person who has the power to control the conduct of another person who has violated securities laws.); *Davidco*

Thus, under controlling law, any person who "controls" a person or entity that violates a provision of the Securities Act or the Exchange Act is jointly and severally liable for the violation. The SEC's implementing regulations define "control" as "the possession, direct or indirect, or the power to direct or cause the direction of the management policies of a person." [65]

The derivative nature of section 20(a) liability has caused courts to disagree over the extent and nature of the burden that the plaintiff must bear to prove section 20(a) liability. In *Brown v. Enstar Group, Inc*., 84 F.3d 393, 396 (11th Cir.1996), the Court held that a plaintiff alleging controlling person liability under section 20(a) must allege that (1) the defendant had the power to control the general affairs of the primary violator, and (2) the defendant had the power to control the specific corporate policy that resulted in the primary violation. However, the Court in *Enstar Group, Inc.* noted an important distinction between the test it adopted and the Eighth Circuit's test requiring a plaintiff to prove that a defendant actually exercised power over the entity primarily liable.[66] Because the Court found that the defendant in *Enstar Group, Inc* neither possessed nor exercised power over the entity primarily liable at the relevant time, it did not decide whether the power to control the general affairs of the entity primarily liable means "simply abstract power to control, or actual exercise of the power to control."[67] Other Courts have required pleading and proof of some "culpable conduct" on the part of the controlling person, along with the power to control the policies that resulted in the primary liability.[68]

Investors, LLC v. Anchor Glass Containers, 2006 U.S. Dist. LEXIS 11527, Fed. Sec. L. Rep. (CCH) P93,732 (M.D.Fla. 2006)(A defendant is liable as a controlling person if he "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability."").

[65]. 17 C.F.R. § 230.405.

[66]. See *Sheinkopf,* 927 F.2d at 1270. "For [defendant] to be liable ... there must be 'significantly probative' evidence that the [defendant] exercised, directly or indirectly, meaningful hegemony over" the controlled person.) (citation omitted); *Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 880-881 (7th Cir.1992) (describing a similar requirement for plaintiff); *Metge v. Baehler,* 762 F.2d 621, 631 (8th Cir.1985) (holding that control person merely must possess, not necessarily exercise, the power to determine the acts or omissions upon which the underlying violation is predicated); *San Francisco-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.,* 765 F.2d 962, 964 (10th Cir.1985) (stating that a plaintiff establishes a prima facie case of controlling person liability "when the ... defendant [is] shown to be a controlling person"); *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1572 (9th Cir.1990) (same).

[67]. *Enstar Group, Inc.,* 84 F.3d at 397 n. 6.; *see also G.A. Thompson & Co., Inc.,* 636 F.2d at 958.

[68]. *See Boguslavsky v. Kaplan,* 159 F.3d 718, 720 (2d Cir. 1998) ("§ 20(a) liability requires an individualized determination of a defendant's control of the primary violator *as well as* a defendant's particular culpability") (emphasis added); *see also Ganino v. Citizens Utilities Co.,* 228 F.3d 154, 170 (2d Cir. 2000) ("To make out a prima facie case under § 20(a)...

Still other claims that are commonly brought in Ponzi scheme cases are tort and contract claims under the common law. Claims for fraud, breach of fiduciary duty, state blue sky laws, common law aiding and abetting, negligence and even breach of contract are also common in Ponzi cases.[69] Since the elements of these claims would likely vary from state to state, it is beyond the scope of this article, but the practitioner would be wise to explore each of these claims.

III. Receiverships and Fraudulent Transfers

It is fairly common, upon discovery of a Ponzi scheme, for a Court to appoint a receiver to take over the affairs of the fraudulent enterprise. The Receiver, in turn, commonly will ask investors to return any of their ill-gotten gains, because, in reality, any investor who made a "profit" really received money that was taken from another defrauded investor. If the investor will not return the money, the Receiver will likely file a lawsuit under the Uniform Fraudulent Transfer Act (UFTA), which has been adopted by most states.[70]

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plaintiff 'must... show that the controlling person was in some meaningful sense a culpable participant' "); *First Jersey Sec.,* 101 F.3d at 1472 (plaintiff must "show that the controlling person was 'in some meaningful sense [a] culpable participant' "); *Hollin v. Scholastic Corp.,* 252 F.3d 63, 77-78 (2d Cir. 2001) (emphasis added). *Gurfein v. Ameritrade, Inc.*, 411 F. Supp. 2d 416, 427 (S.D.N.Y. 2006).

[69]. See e.g. *See Complaint, Scheck Investments LP vs. MBC et al.* Case no. 04-21160 (S.D. FL 2004).

[70]. TABLE OF JURISDICTIONS WHEREIN ACT HAS BEEN ADOPTED

Alabama .... 1989, No. 1-1-1990 Code 1975, §§ 8-9A-1 to 8-9A-12. 89-793Arizona .... 1990, c. 17 4-4-1990 A.R.S. §§ 44-1001 to 44-1010.
Arkansas .... 1987, Act 967 A.C.A. §§ 4-59-201 to 4-59-213.
California .... 1986, c. 383 7-16-1986 West's Ann.Cal.Civ. Code, §§ 3439 to 3439.12.
Colorado .... 1991, c. 137 7-1-1991 West's C.R.S.A. §§ 38-8-101 to 38-8-112.
Connecticut ...... 1991, P.A. 6-25-1991 C.G.S.A. §§ 52-552a to 52-552l. 91-297
Delaware .... 70 Del. Laws, 7-3-1996 6 Del.C. §§ 1301 to 1311. c. 434
District of Columbia .... 1995, D.C. Law 2-9-1996 D.C. Code, §§ 11-83 28-3101 to 28-3111.
Florida .... 1987, c. 87-79 1-1-1988 West's F.S.A. §§ 726.101 to 726.112.
Georgia .... 2002, c. 427 7-1-2002 O.C.G.A. §§ 18-2-70 to 18-2-80.
Hawaii .... 1985, No. 216 6-4-1985 HRS §§ 651C-1 to 651C-10.
Idaho .... 1987, c. 202 I.C. §§ 55-910 to 55-921.
Illinois .... 1989, P.A. 1-1-1990 S.H.A. 740 ILCS 160/1 to 160/12. 86-814
Indiana .... 2002, P.L. 7-1-2002 West's A.I.C. 32-18-2-1 to 2-2002 32-18-2-21.
Iowa .... 1994, H.F. 1-1-1995 I.C.A. §§ 684.1 to 684.12. 2384
Kansas .... 1998, c. 13 1-1-1999 K.S.A. §§ 33-201 to 33-212.
Maine .... 1985, c. 641 7-16-1986 14 M.R.S.A. §§ 3571 to 3582.
Massachusetts .... 1996, c. 157 7-8-1996 M.G.L.A. c. 109A, §§ 1 to 12.

Where causes of action are brought under UFTA against Ponzi scheme investors, the general rule is that to the extent innocent investors have received payments in excess of the amounts of principal that they originally invested, those payments are avoidable as fraudulent transfers: The money used for the underlying investments came from investors taken in by fraudulent representations. Even though the defendant in a UFTA claim was one of those investors, and it may seem "only fair" that he or she should be entitled to the profits on trades made with his money. That would be true as between him and the Ponzi scheme operator. It is not true as between him and either the creditors of or the other investors in the company. He should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud. All he is being asked to do is to return the net profits of his investment-the difference between what he put in at the beginning and what he had at the end.[71]

Michigan .... 1998, P.A. 434 12-30-1998 M.C.L.A. §§ 566.31 to 566.43.
Minnesota .... 1987, c. 19 4-7-1987 M.S.A. §§ 513.41 to 513.51.
Mississippi ...... 2006, c. 371 7-1-2006 Code 1972, §§ 15-3-101 to 15-3-121.
Missouri .... 1992, S.B. 448 8-28-1992 V.A.M.S. §§ 428.005 to 428.059.
Montana .... 1991, c. 324 MCA 31-2-326 to 31-2-342.
Nebraska .... 1989, LB 423 8-25-1989 R.R.S.1943, §§ 36-701 to 36-712.
Nevada .... 1987, c. 8 3-3-1987 N.R.S. 112.140 to 112.250.

New Hampshire .... L. 1987, c. 1-1-1988 RSA 545-A:1 to 545-A:12. 215
New Jersey .... 1988, c. 74 1-1-1989 N.J.S.A. 25:2-20 to 25:2-34.
New Mexico .... 1989, c. 382 4-7-1989 NMSA 1978, §§ 56-10-14 to 56-10-25.
North Carolina ... 1997, c. 291 10-1-1997 G.S. §§ 39-23.1 to 39-23.12
North Dakota ..... 1985, c. 186 NDCC 13-02.1-01 to 13-02.1-10
Ohio .... 1990, H.B. 506 R.C. §§ 1336.01 to 1336.11.
Oklahoma .... 1986, c. 100 11-1-1986 24 Okl.St.Ann. §§ 112 to 123.
Oregon .... 1985, c. 664 1-1-1986 ORS 95.200 to 95.310.
Pennsylvania ..... 1993, No. 70 60 days 12 Pa. C.S.A. §§5101 to 5110.
Rhode Island ..... 1986, c. 438 6-25-1986 Gen. Laws 1956, §§ 6-16-1 to 6-16-12.
South Dakota ..... 1987, c. 365 SDCL 54-8A-1 to 54-8A-12.
Tennessee .... 2003, c. 42 7-1-2003 T.C.A. §§ 66-3-301 to 66-3-313.
Texas .... 1987, c. 1004 9-1-1987 V.T.C.A. Bus. & C. §§ 24.001 to 24.013.
Utah .... 1988, c. 59 4-25-1988 U.C.A. 1953, 25-6-1 to 25-6-14.
Vermont .... 1996, No. 179 7-1-1996 9 V.S.A. §§ 2285 to 2295.
Washington .... 1987, c. 444 7-1-1988 West's RCWA 19.40.011 to 19.40.903.
West Virginia .... 1986, c. 166 7-1-1986 Code, 40-1A-1 to 40-1A-12.Wisconsin .... 1987-89 Act 4-8-1988 W.S.A. 242.01 to 242.11. 192
Wyoming .... 2006, c. 55 7-1-2006 Wyo.Stat.Ann. §§ 34-14-201 to 34-14-212.
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[71]. *Scholes,* 56 F.3d at 757-58; *see also In re Slatkin,* 525 F.3d 805, 814-15 (9th Cir.

The policy justification is ratable distribution of remaining assets among all the defrauded investors. The "winners"in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to "enjoy an advantage over later investors sucked into the Ponzi scheme who were not so lucky."[72]

There are two theories under which a receiver may proceed under UFTA: actual fraud or constructive fraud. Under the "actual fraud" theory, the receiver alleges that the debtor (Ponzi scheme operator) made transfers to the transferee (the winning investor) "[w]ith actual intent to hinder, delay, or defraud" he creditors (the losing investors). "[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to defraud.[73] Under the "constructive fraud" theory, the receiver alleges that the transfer of "profits" to the winning investor was made "[w]ithout receiving a reasonably equivalent value in exchange for the transfer," because profits gained through theft from later investors are not a reasonably equivalent exchange for the winning investor's initial investment.[74] Proof that transfers were made pursuant to a Ponzi scheme generally establishes that the scheme operator "[w]as engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction," or "[i]ntended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due."

In the context of a Ponzi scheme, whether the receiver seeks to recover from winning investors under the actual fraud or constructive fraud theories generally does not impact the amount of recovery from innocent investors. Under the actual fraud theory, the receiver may recover the entire amount paid to the winning investor, including amounts which could be considered "return of principal." However, there is a "good faith" defense that permits an innocent winning investor to retain funds up to the amount of the initial outlay.[75] Under the constructive fraud theory, the receiver may only recover "profits" above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may also recover the amounts that could be considered return of principal.[76] . The Seventh Circuit has suggested that the only practical distinction between these theories of recovery is the allocation of burdens of proof.[77]

May 6, 2008).

[72]. *In re United Energy Corp.,* 944 F.2d 589, 596 (9th Cir.1991).

[73]. *In re AFI Holding,* 525 F.3d at 704 (internal quotation marks omitted); *Agritech,* 916 F.2d at 535.

[74]. *See Scholes, supra, 56 F.3d at 757.*

[75]. See e.g., Cal. Civ. Code 3439.08a); *Scholes,* 56 F.3d at 759; *Agritech,* 916 F.2d at 535.

[76]. See e.g., Cal. Civ. Code 3439.08(d); *Scholes,* 56 F.3d at 757

[77]. See *Scholes* at 756-57.

Drawing from these theories, federal courts have generally followed a two-step process. First, to determine whether the investor is liable, courts use the so-called "netting rule."[78] Amounts transferred by the Ponzi scheme perpetrator to the investor are netted against the initial amounts invested by that individual. If the net is positive, the receiver has established liability, and the court then determines the actual amount of liability, which may or may not be equal to the net gain, depending on factors such as whether transfers were made within the limitations period or whether the investor lacked good faith. If the net is negative, the good faith investor is not liable because payments received in amounts less than the initial investment, being payments against the good faith losing investor's as-yet unsatisfied restitution claim against the Ponzi scheme perpetrator, are not avoidable within the meaning of UFTA. [79]

Second, to determine the actual amount of liability, the court permits good faith investors to retain payments up to the amount invested, and requires disgorgement of only the "profits" paid to them by the Ponzi scheme.[80] Payments of amounts up to the value of the initial investment are not, however, considered a "return of principal," because the initial payment is not considered a true investment. Rather, investors are permitted to retain these amounts because they have claims for restitution or recision against the debtor that operated the scheme up to the amount of the initial investment. Payments up to the amount of the initial investment are considered to be exchanged for "reasonably equivalent value," and thus not fraudulent, because they proportionally reduce the investors' rights to restitution.[81] If investors receive more than they invested, "[p]ayments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity."[82]

Although all payments of fictitious profits are avoidable as fraudulent transfers, the appropriate statute of limitations restricts the payments the Ponzi scheme investor may be required to disgorge. Only transfers made within the limitations period are avoidable.[83] Once the

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[78]. *See Mark A. McDermott, Ponzi Schemes and the Law of Fraudulent and Preferential Transfers,* 72 Am. Bankr. L.J. 157, 168-69 (1998) (surveying federal district court and bankruptcy cases).

[79]. *See* Cal. Civ. Code § 3439.04a)(2) (holding that only payments made "[w]ithout receiving a reasonably equivalent value" re avoidable as fraudulent transfers); *United Energy,* 944 F.2d at 597 (holding there has been no fraudulent transfer to a good faith investor where a Ponzi scheme makes payments that total less than that investor's initial investment).

[80]. See In re Lake States Commodities, Inc., 253 B.R. 866, 872 (Bankr.N.D.Ill.2000) (collecting cases).

[81]. *United Energy,* 944 F.2d at 595.

[82]. *Lake States,* 253 B.R. at 872.

[83]. *Warfield v. Alaniz,* 453 F.Supp.2d 1118, 1131 (D.Ariz.2006) (holding that a court-appointed receiver could not base his claims under Arizona's UFTA on transfers that took place outside of the limitations period); *Neilson v. Union Bank of Cal., N.A.,* 290 F.Supp.2d 1101, 1145-46 (C.D.Cal.2003) (holding that plaintiffs could prevail if they could prove at trial that certain transfers made pursuant to a Ponzi scheme were made within the limitations period of California's UFTA).

district court has identified the avoidable transfers, it has the discretion to permit the receiver to recover pre-judgment interest on the fraudulent transfers from the date each transfer was made.[84]

IV. Claims Against Third Parties

As noted above, it is common for the SEC to seek a receiver in Ponzi scheme cases, because there are often the fraudulent sale of unregistered securities. Normally, the Court enters an injunction to prevent any investor from filing claims against the company or principals of the Ponzi scheme. However, investors can often file claims against third parties. Oftentimes, the Ponzi scheme operator raises investments through third parties, such as brokers, financial advisors, accountants, and yes, even attorneys. The attorney for the investor must first, make sure that the investor files a "proof of claim" in the bankruptcy or in the assignment of benefit of creditors case, and second, analyze the potential liability of the third party promoters of the investment.

Indeed, in one case, the Court appointed Trustee for the bankruptcy of Louis Perlman's businesses made it crystal clear that investors should hire counsel to explore their legal rights against the third party promoters who brokered the sale of the investment. On his website, the Trustee told the investors the following, in a "frequently asked questions" segment of the site:

> Q. I was introduced to this investment by a sales agent or a broker or some other intermediary. Are these intermediaries liable personally or professionally?
> A. This is the subject of each individual fact specific legal analysis for which you need to seek independent legal advice.
> Q. If these agents were not "licensed" to deal in these securities, misrepresented them and continued to sell them even though the OFR [Office of Financial Regulation] had notified Trans Con not to offer them any more, aren't they liable personally and professionally?
> A. This is the subject of each individual fact specific legal analysis for which you need to seek independent legal advice.
>
> Q. Wouldn't a good paper trail to follow be the bank accounts of all the T-con officers and the agents and why aren't their assets seizable since they are also guilty of gross illegalities?
> A. While this may present an avenue for asset recovery which the Trustee is and will investigate, the legal process to achieve this is complicated and time consuming.
> Q. How broadly are you planning to stake your claim to any recoveries that investors make from third parties?

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[84]. *In re Slatkin,* 525 F.3d at 820; *Agritech,* 916 F.2d at 541-42. "[P]rejudgment interest should not be thought of as a windfall in any event; it is simply an ingredient of full compensation that corrects judgments for the time value of money." *In re P.A. Bergner & Co.,* 140 F.3d 1111, 1123 (7th Cir.1998).

> If, for example, an investor wins a judgment against an independent sales agent who sold the EISA plan, or wins a judgment against others involved in the scam, would you (as Trustee) sue the investor to claim the award for the bankruptcy estate?
> A. These questions raise complex legal issues that would require some in-depth analysis on the rights and claims of the individual investors as opposed to the rights and claims that I have as the Chapter 11 Trustee for Pearlman, TCA and other related companies for which I may be named Chapter 11 Trustee in the future. These are complex legal questions that require the advice of a lawyer and depend on the facts that exist for each case. Each investor may have a different fact scenario. I am not in a position to provide legal advice. ["Q" and "A" added].[85]

The common theme is easy to see: the Trustee may have competing claims with the investors against third parties who brokered the sales of the investments. For example, the Trustee might choose to sue the brokers to the extent of commissions paid to them as fraudulent conveyances under the Uniform Fraudulent Transfer Act or as voidable preferential transfers under Section 548 of the Bankruptcy Code, while the investors might have simultaneous claims against the brokers for violations of the Uniform Securities Act, for the sale of unregistered securities. Accordingly, bankruptcy trustees will not overtly encourage investors to sue the brokers of the investments because of competing claims to the same assets or liability insurance.

The investor's attorney, therefor, must act quickly to look to their state's securities act as a primary vehicle to file an action to recover the investor's money, and other common law claims that might be covered under liability insurance.

The Uniform Securities Act, adopted by most states, holds the seller liable to the buyer:
SECTION 509. CIVIL LIABILITY.
(a) [Securities Litigation Uniform Standards Act.] Enforcement of civil liability under this section is subject to the Securities Litigation Uniform Standards Act of 1998.
(b) [Liability of seller to purchaser.] A person is liable to the purchaser if the person sells a security in violation of Section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:
(1) The purchaser may maintain an action to recover the consideration paid for the security, less the amount of any income received on the security, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court, upon the tender of the security, or for actual damages as provided in paragraph (3).

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[85] http://www.pearlmantranscon.com/faq.html

(2) The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of ownership of the security and willingness to exchange the security for the amount specified. A purchaser that no longer owns the security may recover actual damages as provided in paragraph (3).
(3) Actual damages in an action arising under this subsection are the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court

Fortunately, some states, like Florida, do not require proof of "loss causation" or even "scienter" to succeed on a Uniform Securities Act Claim.[86] Therefor, the securities practitioner should seriously consider filing this claim.

One of the drawbacks of a state Uniform Securities Act claim is the liklihood that the broker/promoter of the Ponzi scheme will not be covered by his/her liability insurance. Many insurance policies reviewed by this author specifically exclude coverage for violations of state or federal securities law. Therefor, it is recommended that a claim for breach of fiduciary duty, negligence and gross negligence be filed as well.

Sometimes, the broker/promoter of the Ponzi scheme is an accountant or an attorney. One of the interesting issues to raise in a claim for the investor is a professional malpractice claim predicated on the violation of the duty of confidentiality that most accountants and attorneys owe to their clients, and for conflicts of interest. Sometimes, a negligence or professional malpractice claim can be predicated on the fact that the accountant or attorney "misused" confidential information to target certain clients to sell the investment to, based on the accountant's or attorney's use of confidential financial information learned during the accountant/client or attorney/client relationship. It is the misuse of that confidential information that gives rise to a clear breach of fiduciary duty claim in some states, which oftentimes is a covered claim under a liability policy.

For example, in *Profit Sharing Trust for MarProwear Corp. vs Lamf,Lipkind Prupis, Petigrow and Labue, P.A.,* the Court upheld a jury verdict for the Profit SharingTrust, finding that the Lampf Lipkind law firm was liable to the Trust [its client], for recommending a failed investment while in a conflict of interest. The law firm, acting as a promoter/broker, approached the client/Trust to make an investment in Southeastern Insurance Group (SIG), and explained

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[86]. Stating cause of action under the Florida Securities Investors Protection Act or Florida common-law fraud is virtually identical to stating claim under Rule 10b-5, except that scienter requirement under Florida law is satisfied by showing of mere negligence, whereas Rule 10b-5 requires reckless disregard. *In re Sahlen & Associates, Inc. Securities Litigation*, 773 F.Supp. 342 (S.D.Fla.1991); Proof of loss causation was not required in civil action under §§ 517.211 and 517.301. *Rousseff v. E.F. Hutton Co., Inc.*, 867 F.2d 1281 (11th Cir.1989).

that the investment was "safe and conservative." The law firm also represented that it was investing its own money in the deal. The private placement memorandum even disclosed that some of the attorneys of the law firm were officers of the company. Based upon these representations and without benefit of any independent counsel or other advice, the Trust invested some $449,600.00 in a complex package of stock, debentures and other securities that comprised two "units" of an investment in SIG.

In upholding the jury verdict, the Court noted that there were grounds for the jury to find that the law firm had misused confidential information to target its own client as an investor:

> Lipkind failed to advise the Trust in writing of both the conflict of interest and the need to get independent counsel. Moreover, there was no evidence of the Trust's consent to the conflict in writing. Lastly, Wasserman claimed that *R.P.C.* 1.8(b) [FN3] was violated because Lampf-Lipkind used its knowledge of the Trust's financial wealth as a basis for targeting the Trust as a potential investor. Wasserman did not render any opinion on proximate causation.
>
> *R.P.C.* 1.8 CONFLICT OF INTEREST: PROHIBITED TRANSACTIONS
> (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless (1) the transaction and terms in which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in manner and terms that should have reasonably been understood by the client, (2) the client is advised of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent counsel of the client's choice on the transaction, and (3) the client consents in writing thereto.
>
> FN3. "*R.P.C.* 1.8(b) provides: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation."

* * *

Ultimately, the Court upheld the jury verdict, rejecting the law firm's claims of lack of proximate cause, mostly on policy grounds:

> "If proximate cause is ultimately a question of fairness and policy, imposing liability on these facts is both fair and good policy. Lawyers who fail to inform clients of their own interests, fail to advise clients to seek other counsel, unabashedly sell their clients the notion that an investment with them or their colleagues is a good and safe one, and use their clients as sources of investment funds, must accept responsibility for the outcome. Lawyers may not burrow their way into their clients' confidences and then exploit those confidences for their own ends. This is the law in New Jersey. This Court will no more tolerate the hoodwinking of helpless clients out of funds in a business venture that is essentially for the benefit of the lawyer than it will outright

> misappropriation of funds.[87]The Rules of Professional Conduct bar such conduct. Such conduct is reprehensible and foreseeable damages are proper, if so found by the jury. Here the PPM provides a convenient yardstick as to the foreseeable consequences. While, given their own large investment in SIG, there is little doubt but that Lampf-Lipkind honestly believed, as did the attorney in In re Smyzer, supra, at 57, 527 *A*.2d 857, that the investment was a good one, there is also little doubt that they understood the risks. Risky investments are not barred; they are essential to our economic system. Lawyers, however, cannot use their clients to bankroll such risks.[88]

In addition to professionals such as attorneys and accountants, it is common for the Ponzi scheme operator to have a network of licensed or unlicensed promoters selling the investment for a commission. In *In re World Vision Entertainment, Inc*.[89] the Ponzi scheme operator/debtor did not directly sell most of the promissory notes used to defraud investors. Instead, the Ponzi operator actively solicited and recruited a network of brokers, primarily insurance agents, to sell the notes in exchange for a generous commission. Commission rates ranged from 12 to 15 percent.[90] Brokers received a commission payment both when notes were sold and also when notes were renewed. The receiver sued the note brokers alleging a fraudulent transfer under the Bankuprty Code, 11 USC 548[91], alleging many of the brokers fraudulently received commissions averaging 14 percent of the total notes sold. The Court noted that the brokers' sole job was to sell the fraudulent notes or mortgages to investors. In trying to determine whether the notes were sold in good faith, the court observed,

> the brokers often have long-term relationships with their clients. The clients usually are elderly and financially unsophisticated. The clients rely on the brokers for financial advice. Therefore, the issue is whether these brokers act in good faith if they make no or little effort to verify the legitimacy of the debt instruments they market. Stated differently, can a broker simply rely on promises made by a dishonest and fraudulent

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[87]. In re Wolk, 413 A.2d 317 (1980), citing *In re Wilson,* 81 N.J. 451, 409 *A*.2d 1153 (1979).

[88]. 267 N.J.Super. 174, 630 A.2d 1191 (1993).

[89]. 275 B.R. 641 Bkrtcy.M.D.Fla.,2002.

[90]. Id.

[91].Bankruptcy Code §548(a) provides:(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily-(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date such transfer was made or such obligation was incurred, indebted; or(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

> debtor and still act in good faith? Good faith is not a precise, defined term. Good faith is judged using an objective standard. *See In re M & L Business Machine Co.,* 84 F.3d at 1337-39 (good faith should be measured using an objective standard which examines whether circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose); *Hays v. Jimmy Swaggart Ministries, et al.,* 263 B.R. 203, 211 (M.D.La.1999) ("Good faith is determined on a case-by-case basis using an objective standard ..."); *but see Independent Clearing House Co.,* 77 B.R. at 862 (good faith is a subjective question).[92]

Importantly, the Court in *World Vision* found that these brokers had at least a minimal duty to investigate the product and the company before they sold it to unsuspecting investors:

> The Court accepts Sand's testimony that any broker selling short-term promissory notes, even unregistered promissory notes such as the debtor's notes, has a minimal duty of care owed to investors. Before selling the notes, the broker must review *655 available investment ratings from qualified financial rating services. The broker must request and review with a critical eye audited financial statements of the company as well as other literature provided by the company discussing its sales history and the background of key employees. A broker cannot rely only on slick, marketing brochures or insurance coverage, refrain from asking hard questions about the legitimacy of the product, and then assume a proper investigation was completed. In some cases, other types of investigation may be merited. However, unless these minimal steps are taken, a broker selling a short-term promissory note is not performing the minimum standard of care required throughout the United States.[93]

In the end, the Court in the World Vision case found all of the brokers' liable, rejecting their claims that they acted in good faith.[94]

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[92]. *In re Worldwide Entertainment*, 275 B.R. 641 (Bkrtcy.M.D.Fla.,2002).

[93]. Id at. 654-655.

[94]. Id. A party can rebut the § 548(c) good faith defense by showing that the recipients of the avoidable transfer had knowledge or notice of the debtor's financial difficulties or fraudulent purpose. "[C]ourts look to what the transferee objectively 'knew or should have known' ather than examining what the transferee actually knew from a subjective standpoint." *In re Agricultural Research & Technology Group, Inc.,* 916 F.2d 528, 535-36 (9th Cir.1990). "[I]f the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and diligent inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." *Id.* at 536 (*citing In re Polar Chips Int'l., Inc.,* 18 B.R. 480 (Bankr.S.D.Fla.1982)). "[A] transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency." *In re Sherman,* 67 F.3d 1348, 1355 (8th Cir.1995). Further, "a transferee may not remain willfully ignorant of facts which would cause it to be on notice of a debtor's fraudulent purpose," *Model Imperial,* 250 B.R. at 798, and then "put on 'blinders prior to entering into transactions with the debtor and claim the benefit of 548(c)." *In re Cannon,* 230 B.R. 546, 592 (Bankr.W.D.Tenn.1999) (*rev'd on other grounds,*

What is a note-broker's minimal duty? Any broker selling short-term promissory notes has a duty to conduct a reasonable investigation into the legitimacy of the notes.[95] As general rule, before selling the notes, a reasonable broker must review available investment ratings from qualified financial rating services.[96] The broker also must request and review audited financial statements of the company as well as other literature provided by the company discussing its sales history and the background of key employees.[97] "A broker cannot rely only on slick, marketing brochures or insurance coverage, refrain from asking hard questions about the legitimacy of the product, and then assume a proper investigation was completed."[98] Other types of investigation may also be merited. In short, "unless these minimal steps are taken, a broker selling a short-term promissory note is not performing the minimum due diligence required throughout the United States."[99]

IV. Collection Issues

It is quite common for a Court, in response to an SEC action for injunctive relief, to appoint a receiver. The injunction normally prohibits any third party from suing the persons or entities involved in the receivership itself. Often, there are both named defendants and "relief defendants.: A "relief defendant" is one who, while not accused of directly participating in the Ponzi scheme, is a person or an entity in possession of assets derived from the Ponzi scheme. The practitioner must be careful not to file a shotgun suit, because naming any of the defendants or relief defendants in an SEC injunction or receivership case will net a contempt action from the Court.

If the seller of the Ponzi scheme investment is a registered representative, he or she is subject to liability in a FINRA arbitration, most likely for "selling away." [100] If the seller/promoter/broker is unregistered, the investor will have to sue in Court. If the investor is successful, a judgment will be entered, and then the collection process must begin. Some practitioners will hire "collection attorneys" who specialize in the collection of judgments to find assets. It is recommended that a securities attorney unfamiliar with the collections process hire a collection attorney to collect a judgment.

The Commercial Law League is a good source to find a collection attorney (aka "creditors rights attorney"), or a bankruptcy attorney, if needed.[101] Moreover, a good source for

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277 F.3d 838 (6th Cir.2002)).

[95]. Id.

[96]. Id.

[97]. Id.

[98]. Id.

[99]. Id.

[100]. Since this topic is covered by another author in this program, it is not being covered in detail in this article.

[101]. http://www.clla.org.

collection attorneys is the local bankruptcy bar association, as there are normally many creditors' rights attorneys who will collect judgments in and out of bankruptcy court.

Still others will hire private investigators who will charge a fee to find bank accounts or other assets to garnish or attach. There are private investigators, in this author's experience, who will only charge a fee if they locate a bank account for the judgment creditor. There are other investigators who specialize in asset searches, again, charging a fee on contingency only if they are successful. Since the area of collections is so broad, it is recommended that the judgment creditor hire an attorney who is skilled in collections, who in turn may use the services of a private investigator to identify assets to satisfy the judgment.

If the debtor files for bankruptcy, the victim of the Ponzi scheme, holding the judgment, can sue the debtor for a finding that the judgment is "nondischargeable," meaning that the judgment remains collectable against the debtor. This is significant, because judgments are often collectable for many years, and, once the debtor "discharges" all of his other debts, the nondischargable judgment may be easier to collect. A recorded judgment may be deemed a "secured" debt against the debtor's remaining assets, putting the investor/creditor higher up on the food chain, eligible for a distribution of moneys or assets from the bankruptcy estate.

The purpose of the nondischargability action is to prevent the judgment from being wiped out in bankruptcy, as part of the debtor's discharge. A discharge means the debtor gets a "fresh start" free from the claims of the all the creditors. However, the Bankruptcy Code was not designed to shield debtors from committing fraud, and then washing one's hands in bankruptcy. Under Section 523(a)(2)(A) of the Bankruptcy Code there is an exception to discharge from debts obtained by fraud. It states, in pertinent part, as follows:

(a) A discharge under section 727 ... does not discharge an individual debtor from any debt-
(2) for money, property, services, ... to the extent obtained by-
(A) false pretenses, a false representation, or actual fraud ....[102]

Exceptions to discharge are narrowly construed to further the Bankruptcy Code's "fresh start" policy; thus, the claimant has the burden to demonstrate that his claim comes within an exception to discharge by a preponderance of the evidence.[103]. Still, the very purpose of some sections of the Bankruptcy Code "is to make certain that those who seek shelter of the bankruptcy code do not play fast and loose with their assets or with the reality of their affairs."[104] In this respect, § 523(a)(2)(A), is intended to make certain that those who obtain property by fraudulent means are not afforded bankruptcy protection.[105]

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[102]. 11 U.S.C. §523(a)(2)(A) (2004).
[103]. *Grogan v. Garner,* 498 U.S. 279, 286, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991)
[104]. *Palmacci v. Umpierrez,* 121 F.3d 781, 786 (1st Cir.1997).
[105]. *Id.*

To establish that a debt should not be subject to discharge, a claimant must prove:

(1) that the debtor made a fraudulent misrepresentation;
(2) that the debtor's conduct was with the intention and purpose of deceiving or defrauding the creditor;
(3) that the creditor relied on the debtor's representations or other fraud; and
(4) that the creditor sustained loss and damage as a proximate result of the representations of fraud.[106] Element one is satisfied if the debtor's representation was known to be false or recklessly made without knowing whether it was true or false.[107] Pertinent considerations for determining recklessness are the debtor's pattern of conduct and his prior business expertise.[108]

The conclusion that a debtor knew that his representations were false is closely linked to, but separate from, the issue of an intent to deceive to influence another's conduct. Indeed, most cases revolve around the second element: whether the debtor acted with the requisite intent to defraud. When a debtor invests funds on behalf of another party, "a debtor will be found to have acted with the requisite intent to defraud under § 523(a)(2)(A) when, at the time the transaction occurred, it is established that the debtor, for his or her personal gain, knowingly mislead the investor as to a material fact concerning the investment."[109] A showing of reckless indifference to the truth is sufficient to demonstrate the requisite intent to deceive. [110] Because a debtor will rarely, if ever, admit to acting with an intent to deceive, intent may be inferred from the totality of the circumstances.[111] Element three will be satisfied by a showing of "justifiable reliance" on the representations. This standard of reliance requires more than actual reliance but less than reasonable reliance.[112]

An instructive case is *In re Justice.*[113] In *In re Justice,* the bankruptcy court found that the actions of the debtor, who was the creditor's financial advisor, in inducing the creditor to invest in what turned out to be a fraudulent securities investment constituted gross recklessness

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106. *In re Biondo,* 180 F.3d 126, 134 (4th Cir.1999); *In re Hale,* 274 B.R. 220, 222-23 (Bankr.E.D.Va.2001).

107. *In re Woolley,* 145 B.R. 830, 834 (Bankr.E.D.Va.1991) (citing *In re Taylor,* 514 F.2d 1370, 1373 (9th Cir.1975)).

108. *Id.* at 834-35.

109. *In re Grim,* 293 B.R. 156, 163 (Bankr.N.D.Ohio 2003).

110. *Umpierrez,* 121 F.3d at 787; *In re Bonnanzio,* 91 F.3d 296, 301 (2d Cir.1996); *In re Woolley,* 145 B.R. at 835.

111. *Umpierrez,* 121 F.3d at 789; *In re Woolley,* 145 B.R. at 836.

112. *In re Justice,* No. 01-02156, 2002 Bankr.LEXIS 1540, n. 3 (Bankr.N.D.Ohio Dec. 27, 2002). "It is a more subjective standard ... that takes into account the interactions between and experiences of the two parties involved." *Id.* (quoting Jeffrey R. Priebe, Fields v. Mans *and* In re Keim: *Excepting Debts From Bankruptcy Discharge and The Difference Between Experienced Horsemen and Reasonable Men,* 54 Ark. L.Rev. 99, 109-110 (2001)).

113. No. 01-2156, 2002 Bankr.LEXIS 1540 (Bankr.S.D.Ohio).

rising to the level of an intent to deceive.[114] In *Justice,* the debtor represented the investment as "safe" to the creditor; the debtor, who had experience with securities, relied solely on the claims of the investment brochure that it was exempt from registration and otherwise legitimate; the debtor did not call the SEC, the Ohio Attorney General, any financial rating service, or otherwise test the validity of the information; and the debtor did not question how the investment could guarantee such a high rate of return.[115] The Court found the debt nondischargeable.

Similarly, in *In re White,* the Court found that the debt was nondischargeable, in part because the note-brokers did no real investigation of the product that they sold: "the overwhelming failure of White and Pangle to do any real investigation into the Notes characterizes their recklessness. Their actions evidence that they wanted to receive commissions without asking the hard questions."[116]. In *In re White*, the Court also found that under the circumstances, nothing was apparent to indicate to the investors that they should be wary of the investment, especially given that the solicitations arose out of a church relationship.[117] The Court also rejected the debtor's other argument that the investor was an experienced businessman, who should have done research into the investments himself.[118]

V. How to Find The Victims of Ponzi Schemes

Many Ponzi schemes are reported in the press, and often on the website of the Securities and Exchange Commission. Often, Receivers appointed by the Court in an SEC case will place the Ponzi company in a bankruptcy. After a financial audit is complete, the Receiver will communicate with the victims of the Ponzi via letters and a website.[119] As part of the bankruptcy process, the debtor will have to file schedules with the court, which includes a list of its known creditors, and whether the claims are liquidated or unliquidated. The bankrupcty schedules are easily downloaded from the Public Access to Court Electronic Records (PACER).[120] One obviously must follow the local ethics rules to see whether targeted mailings are allowed to alert the investors to the attorney's willingness to help them make a recovery in the Ponzi scheme case.

Another common method to find the victims of the Ponzi scheme is the internet. It is quite common for attorneys to publish blogs or even public relations releases about the Ponzi scheme, netting them searchable by the victims who are looking for information on the Ponzi

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[114]. 2002 Bankr.LEXIS 1540, at n.20.

[115]. 2002 Bankr.LEXIS 1540, at n.16-22.

[116] . *In re White*, 128 Fed.Appx. 994, 998, 2005 WL 984195, *3 (4th Cir.2005).

[117]. Id. Fraudulent solicitations through a church are commonly called "affinity fraud."

[118]. Id.

[119]. The Receiver will not, as a matter of policy, give out any list of victims.

[120]. www.pacer.psc.uscourts.gov. All attorneys should sign up for this service and get an account.

scheme.

Another common technique is to take out an advertisement in the local paper where most of the Ponzi schemes are located. Moreover, sometimes victim lists are published in the receivership action. If the Receiver locates assets that are available for distribution, the Receiver will file a motion with the Court to approve the amount of the distribution. The motion is normally accompanied by a list of the investors, the amount of their investment, and the proposed distribution. Again, the practitioner is cautioned to carefully follow local bar rules on targeted or general advertising to the victims, who sometimes can make a recovery outside of the receivership.

About the Author

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Mr. Sonn focuses his practice principally on complex securities litigation and arbitration matters, including class actions.

During his career, Mr. Sonn has litigated numerous cases to successful resolution, recovering many millions of dollars for defrauded investors. He recently won a $50 million final judgment in Katz v. MRT Holdings, one of the few cases in the Private Securities Litigation Reform Act passed in 1995 to yield a final judgment on the merits.

Frequently, Mr. Sonn serves as a television commentator on securities fraud and ponzi scheme cases for CNBC, The CBS Sunday Morning Show, BBC Radio, ABC and MSNBC.

Mr. Sonn was the CNBC contributing expert on the Bernard Madoff Ponzi Scheme for the CNBC shows “On the Money” and “Scam of the Century,

Bernie Madoff and the $50 Billion Dollar Heist." Mr. Sonn recently appeared in the CNBC show "American Greed."

Mr. Sonn is the author of "Ponzi Schemes, Picking up the Pieces from a Fallen House of Cards" (Practicing Law Institute, 2009, Securities Arbitration in the Meltdown Era), and spoke at the 2009 Practicing Law Institute on Ponzi Schemes.

Mr. Sonn also authored "Group Arbitration Techniques", "The ABC's of Mortgage Backed Securities", "How CPA's Can Detect Securities Fraud," "The Broker Went Bankrupt—Now What?" "Survey of Arbitrator Misconduct," as well as other securities related publications.

Mr. Sonn serves as a Director of the Public Investor Arbitration Bar Association, the national bar association for attorneys who practice securities fraud law. Mr. Sonn regularly lectures, and participates at national seminars, on the topic of securities fraud.

Mr. Sonn has acted as trial counsel in a number of successful cases, including First Union vs. the FDIC and Hollywood Associates (a $16 million dollar verdict), Regas v. Painewebber (a $2.2 million dollar verdict) and Tartell v. Krieger Financial ($1.7 million dollar verdict).

Prior to founding the Firm in 1995, Mr. Sonn was associated with the Miami-based securities-litigation defense firm Gilbride Heller & Brown and the bankruptcy law firm of Mishan, Sloto, Hoffman and Greenberg (the firm was founded by United States Bankruptcy Judge A.J. Cristol).

Mr. Sonn graduated from the University of Florida in 1984 and from University of Miami Law School in 1988. Mr. Sonn was an Associate Editor of the University of Miami InterAmerican Law Review.

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