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Fraudulent Schemes Involving Real Estate

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FRAUDULENT SCHEMES INVOLVING REAL ESTATE[1]

Whether boom or bust, there are two elements of the economy which are always present: real estate and fraud. Real estate is tangible and never disappears absent rising waters.[2] Experienced lawyers know fraud may be as inevitable as death and taxes. Although bankruptcy is not inevitable when fraud and real estate deals go bad, it is not uncommon either.

This paper discusses a common fraud scheme (a Ponzi scheme) a less common scheme (an EB-5 scheme) and inevitable attempts to hide the proceeds of a fraud or crime (money laundering). It also discusses some of the unique issues that arise when these cases reach the bankruptcy courts.

I. Ponzi Schemes

What is a Ponzi Scheme?

"A Ponzi scheme is any sort of fraudulent arrangement that uses later acquired funds or products to pay preexisting investments."[3] Ponzi schemes usually have the following common characteristics:

1. The fraud of the Ponzi scheme will usually entail using funds contributed by previous investors to pay subsequent investors.

2. Investors are promised high rates of return, usually over a short period of time.

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[2] https://www.npr.org/2019/11/13/778812333/venice-is-on-its-knees-mayor-blames-worst-tides-in-50-years-on-climate-change

[3] *Bartson v. Marroquin (In re Marroquin),* 441 B.R. 586 (Bankr. N.D. Ohio 2010)

3. The promoter of the Ponzi scheme will generally pay back the early investments on a timely and expedited basis so as to generate enthusiasm for additional contributions.

4. The Ponzi business commonly has little or no legitimate business purpose. As such, Ponzi schemes are subject to ultimate collapse when the promoter of the scheme is unable to attract more funds to pay for demands made on previous contributions.

5. The promoter of the Ponzi scheme typically lives a lavish lifestyle.[4]

Fraudsters focus on attracting new money to make payments to investors early to generate the false appearance that a Ponzi scheme is a legitimate, profitable business. Ponzi schemes require a consistent inflow of new money from new investors to continue, and without this money, the "music stops" and Ponzi schemes tend to collapse.[5]

These schemes are named after Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s.[6] He originally purchased a few legitimate investments, but swapped real returns for fake returns using new investor money. Ponzi promised investors a 50% return in 90 days[7], despite the fact that interest rates at the time were only 5%.

When a deal is too good to be true, it probably is. Warning signs include promises of high return with no risk, consistent returns, the use of unregistered

[4] *Bartson v. Marroquin (In re Marroquin)*, 441 B.R. 586 (Bankr. N.D. Ohio 2010)
[5] https://www.sec.gov/fast-answers/answersponzihtm.html
[6] https://www.sec.gov/fast-answers/answersponzihtm.html; see also *In re Ponzi*, 268 F. 997 (D. Mass. 1920)
[7] *In re Ponzi*, 268 F. 997 (D. Mass. 1920)

investments and unlicensed sellers. Ponzi schemers typically explain their promised success as the result of secret or complicated strategies. The investment is usually poorly documented.

Recent Real Estate Ponzi Schemes

Do you think Ponzi schemes don't usually involve real estate? Well, a reporter at the *TheRealDeal.com* recently identified six alleged real estate Ponzi schemes in that are making their way through the courts in 2019.[8] These include:

a. Woodbridge Group: Involved the sale of unregistered securities to over one hundred retail investors between 2013 and 2017 raising more than $1.2 billion before collapsing in December 2017 and filing for bankruptcy.[9]

b. Robert C. Morgan: SEC complaint alleges a Ponzi scheme involving investments in multi-family projects.[10]

c. Carl Chen: Ponzi scheme involved at least 3 million in investments.[11]

d. Viktor Gjonaj: Ponzi scheme allegations which are denied by Mr. Gjonaj.[12]

e. Glenn C. Mueller: SEC complaint alleges fraud involving 300 investors in 32 states with promissory notes totaling $41.6 million relating to apartment building flips.[13]

f. Rick Koerber: Ponzi scheme involving more than $100 million raised from friends, family and fellow church members.[14] Proceeds used for a lavish lifestyle and to

[8] Elizabeth Kiefer, *Robert Shapiro is Not Alone: 5 Real Estate Ponzi Schemes You Should Know About*, The Real Deal, Nov. 12, 2019, located at https://therealdeal.com/2019/11/12/robert-shapiro-is-not-alone-5-real-estate-ponzi-schemes-you-should-know-about/

[9] *SEC v. New*, 2019 Us Dist Lexis 19614 (S.D. Ind. Feb. 07, 2019*); Contrarian Funds, LLC v. Woodbridge Grp. of Cos. (In re Woodbridge Grp. of Cos.)*,No. 18-996 (D. Del. Sept. 11, 2019)

[10] https://www.sec.gov/litigation/litreleases/2019/lr24477.htm

[11] https://www.justice.gov/usao-de/pr/delaware-businessman-sentenced-federal-prison-multi-million-dollar-ponzi-scheme

[12] https://www.crainsdetroit.com/real-estate/real-estate-executive-denies-crimes-response-ponzi-type-scheme-lawsuit-more-investors

[13] https://www.sec.gov/litigation/complaints/2019/comp24594.pdf

[14] https://www.sltrib.com/news/2018/09/20/jury-finds-rick-koerber/

purchase hamburger franchise and "B" horror movie called "Evil Angel"[15] starring Ving Rhames.[16]

II. EB-5 Scheme

The EB-5 visa program was created by the Immigration Act of 1990[17] and permits immigrant investors to obtain lawful permanent residency in the United States for themselves and their families.[18] It is intended to attract foreign capital, encourage economic development, and benefit the U.S. economy and labor market.[19]

A foreign investor seeking an EB-5 visa prove that they are 1) investing $1,300,000 into a new commercial enterprise or $900,000 into a new commercial enterprise if the investment is made in a rural area or area of high unemployment, and 2) creating at least ten new jobs from the investment.[20]

As might be expected, fraudsters have found numerous ways to exploit the desire of individuals to bypass typical immigration requirements in exchange for investments. Sometimes the immigrants are the victims of the fraud[21] and sometimes it is the government.[22] Sometimes the EB-5 scheme is merely an element of a larger and more traditional fraud like a Ponzi scheme.[23]

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[15] Elizabeth Kiefer, *Robert Shapiro is Not Alone: 5 Real Estate Ponzi Schemes You Should Know About*, The Real Deal, Nov. 12, 2019, located at https://therealdeal.com/2019/11/12/robert-shapiro-is-not-alone-5-real-estate-ponzi-schemes-you-should-know-about/; https://www.sltrib.com/news/business/2017/09/12/accused-real-estate-guru-invested-in-sexy-horror-flick-to-raise-funds-for-movie-on-mormon-church-founder-joseph-smith/

[16] Best known for playing Marsellus Wallace in *Pulp Fiction.*

[17] Pub. L. No. 101-649 , 104 Stat. 4978

[18] *Wang v. Pompeo*, 354 F. Supp. 3d 13 (D.D.C. 2018)

[19] *Wang v. Pompeo*, 354 F. Supp. 3d 13 (D.D.C. 2018)

[20] 8 U.S.C. § 1153(b)(5) ; 8 C.F.R. § 204.6(j)

[21] *United States v. O'Connor*, 321 F. Supp. 2d 722 (E.D. Va. 2004)

[22] *United States v. O'Connor*, 321 F. Supp. 2d 722 (E.D. Va. 2004)

[23] For a case involving allegations of a Ponzi scheme in conjunction with an EB-% scheme, see *Daccache v. Quiros*, 2018 WL 2248409 (S.D. Fla. May 15, 2018)

III. Money Laundering

When a reporter asked Willie Sutton why he robbed banks, he replied "Because that's where the money is." Why would a money launderer invest in real estate? Because that's where the legitimacy is. That's the purpose of money laundering: to take illegitimate assets and make them legitimate. There is arguably no better way to make assets look legitimate than to have them out in the open. Real estate investments accomplish the job.

The average bankruptcy practitioner may think their practice is not affected by money laundering. But the scope of the problem suggests otherwise. The Department of the Treasury estimates domestic financial crimes, excluding tax evasion, generate approximately $300 billion of proceeds for potential laundering.[24] The crimes include healthcare fraud ($100 billion alone), drug trafficking, human smuggling, human trafficking, organized crime, and corruption.[25]

The $300 billion estimate is more than the gross domestic product of 28 states.[26] The estimate is based on domestic financial crimes alone. The true money laundering figure would likely be staggering when international financial crimes are considered.[27]

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[24] 2018 National Money Laundering Risk Assessment (https://home.treasury.gov/system/files/136/2018NMLRA_12-18.pdf)
[25] 2018 National Money Laundering Risk Assessment (https://home.treasury.gov/system/files/136/2018NMLRA_12-18.pdf)
[26] https://en.wikipedia.org/wiki/List_of_U.S._states_and_territories_by_GDP
[27] International cases can be massive. For example, one money laundering case involved a $230 million tax refund fraud scheme allegedly committed by Russian organized crime against the Russian treasury. The Justice Department settled the case for $5.9 million in 2017 (https://www.justice.gov/usao-sdny/pr/acting-manhattan-us-attorney-announces-59-million-settlement-civil-money-laundering-and). Another case involves an allegation of $4.5 billion stolen from a Malaysian sovereign wealth fund (https://www.justice.gov/opa/pr/us-seeks-recover-approximately-540-million-obtained-corruption-involving-malaysian-sovereign)

Given the size and scope of the money laundering problem, it is not a great leap to conclude most bankruptcy practitioners have handled matters involving elements of money laundering, whether they knew it or not.

What is money laundering?

"Money laundering is the process of making illegally-gained proceeds (i.e. 'dirty money') appear legal (i.e. 'clean')."[28] Money laundering addresses the problem of hiding the proceeds of illegal or illicit activities from the government and making them available to use. It hides the illegal activity and makes it appear the assets are from a legitimate source.

How is it accomplished?

The main character from the Netflix show *Ozark* is a professional money launderer. His simplified description is:

> Money Laundering 101. Say you come across a suitcase with five million bucks in it. What would you buy? A yacht? A mansion? A sports car? Sorry. The IRS won't let you buy anything of value with it. So you better get that money into the banking system. But here's the problem. That dirty money is too clean. Looks like it just came out of a bank vault. You gotta age it up. Crumple it. Drag it through the dirt. Run it over with your car. Anything to make it look like it's been around the block. Next, you need a cash business. Something pleasant and joyful with books that are easily manipulated. No credit card receipts, etcetera. You mix the five million with the cash from the joyful business. That mixture goes from an American bank to a bank from any country that doesn't have to listen to the IRS. It then goes into a standard checking account and voila. All you need is access to one of over three million

[28] https://www.fincen.gov/history-anti-money-laundering-laws

> terminals, because your work is done. Your money's clean.
> It's as legitimate as anybody else's.[29]

In reality, not every money laundering scheme employs front businesses and foreign bank accounts. However, most involve three elements: placement, layering and integration.[30]

Placement

Placement is the process of taking illicit cash (or another asset) and placing it into the legitimate financial system. The prototypical method, as described *Ozark*, is to use a front business[31] which enables the mixing of legitimate and illicit cash.[32]

Another method of placement involves "structuring" transactions to fall below applicable reporting requirements which may trigger investigation by law enforcement. Structuring is a crime by itself[33] and frequently utilizes multiple parties, known as "smurfs" to disguise the scope of the placement.[34]

Imagination is the only limit on the variety of schemes used to place illicit funds into the financial system.[35] It is not uncommon for money launderers to

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[29] Marty Byrde, *Ozark*.
[30] *United States v. Cordoba*, 2012 WL 3620306 (S.D. Fla. Aug. 21, 2012)(describing testimony of money laundering expert); 2018 National Money Laundering Risk Assessment (https://home.treasury.gov/system/files/136/2018NMLRA_12-18.pdf)
[31] See example, *United States v. Okeke*, 779 Fed. Appx. 389 (7th Cir. 2019)(car dealership operated as front for laundering proceeds from romance frauds, business email takeover schemes, identity theft, and credit card fraud)
[32] "Trust me, a bakery is virtually impossible to run without drug money." Doug Wilson, *Weeds*
[33] 31 U.S.C. § 5324
[34] *United States v. $9,980 Seized from Community Bank & Trust Account No. 067-0022713*, 859 F. Supp. 2d 1281 (M.D. Fla. 2012)(noting a "smurf" is like "the little blue cartoon character, engages a simple but bold adventure, albeit one which involves running around to different banks to conduct transactions just below the reporting requirement.")
[35] The detestable nature of fraud "embraces all the multifarious means which human ingenuity can devise and are resorted to by one individual to get an advantage over another." *Graves v. Graves*, 1971 OK 15, 481 P.2d 136 (1971).

purchase casino chips with illicit funds which are cleaned when the casino issues a check to cash them out.[36] Increasingly, real estate investment has become a favorite vehicle for money launderers.[37]

Lawyers are sometimes unwittingly, or perhaps wittingly, involved in money laundering when clients transfer illicit funds into the attorney's IOLTA account in contemplation of a transaction and then requests the funds be returned from the IOLTA account to the client.[38] The Department of the Treasury described how IOLTA accounts are particularly susceptible to money laundering:

> Prosecutors have increased their focus on attorneys suspected of being complicit in money laundering, particularly those suspected of laundering funds for drug traffickers. According to HSI, one method attorneys employ to facilitate money laundering is to misuse their Interest on Lawyers Trust Account (IOLTA). These are accounts that lawyers establish at banks to hold or transfer funds on behalf of various clients. The interest earned on an IOLTA is ceded to the state bar association or another entity to pay for pro bono representation or other public interest purposes. These accounts present money laundering risks because they are not subject to mandatory reporting requirements which can allow cash deposits and withdrawals over $10,000 to go undetected, and because the accounts are used to pool the funds of multiple clients the bank holding an IOLTA has no direct relationship with or knowledge of the ultimate beneficial owner of the account. Complicit attorneys might allow illicit proceeds to

[36] See *Baghoumian v. United States*, No. 14 Civ. 8683 (PGG)(S.D.N.Y. May 21, 2019)(describing money laundering scheme using casino chips); *Commonwealth v. Coleman*, 34 Mass. L. Rptr. 215 (Super. Ct. 2017)(discussing state gaming statute designed to prohibit money laundering through the purchase and cashing out of casino chips)

[37] https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf

[38] See example https://www.law.com/sites/almstaff/2016/08/08/money-laundering-case-puts-spotlight-on-law-firms-use-of-trust-accounts/?slreturn=20191011162155

> be deposited in their IOLTAs and then launder the funds through the purchase of real estate or investments, or by transferring the money out of the United States. Attorneys may also be unwitting participants in money laundering schemes, through the use of IOLTAs or by helping clients establish legal entities, open bank accounts, and engage in other "transactional" activities. [39]

Layering

Layering is sometimes referred to as the "shell game"[40] and involves shifting funds to create confusion and obscure the true source of the funds. The inclusion of a layering element to a money laundering scheme renders it "sophisticated laundering" which triggers penalty enhancements under the Federal Sentencing Guidelines.[41]

"Sophisticated laundering" means "complex or intricate offense conduct pertaining to the execution or concealment of the 18 U.S.C. § 1956 offense." [42] Sophisticated laundering "typically involves the use of fictitious entities; shell corporations; two or more levels (i.e., layering) of transactions, transportation, transfers, or transmissions, involving criminally derived funds that were intended to appear legitimate; or offshore financial accounts." [43]

Integration

The last part of a money laundering scheme involves the integration of the "cleaned" money into legitimate commerce. It can be as simple as depositing funds into a bank from a front business. A front business could also integrate the funds

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[39] 2018 National Money Laundering Risk Assessment (https://home.treasury.gov/system/files/136/2018NMLRA_12-18.pdf)
[40] *United States v. Cordoba*, 2012 WL 3620306 (S.D. Fla. Aug. 21, 2012)
[41] U.S.S.G. § 2S1.1(b)(3)
[42] *United States v. Feldman*, 931 F.3d 1245 (11th Cir. 2019)
[43] *United States v. Feldman*, 931 F.3d 1245 (11th Cir. 2019)

through the payment of ghost employees or further layered through payment of fictitious invoices submitted by a shell company controlled by the money launderer.

Statutory and Regulatory Framework

There are numerous federal and state laws and regulations governing money laundering in the United States. The principal federal criminal statutes are 18 U.S.C. §§ 1956 (laundering of monetary instruments) and 1957 (engaging in monetary transactions in property derived from specified unlawful activity) as well as 31 U.S.C. § 5324 (crime of structuring).

Section 1956 criminalizes the following:

> (1) Conducting a financial transaction knowing the transaction represents the proceeds of an specified unlawful activity:
>
> (A) with the intent to promote the specified unlawful activity, evade federal taxes or engage in tax fraud; or
>
> (B) knowing the transaction is designed to conceal or disguise the nature, location, source, ownership or control of the proceeds of the specified unlawful activity or to avoid state or federal reporting requirements
>
> (2) Transferring money in or through the United States with the intent to promote the specified unlawful activity or to avoid a transaction reporting requirement under state or federal law.[44]

The penalties for violating § 1956 include imprisonment for not more than 20 years and fines of the greater of $500,000 or twice the value of the transactions.

[44] The statute is not quoted verbatim.

Section 1957 criminalizes the knowing engagement in a monetary transaction in criminally derived property of a value greater than $10,000 derived from a specified unlawful activity. The penalty for violating section 1957 is a fine and imprisonment for not more than 10 years.

There are a number of other federal statutes and regulations directly or tangentially related to money laundering including the Bank Secrecy Act of 1970 (establishing reporting requirements for financial institutions), the Money Laundering Control Act of 1986 (criminalizing money laundering and requiring banks to maintain procedures to ensure and monitor compliance with the reporting requirements), the Annunzio-Wylie Anti-Money Laundering Act of 1992(requiring filing of suspicious activity reports), the Patriot Act (criminalizing the financing of terrorism and significantly expanding anti-money laundering requirements for banks), and the Intelligence Reform & Terrorism Prevention Act of 2004 (requiring regulations to ensure certain financial institutions report cross-border wire transfers of the Secretary of the Treasury determines the reporting is required to fight money laundering and terrorism and permits the Secretary to designate jurisdictions, classes of transactions and types of accounts as being a "primary money laundering concern").

The principal federal regulations include 12 C.F.R. § 21.21 (requiring financial institutions to maintain internal controls and training to comply with the Bank Secrecy Act), 12 C.F.R. §§ 21.11 and 163.180 (requiring reports of suspicious activities by banks).

Various states have also have anti-money laundering laws including those listed[45] in the following table:

Jurisdiction	Statute
California	California Penal Code §§ 186.9-186.10
Connecticut	Penal Code §§ 53a-275 *et seq*
Delaware	Delaware Criminal Code § 951
Florida	Florida Statutes § 896.101
Hawaii	Hawaii Revised Statutes 708A-3
New Jersey	New Jersey Code of Criminal Justice 2C § 21-25*, et seq*
New York	New York Penal Law Article 470, *et seq*
Pennsylvania	18 Pa. Cons. Stat. section 5111
Rhode Island	Title 11, § 11-9.1-15
Texas	Penal Code, Title 7, Chapter 34, Section 34.02
Washington	Sections 9A.83.010 *et seq*

Reporting Requirements

The Bank Secrecy Act[46] and regulations require certain financial participants like banks to report certain transactions and suspicious activity to the Federal government's Financial Crimes Enforcement Network (FinCEN).

Most significantly, a federal regulation requires banks to file Suspicious Activity Reports (SARs) to report transactions aggregating $5,000 or more that involve "potential money laundering" or violate the Bank Secrecy Act.[47] The

[45] This is an incomplete list.
[46] 31 U.S.C. § 5311 *et seq*
[47] 12 C.F.R. § 21.11(c)(4)

regulation requires the SAR if the bank "knows, suspects or has reason to suspect" money laundering or structuring or if the "transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction." [48]

SARs are confidential and may not be disclosed by the bank or by any agent or employee of the bank.[49] In fact, the regulations prohibit banks from disclosing any information that would reveal the existence of a SAR. [50]

The regulations require banks to decline to produce SARs in response to a subpoena or other request.[51] However, banks may share SARs with the Office of the Controller of the Currency, FinCEN and any Federal, State or local law enforcement agency. [52] Banks may also share underlying facts, transactions and documents upon which a SAR is based with other financial institutions for, *inter alia*, the preparation of a joint SAR. [53]

Willful violations of the SAR reporting and confidentiality requirements are punishable as crimes.[54]

FinCEN is currently expanding the reporting requirements to include title insurance companies in select geographic markets. In particular, FinCEN recently

[48] 12 C.F.R. § 21.11(c)(4)
[49] 12 C.F.R. § 21.11(k)
[50] 12 C.F.R. § 21.11(k)
[51] 12 C.F.R. § 21.11(k)
[52] 12 C.F.R. § 21.11(k)
[53] 12 C.F.R. § 21.11(k)
[54] 31 U.S.C. 5322

issued its latest Geographic Targeting Order (GTO) requiring title insurance companies to collect and report information about persons involved in certain residential real estate transactions. The GTO requires title companies to identify the beneficial owner (i.e., the "natural persons behind shell companies") in all-cash purchases of residential real estate of $300,000 or more in the following locations: Boston, Chicago, Dallas-Fort Worth, Honolulu, Las Vegas, Los Angeles, Miami, New York City, San Antonio, San Diego, San Francisco, and Seattle.[55] Previous GTOs were more limited in geographic scope and had higher dollar thresholds.

The GTO appears to be in response to the ever growing trend for criminals to use all cash purchases of luxury real estate as a means to launder money.[56] FinCEN describes the real estate implications for money laundering as follows:

> Real estate transactions and the real estate market have certain characteristics that make them vulnerable to abuse by illicit actors seeking to launder criminal proceeds. For example, many real estate transactions involve high-value assets, opaque entities, and processes that can limit transparency because of their complexity and diversity. In addition, the real estate market can be an attractive vehicle for laundering illicit gains because of the manner in which it appreciates in value, "cleans" large sums of money in a single transaction, and shields ill-gotten gains from market instability and exchange-rate fluctuations.[57]

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[55] https://www.fincen.gov/sites/default/files/shared/Real%20Estate%20GTO%20Order%20FINAL%20GENERIC%205.15.2019_508.pdf

[56] See reporting which purportedly prompted the FinCEN action: https://www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html

[57] https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf

As of May 2, 2017, over 30% of the real estate transactions reported under prior GTOs involved a beneficial owner or purchaser representative that had been the subject of unrelated SARs.[58]

IV. Susceptibility to Fraud

Studies suggest there are four key factors to make people more likely to respond to fraudulent communications: (1) high motivation triggers in the size of the reward; (2) trust by focusing on interaction rather than message content, often generated by using 'official' notices, logos etc.; (3) social influence, including liking and reciprocation, designed to gain compliance; and (4) the scarcity or urgency of the opportunity.[59]

Particularly in the Ponzi scheme context, fraud preys on the willingness of some to suspend skepticism faced with promises of substantial gains with no risk.[60]

[58] https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf

[59] Fischer P, Lea SE, Evans KM (2013), *Why do individuals respond to fraudulent scam communications and lose money? The psychological determinants of scam compliance.* J Appl Soc Psychol 43(10):2060–2072

[60] *United States v. Gravatt*, 280 F.3d 1189 (8th Cir. 2002)(scheme offered 2,000% return wit no risk). Another example in a recent case, the alleged scheme was reportedly producing annual profits between 20% to 25% and sometimes as high as 40%. See, https://www.deseret.com/2018/11/16/20658956/utah-rare-coin-dealer-accused-of-running-multimillion-dollar-ponzi-scheme

V. Uncovering Fraud

Some jurisdictions subscribe to the common law rule which withholds a remedy if a party could have learned of the basis of the fraud, or could have uncovered it by ordinary vigilance or attention.[61] However, uncovering a fraud scheme is sometimes easier said than done.[62] The reality is fraud detection sometimes involves healthy skepticism, sometimes it involves hard work and other times luck.

Absent luck, many fraudulent scheme require hard work to discover and piece together. The skills and knowledge required are frequently outside the abilities of a layperson or even a lawyer. A financial advisor may be needed to identify the fraud which frequently begins with an analysis of the financial statements.

The right financial advisor can identify fraud through deposit verification tests and vendor and accounts payable analysis. The FA can track payments to owners, officers and consultants, as well as loan payments which sometimes may be a morass and difficult to untangle.

In bankruptcy, tracing techniques by an FA may be necessary to establish a claim or defense against one. Tracing is often important to determine if funds fall into the estate or are trust property outside of the estate.

[61] *Vogel v. E.D. Bullard Co.*, 597 Fed. Appx. 817, 39 IER Cases 978 (6th Cir. 2014).
[62] *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51 (Bankr. S.D.N.Y. 1999)(" While with the benefit of hindsight, it may be easier to claim that [a party] should have been more vigilant, the fact remains that it took an investigation lasting several years to uncover the details of [the] fraud, while [the party], at best, had one or two weeks."

VI. Bankruptcy Implications for Fraudulent Schemes

In many ways, the Bankruptcy Code should deal with fraudulent schemes seamlessly. Filing the bankruptcy petition creates an estate of virtually all of the debtor's property[63] and the estate is administered for the benefit of creditors in the order of the priority of their claims and interests.[64] All matters related to the claims and estate are centralized in the bankruptcy court.

But the Bankruptcy Code does not seamlessly deal with fraud. There are conflicts between the Code and other laws that impact the estate, the administration and the claims. Because there are other laws at play, the case may not even be centralized in a bankruptcy court.

Ponzi Schemes (Bankruptcy vs. SIPA)

Ponzi schemes are perpetrated by all types of people, including registered brokers and dealers. When the scheme is perpetrated by registered brokers and dealers, the federal Securities Investor Protection Act ("SIPA")[65] may apply. SIPA is designed to protect investors. In contrast, the Bankruptcy Code is designed to protect creditors.

To protect investors. SIPA provides for the establishment of a fund[66] "designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of

[63] 11 U.S.C. § 541
[64] See 11 U.S.C. §§ 726, 1129(a)(7) and 1129(b)(2)(B)(ii)
[65] 15 U.S.C. § 78aaa et seq.
[66] 15 U.S.C. § 78ddd

financial failure of the member."[67] The fund protects up to $500,000 for each customer.[68]

SIPA authorizes the Securities Investor Protection Corporation ("SIPC") to initiate an application for a protective degree[69] which may be filed notwithstanding the pendency of a bankruptcy proceeding.[70] SIPA authorizes a court to enter the protective decree if the debtor fails to contest the application or the court finds the debtor is (A) insolvent; (B) is the subject of a proceeding in which a receiver or trustee has been appointed, (C) is not in compliance with the Securities Act of 1934, or (D) is unable to make computations to establish financial responsibility or the hypothecation rules.[71]

Pending the issuance of a protective decree, the court shall stay other proceedings, including any pending bankruptcy proceeding.[72] If the court issues a protective decree, it is required to appoint a liquidating trustee[73] and remove the entire liquidation to the bankruptcy court.[74] To the extent consistent with SIPA, the liquidation proceeding is conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of the Bankruptcy Code.[75] However, there are some differences between a chapter 7 case and a SIPA case.

[67] https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/securities-investor-protection-act-sipa
[68] https://www.sipc.org/for-investors/introduction
[69] 15 U.S.C. § 78eee(a)(3)
[70] 15 U.S.C. § 78eee(a)(4)
[71] 15 U.S.C. § 78eee(b)(1)
[72] 15 U.S.C. § 78eee(b)(1)
[73] 15 U.S.C. § 78eee(b)(3)
[74] 15 U.S.C. § 78eee(b)(4)
[75] 15 U.S.C. § 78fff(b)

In a traditional chapter 7 liquidation, the purpose is to liquidate the property of the estate and to distribute the proceeds to creditors in the order of priority.[76] A SIPA liquidation proceeding, in some respects, does the opposite. One of the purposes of a SIPA liquidation is to deliver customer name securities to customers of the debtor.[77] A SIPA trustee even has the power to purchase securities for a customer to accomplish this goal.

SIPA also differs from a chapter 7 in how it calculates victim claims. In a SIPA case, customer claims are based on "net equity" net of any margin loans owed by the customer.[78]

Ponzi Schemes (Winners vs. Losers)

One of the principal features of a Ponzi scheme is that some of the investors have to get paid. Paying investors lends credibility to the scheme and enables the perpetrator to attract more investors to satisfy the ever increasing need for cash. This creates "winners" and "losers".

When the music stops, the losers are the victims and have claims in the bankruptcy case. Conversely, the winners have likely received transfers that may be avoidable by the trustee. This is partly because the mere existence of a Ponzi scheme usually establishes an actual intent to defraud.[79] The existence of a Ponzi scheme also generally establishes the insolvency element of a fraudulent transfer.[80] The

[76] 11 U.S.C. §§ 726, 748
[77] 15 U.S.C. § 78fff(a)(1)(A)
[78] "Net equity" is defined in 15 U.S.C. § 78lll(11)
[79] *Calvert v. Kooshian,* 690 Fed. Appx. 1011 (9th Cir. 2017)
[80] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)

winners are susceptible to liability partly because of the notion that they should not enjoy any advantage over later investors who were not so lucky.[81]

But how much should the winners be required to disgorge? Applying the traditional measure of damages for an actual intent to defraud would make the winner liable for the entire transfer without consideration of the initial investment.[82] In an actual intent to defraud case, if the winner can prove a good faith defense, the winner should get credit for the initial investment.[83] Under traditional constructive fraud analysis, the winner is only liable for profits unless the trustee can prove lack of good faith.[84] The difference between the two is which party has the burden of proving good faith or lack of good faith. [85]

Courts have generally addressed these issues by establishing a "netting" rule which invokes a two-step process. First, 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.[86]

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

[81] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[82] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[83] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[84] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[85] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[86] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)

good faith losing investor's as-yet unsatisfied restitution claim against the Ponzi scheme perpetrator, are not avoidable. [87]

Second, to determine the actual amount of liability, courts permits good faith investors to retain payments up to the amount invested, and require disgorgement of only the "profits" paid to them by the Ponzi scheme. [88] 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. [89] Instead, investors are permitted to retain these amounts because they have claims for restitution or rescission against the debtor that operated the scheme up to the amount of the initial investment.[90]

Payments up to the amount of the initial investment are considered to be exchanged for "reasonably equivalent value," and not fraudulent, because they proportionally reduce the investors' rights to restitution. [91] If investors receive more than they invested, payments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity.[92]

Ponzi Schemes (Amount of the Claim)

In a normal bankruptcy case, the amount of a claim would typically be based on the contract between the debtor and the creditor. If the debtor promised to pay $100,000 but didn't pay it, the claim would be $100,000 to give the creditor the benefit

[87] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[88] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[89] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[90] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[91] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)
[92] *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)

of the bargain. But Ponzi schemes are inherently different because the scheme itself is illegal and perhaps not contractually enforceable. As the victims of a crime, the investors arguably have a restitution claim for the amount of their investment as opposed to a contract claim for their expectancy.

To resolve this issue, at least one court has adopted a hybrid approach that establishes to separate claims, an "A" and "B" claim.[93] The "A" claim represents the difference between what an investor actually invested, lent, or gave the debtor, minus the total the investor received back at any time.[94] The "B" portion consists of all profit, interest, return of principal, punitive damages, multiple damages, or any amount in excess of actual pecuniary loss.[95] The court subordinated the "B" claims to the "A" claims so the "B" claims would receive distribution only after all "A" claims have been paid in full.[96]

Property of the Estate Issues

Bankruptcy professionals are accustomed to the adage that virtually all of the debtor's property becomes property of the bankruptcy estate.[97] We know property of the estate is broadly construed[98] and includes "every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative."[99] The estate includes proceeds from

[93] *In re Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993)
[94] *In re Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993)
[95] *In re Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993)
[96] *In re Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993)
[97] 11 U.S.C. § 541
[98] *Parks v. Dittmar (In re Dittmar)*, 618 F.3d 1199 (10th Cir. 2010)
[99] *In re Yonikus*, 996 F.2d 866, 869 (7th Cir. 1993)

property of the estate and any property acquired by the estate after the commencement of the bankruptcy case.[100]

But the estate does not include property in which the debtor owns only legal title but no equitable interest.[101] For example, the bankruptcy estate does not include the beneficial interest of property held by a debtor in trust for another.[102] In a fraud context, this exception could be very significant.

Under many applicable state laws,[103] a constructive trust may arise for property acquired through fraud.[104] "A constructive trust, therefore, confers on the true owner of the property an equitable interest in the property superior to the trustee's." [105] But the constructive trust analysis is not always as easy in bankruptcy. State court constructive trust claims frequently involve a fraud perpetrated on a single victim. The proceeds of the fraud are traceable to the victim.

In matters with multiple creditors, and in bankruptcy in particular, the victims may be a substantial portion of the creditor population and the proceeds may be difficult to trace. For this reason, a rule has developed requiring a creditor to be able to trace the *res* to the fraud.[106]

However, even if a creditor is entitled to impress a constructive trust on *res* which would otherwise be property of the bankruptcy estate, the *res* may still wind up as estate property because 11 U.S.C. § 544(a)(3) gives the trustee the same

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[100] 11 U.S.C. § 541(a)(6) and (7)
[101] 11 U.S.C. § 541(d)
[102] *Begier v. IRS*, 496 U.S. 53, 110 S. Ct. 2258, 110 L. Ed. 2d 46 (1990)
[103] State law creates and determines the debtor's interest in property. *Butner v. United States*, 440 U.S. 48 (1979).
[104] See example, *Fortin v. Roman Catholic Bishop of Worcester*, 416 Mass. 781 , 625 N.E.2d 1352 (1994).
[105] *Sanyo Electric, Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.)*, 874 F.2d 88 (2d Cir. 1989)(internal quotations omitted)
[106] *Hill v. Kinzler (In re Foster)*, 275 F.3d 924 (10th Cir. 2001*); Century Res. Land LLC v. Adobe Energy Inc. (In re Adobe Energy Inc.)*, 82 Fed. Appx. 106 (5th Cir. 2003)

avoidance power as possessed by a hypothetical *bona fide* purchaser. As a result, the operative question is whether the trustee's avoidance power under section 544(a)(3) trumps the general rule of section 541(d). The majority of courts conclude that section 541(d) is subject to the trustee's avoidance power under section 544.[107]

Asset Forfeiture Issues

The two principal federal asset forfeiture statutes are 18 U.S.C. § 981 (civil forfeiture) and 18 U.S.C. § 982 (criminal forfeiture). The statutes also include an innocent owner defense at 18 U.S.C. § 983(d).[108]

Importantly from a bankruptcy perspective, 21 U.S.C. § 853(c) vests all forfeited property in the United States upon the commission of the act giving rise to forfeiture. This means that the divestment from the debtor could potentially relate back to the pre-petition period. As a result, issues arise in bankruptcy cases over whether forfeited assets are property of the estate and whether the automatic stay of 11 U.S.C. § 362 applies to prevent the federal government from taking action to effectuate the forfeiture.

Similar to the previously discussed conflict between section 541 and 544 with respect to constructive trust property, there is a conflict in forfeiture cases over whether a bankruptcy trustee can use section 544(a) of the Bankruptcy Code to avoid a forfeiture from relating back pursuant to 21 U.S.C. § 853(c). However, in the asset forfeiture context, the case law generally provides favors section 853(c) over section 544(a).[109] The result is that the forfeiture is generally permitted and forfeited assets are not property of the estate.[110]

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[107] *In re DVI, Inc.*, 306 B.R. 496 (Bankr. D. Del. 2004); *Rhodes v. Fla. Metal Trading, Inc. (In re Hayes Iron & Metal, Inc.),* Case No. 13-10157C-11G, Adversary No. 13-2058 (Bankr. M.D.N.C. May 23, 2014)
[108] The Department of Justice *Asset Forfeiture Policy Manual* is an excellent resource on asset forfeitures. The 2019 version can be found here: https://www.justice.gov/criminal-afmls/file/839521/download
[109] *United States v. French*, 822 F. Supp. 2d 615 (E.D. Va. 2011)
[110] *United States v. Pelullo*, 178 F.3d 196 (3d Cir. 1999)(without considering the section 544 issue)

In a similar vein, courts have held the post-petition prosecution of a forfeiture action did not violate the automatic stay because it fell within the police power exception of section 362(b)(4).[111]

Federal Restitution

The Mandatory Victims Restitution Act of 1996 (the "MVRA")[112] permits the United States to enforce a judgment imposing a fine in accordance with the practices and procedures for the enforcement of a civil judgment under federal or state law. This specifically applies to restitution claims.[113]

The MVRA includes a sentence saying: "Notwithstanding any other Federal law… a judgment imposing a fine may be enforced against all property or rights to property of the person fined."[114] This sentence is subject to three specific exceptions relating to property exempt from tax levy and enforcement and enforcement under non-bankruptcy statutes. [115] None of these exceptions are the automatic stay in bankruptcy.

As a result, most courts, if not all, that have addressed the apparent conflict between the MVRA and the automatic stay have concluded that the MVRA prevails and the government's efforts to collect restitution is not automatically stayed in a bankruptcy case.[116]

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[111] *Jahn v. United States (In re WinPar Hospitality Chattanooga, LLC)*, 404 B.R. 291 (Bankr. E.D. Tenn. 2009); *United States v. Klein (In re Chapman)*, 264 B.R. 565 (B.A.P. 9th Cir. 2001)
[112] 18 U.S.C. § 3613(a)
[113] 18 U.S.C. § 3613(f)
[114] 18 U.S.C. § 3613(a)
[115] 18 U.S.C. § 3613(a)
[116] See, *Partida v. DOJ (In re Partida)*, 862 F.3d 909 (9th Cir. 2017); *United States v. Robinson (In re Robinson)*, 764 F.3d 554 (6th Cir. 2014)