

**An Overview of the Role of Forfeiture and Bankruptcy
Following the Collapse of Large Ponzi Schemes**

Allan Diamond
Amos B. Elberg
Jack Watkins

Diamond McCarthy, LLP
620 8th Ave.
New York, NY 10018
(212) 430-5400

American Bankruptcy Institute
2009 Winter Leadership Conference

On A Collision Course: Ponzi Schemes,
Bankruptcy, Receiverships, and
Forfeitures

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1) Introduction

- a) The hypothetical fact pattern is, sadly, far from hypothetical. In fact, it has become a new class of litigation all its own. The discussion below focuses on issues that arise between the forfeiture and bankruptcy administration regulatory regimes. That is not because we view issues of SIPC receivership as unimportant, but simply because there are others on the panel with far more expertise in that area.
- b) The hypothetical arises from a new role that the forfeiture laws have begun to play, or which the Department of Justice believes they should play, that appears to be more accidental than intentional. Before 1970, forfeiture was rare in the United States outside of the seizure of contraband by customs officers. Congress began enacting forfeiture laws in connection with the RICO statute, to aid in the prosecution of organized crime syndicates and major drug offenders. The statutes expanded in scope and evolved in complexity over time. A series of revisions at the beginning of this decade cross-referenced many of these statutes against each other, effectively eliminating what had been statutory procedural impediments to the application of forfeiture to widespread financial crimes. At the same time, those and other revisions obligated the Department of Justice to use forfeited property not to benefit the fisc or reward cooperating law enforcement agencies, but instead to benefit crime victims.
- c) On that basis, in recent Ponzi cases such as *Madoff* and *Dreier*, the Department of Justice has sought to set up what is effectively a second system for the equitable distribution of a fraudster's assets, parallel to the bankruptcy system. In fact, the government has said in these cases that it may appoint trustees or special masters to oversee victims' compensation. In this system, the government would seek the forfeiture of fraud proceeds in the hands of the fraudster and others, and would then distribute any forfeited property to victims of the crimes the government chose to prosecute—but not to other creditors of the fraudster, or of the persons or entities from whom the forfeitable property is taken. This would be a system very much like bankruptcy, but with a different ordering of priorities, a different scope to the administrators' right to recover assets transferred out by the scheme, and an almost complete absence of either procedural safeguards for claimants or law governing how competing claims should be resolved.
- d) To date, Courts that have considered the issue, at least of which we are aware, have reached the same conclusion as Judge Easterbrook in *United States v. Frykholm*, 362 F.3d 413, 417 (7th Cir. 2004) (Easterbrook, J.): That bankruptcy provides a system for the comprehensive marshalling and distribution of assets that is superior to forfeiture in the Ponzi context. This is because bankruptcy is designed for the marshalling of a debtor's assets and the resolution of competing claims. The forfeiture system is not – it is designed to aid the government in shutting down criminal enterprises and prevent career criminals from hiding away

their ill-gotten gains and, as a late addition, also to provide some compensation to some victims.

- e) This outline focuses on the scope and structure of the forfeiture power. In our view, a review of the forfeiture laws demonstrates that, to whatever extent forfeiture plays any role in the resolution of Ponzi schemes, that role is a statutory accident, and forfeiture an inappropriate tool.
 - f) That does not, however, mean that the bankruptcy system is presently well-adapted to deal with Ponzi schemes. A bankruptcy trustee's power to marshal the assets of a debtor is governed by a set of laws little-changed from the middle-ages, whose application to Ponzi schemes is somewhat accidental. The extent of the trustee's ability to effect an equitable distribution may, for this reason, have come to depend on such vagaries as whether the Ponzi scheme was structured in terms of fixed income or an investment, and whether the fraudster's conduct is attributable to the fraudster's entity under principles of agency law.
 - g) There is a compelling need for a statutory regime that "fits" the problem of Ponzi schemes. The evil of a Ponzi scheme is that the fraudster, usually via an entity, and today usually via one or more entities that also have legitimate operations which may or may not be profitable on their own, conceals the fact that the operation is insolvent by using new creditors' cash to pay old creditors. So that the operation continues to operate, and its liabilities only grow, becoming more insolvent.
 - h) The worsening of a debtor's insolvency by concealing the insolvency to prolong the debtor's operations is the Ponzi fraud. Ordinary trade creditors of a Ponzi scheme, its employees, the people who sell it pencils on credit, and so forth, are just as much victims, and were defrauded, just like the "investors" in the scheme itself.
 - i) The direct victims of the crimes the government chooses to charge and prosecute are not the only victims of a Ponzi scheme. Creditors, both voluntary trade creditors and involuntary tort creditors, not to mention employees, lenders, and the like, are all victims. The extent to which one trade creditor may be better off than one Ponzi victim at present, or vice versa, is a fortuity. The appropriate goal for the bankruptcy system is to undo that fortuity, and replace it with equity.
- 2) Procedural Overview
- a) Because of the operation of the procedural provisions of the forfeiture statutes, the majority view seems to be that if property is forfeitable to the government, that it never enters the bankruptcy estate. Forfeiture "wins" over bankruptcy. That may not be correct under the statutes, but it is the present consensus view.
 - b) Forfeiture occurs within criminal proceedings in which third parties cannot intervene. 21 U.S.C. § 853(k). There is no opportunity to assert an interest in property targeted for forfeiture until after the defendant's sentencing – after the defendant has either plead guilty to, or been convicted of, conduct demonstrating the forfeitability of the property.

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- i) The government could, if it chose, commence a separate *in rem* action against property. But more recently Congress authorized the government to seek *in rem* civil forfeiture in criminal proceedings. Civil Asset Forfeiture Reform Act of 2000, Pub. L. 106-185, §2, 114 Stat. 202, (codified as amended at 18 U.S.C. §983(a)(3)(C)). So, as above, claimants on forfeiture property today generally cannot assert their claims until a Court has already determined that the property is subject to forfeiture, which usually means that the property has been adjudged “crime proceeds,” and therefore that third-parties’ interests are forfeitable too.
- c) The automatic stay does not apply to an action by the government to seek the forfeiture of property of, or in the possession of, a bankruptcy estate, 11 U.S.C. § 362(b)(4); *In re James*, 940 F.2d 46, 51 (3d Cir. 1991), at least where the bankrupt is the criminal defendant.
- d) If the government succeeds in obtaining a forfeiture order, title “relates back” and vests with the government as of the date of the offense giving rise to the forfeiture. *See United States v. Parcel of Land, Bldgs.*, 507 U.S. 111, at 133-34 (1993) (Scalia, J., concurring).
- e) The Department of Justice believes that under the relation-back doctrine, forfeited property never became property of a bankruptcy estate.
 - i) Thus, in the Madoff case, the SEC argued that neither Madoff nor his entity should be put into bankruptcy because, the SEC said, there could be no assets in either estate after forfeiture. Mem. of Law in Opp’n re: Mot. For Leave to File an Involuntary Bankruptcy Petition, 2, April 8, 2009, in *SEC v. Madoff*, No. 08 Civ. 10791 (LLS) (S.D.N.Y. 2009) The government cited for this proposition principally *United States v. Pelullo*, 178 F.3d 196, 203 (3d Cir. 1999), and *United States v. Klein*, 264 B.R. 565, 572 (9th Cir. B.A.P. 2001).
 - ii) This is an odd result. The Bankruptcy Code says that “fine[s], penalt[ies], and forfeiture[s] . . . arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture . . . are not compensation for actual pecuniary loss suffered by the holder of such claim” are paid *fourth*, after tardy unsecured claims. 11 U.S.C. § 726(a)(4). And 11 U.S.C. § 523(a)(7) seems to make non-dischargeable “fine[s], penalt[ies], or forfeiture payable to and for the benefit of a governmental unit . . . not compensation for actual pecuniary loss, other than a tax penalty . . .”, which suggests that *other* forfeitures are dischargeable.
 - iii) *Pelullo* actually involved a criminal defendant filing for bankruptcy after forfeiture was ordered in connection with his sentencing. *United States v. U.S. Currency*, 895 F.2d 908, 916 (2d Cir. 1990), another case sometimes cited by the government on this point, said nothing about bankruptcy.
 - iv) Two authorities to have addressed the question are *United States v. Klein (In re Chapman)*, 264 B.R. 565, 572 (9th Cir. B.A.P. 2001), and *In re Winpar Hospitality Chattanooga, LLC*, 401 B.R. 289, 293 (E.D. Tenn. 2009). These Courts focused principally on the question of the applicability of the

automatic stay, but they did say in passing that the government, in seeking forfeiture, is not acting as a claimant on the estate, and that forfeited property is not part of the estate because of the relation-back doctrine.

- v) No Court has yet reached the opposite conclusion, but neither has any Court explained what Sections 726(a)(4) or 523(a)(7) mean if *Klein* is correct.
- vi) In the Madoff case, Judge Stanton did not address the question. But in allowing the Madoff victims to put Madoff into bankruptcy, reached the same conclusion as Judge Easterbrook: Bankruptcy is a superior regime to forfeiture for marshalling and equitably distributing the assets of a Ponzi fraudster. *SEC v. Madoff*, No. 08 Civ. 10791 (LLS), 2009 WL 980288, at *1 (S.D.N.Y. Apr. 10, 2009).
 - (1) The Department of Justice then applied for an order in Madoff’s criminal case restraining Madoff and anyone acting in concert with him from transferring his property.
 - (2) Because the government brought the motion in the criminal proceeding, the Madoff victims and receiver had no standing to oppose the motion, and according to at least one news report may not even have had notice of it.
- vii) It is an open question whether a forfeiture order takes property out of the bankruptcy system, or merely makes the government a claimant consistent with 11 U.S.C. §§ 523(a)(7) and 726(a)(4).
- f) If the relation-back doctrine does generally prevent forfeited property from becoming part of a bankruptcy estate, there are still at least some exceptions within the forfeiture regime:
 - i) In criminal (as opposed to civil, a distinction discussed below) forfeiture, if the government cannot find crime proceeds because the criminal defendant hid or commingled them, then the government can take “substitute assets” of the defendant instead. *See* 21 U.S.C. § 853(p). Some Circuits have held that the forfeiture of substitute assets does not relate back. *United States v. Jarvis*, 499 F.3d 1196, 1203-04 (10th Cir. 2007) (relation-back gave the government pre-conviction interest in crime proceeds but not in substitute property); *United States v. Kramer*, 2006 WL 3545026, *7 (E.D.N.Y. Dec. 8, 2006) (“this Court cannot then escape the conclusion that the relation back provision does not apply to substitute assets”).
 - (1) This may mean that with respect to substitute assets, the government’s claim for criminal forfeiture is merely an unsecured claim, or a claim governed by Section 726(a)(4), even if other forfeiture claims would not be.
 - (2) But, the government may be able to obtain the *civil* forfeiture of the same property. The civil forfeiture laws allow the government to seize property from innocent persons without compensation if the property was used in a criminal offense.

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- ii) If a third party can demonstrate that property was taken from him or her by fraud, the Courts generally hold that the criminal defendant never obtained an equitable interest in the property, and it was instead held by the criminal defendant in constructive trust, and there is therefore no interest for the government to criminally forfeit.
 - (1) This is a topic discussed in some detail below, because it means that using forfeiture to recover Ponzi proceeds leads to something of a free-for-all as competing victims claim that particular assets belong to them under various tracing rules. That is a result courts interpreting the commercial law and bankruptcy code consistently reject as inequitable. *E.g., S.E.C. v. Credit Bancorp, Ltd.*, 290 F.3d 80 (2d Cir. 2002).
 - (2) Broader tracing rules do apply to forfeiture, however. Thus, the government's power to distribute forfeited property is demarked by the difference between what the government can obtain under the tracing laws applicable to it and what fraud victims can claim under the narrower tracing rules applicable to them.
 - (a) That is the property that, under the common law, would be distributed *pro rata* to the criminal defendant's creditors.
 - (3) The government can still seek the civil forfeiture of property in the hands of persons other than the criminal defendant, including funds that were paid to earl Ponzi victims. That power is limited by narrow "innocent owner" exceptions, which again are analyzed in greater detail below.
- iii) In today's cases, the fraudster most likely conducted the fraud through one or more entities which had legitimate operations of their own, profitable or unprofitable, but which were ultimately principally owned and/or controlled by the fraudster.
 - (1) The role of corporate veils remains unresolved today, but at various times the government has asserted, in different cases, successfully or not:
 - (a) That all of a business' assets were "involved in" money laundering and were therefore forfeitable, even though the criminal defendant was not the sole owner of the business. *United States v. Baker*, 227 F.3d 955, 969-70 (7th Cir. 2000).
 - (b) That the entity was merely a straw owner or nominee of the criminal defendant. *See United States v. Totaro*, 345 F.3d 989, 995 (8th Cir. 2003).
 - (c) That the business' assets include fraud proceeds that are civilly forfeitable *in rem* regardless of the innocence of their owner.
 - (2) This is an issue that is playing out at the moment in the *Dreier* case, and in others.

3) Forfeiture

- a) Forfeiture needs to be understood against the backdrop of the broad expansion in the scope of federal crimes beginning around 1970 with the passage of the RICO statute.
- b) Before that time, there was no criminal forfeiture statute in the United States. There were civil forfeiture statutes targeted to particular crimes, such as which gave the government the right to seize contraband, but forfeiture was rare.
- c) That changed around 1970, with the development of RICO and later of other statutes targeting the business of crime.
- d) Criminal vs. Civil Forfeiture
 - i) The criminal forfeiture statute, 18 U.S.C. § 982, allows the government to include an *in personam* judgment in a criminal defendant’s sentence.
 - (1) Criminal forfeiture is a relatively recent development in American law.
 - (2) The statute derives from drug seizure laws, which in turn derive from RICO, which contained the first Federal criminal forfeiture law.
 - (3) RICO is structured to target *enterprises* that are infiltrated through, or exist to commit, enumerated predicated offenses, and its forfeiture provisions target the criminal organization rather than any particular act. *See* Gerard E. Lynch, *RICO: The Crime of Being A Criminal*, 87 COLUM. L. REV. 661 (Parts I & II) & 920 (Parts III and IV) (1987).
 - (4) The criminal forfeiture statute thus evolved to maintain similar breadth, applying to any property used in or derived from any of the enumerated RICO predicate offenses – which have expanded to include the bulk of federal financial crimes. *See* Heather J. Garretson, *Federal Criminal Forfeiture: A Royal Pain in the Assets*, 18 S. CAL. REV. L. & SOC. JUST. 45, 47-49 (2008).
 - ii) The civil forfeiture statute, 18 U.S.C. § 981, allows the government to bring an *in rem* action to forfeit property derived from or used in connection with a crime.
 - (1) Section 981 was enacted in 1986 as part of the Anti-Drug Abuse Act of that year, the height of the “war on drugs.”
 - (2) A civil forfeiture judgment is *in rem*; the government is seizing “guilty property” – property which is “guilty” in the sense that it was “used” in a crime. *See generally* *United States v. Bajakajian*, 524 U.S. 321, 329-30 (1998).
 - (3) This right of the government to seize “guilty property” derives from the biblical remedy applied to misbehaving oxen. *See id.* at 330 (citing *Exodus* 21:28). Really.
 - (4) Because of its ancient origins and place in the common law tradition, innocent persons have no 14th or 5th Amendment right to prevent the forfeiture of property of theirs that was involved in a criminal offense.

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Bennis v. Michigan, 516 U.S. 442, 452-53 (1996). There are statutory “innocent owner” defenses, but they are narrow.

- (a) It is interesting to note that England abandoned the predecessor to civil forfeiture that existed in 1781, the *deodand* system, in 1846. It was replaced by the tort of wrongful death. See The Fatal Accidents Act 1846, 9 & 10 Vict. c. 93; Deodands Act, 9 & 10 Vict. c. 62; see also OLIVER WENDELL HOLMES, JR., THE COMMON LAW, at 24-25 (1881) (observing that the civil forfeiture doctrine derives from the *deodand*).
 - (5) Because it is an *in rem* proceeding against the property, civil forfeiture actions can have a greater effect on the rights of third parties than an *in personam* criminal forfeiture proceeding against a defendant. In the civil forfeiture proceeding, the government is actually adjudicating all persons’ rights to the property, not just the defendant’s.
 - (6) The need to bring a separate proceeding against the property was an impediment to the use of this power, and civil forfeiture actions were not common, but since 2000 the government has had the power to include civil forfeiture charges in criminal indictments. Civil Asset Forfeiture Reform Act of 2000, Pub. L. 106-185 § 2(a), 114 Stat. 202, codified as amended at 18 U.S.C. § 983(a)(3)(C).
 - (7) There is a substantial difference between a traditional *in rem* civil forfeiture proceeding and a Section 983(a)(3)(C) proceeding, however. In the Section 983(a)(3)(C) proceeding, claimants other than the criminal defendant have no opportunity to challenge the forfeiture of the property until after the resolution of the defendant’s criminal case. Whether this implicates the procedural due process or Takings Clause rights of non-defendants with an interest in the property, is an open question.
- iii) There is another interesting distinction between civil and criminal forfeiture worth considering for a moment.
- (1) The 8th Amendment prohibition against excessive fines applies to criminal forfeiture. See *Bajakajian*, 524 U.S. 321. Traditionally, criminal forfeiture is not to be so large as to deprive the criminal of his or her livelihood. *Id.* at 335; *United States v. Levesque*, 546 F.3d 78, 83-85 (1st Cir. 2008) (tracing the history of this prohibition to the Magna Charta).
 - (2) In *Madoff*, as noted above, the government told two Courts that Madoff could not possibly have any assets remaining after forfeiture.
 - (3) In all events, even if the Excessive Fines clause suggests that the government’s approach to criminal forfeiture in Ponzi cases is overbroad, there is no such limitation on civil forfeiture, which punishes guilty property rather than the person.
- iv) Today, the indictment of a Ponzi criminal will typically include a charge of criminal forfeiture, and a charge of civil forfeiture, joining to a criminal prosecution an *in rem* proceeding against property – a proceeding which third

parties are forbidden from intervening until the criminal prosecution has been adjudicated and the defendant sentenced.

- v) Forfeiture counts are thus easily traded by a Ponzi defendant in plea negotiations since, if the government prevailed at trial, the civil claims that would follow would render the defendant asset-free anyway.
 - (1) A third party claiming a right to the property can do so only after, in the typical case, the defendant has already pleaded guilty to a charge that the property at issue is crime proceeds or was involved in a crime.
- e) Where does forfeited property go?
 - i) The forfeiture laws were designed around drug kingpins, mobsters, the seizure of contraband, and so forth. Forfeited property thus generally vests with the government. Orders of restitution and the use of forfeited property for the benefit of victims are developments of the past decade.
 - ii) 18 U.S.C. § 981(e) holds that civilly forfeited property will be retained or disposed of in the Attorney General’s discretion, except that forfeited property must be “equitabl[y] transfer[red]” to State and local law enforcement agencies “so as to reflect generally” those agencies’ contribution to the forfeiture. Such transfers cannot be challenged.
 - (1) There is no analogous subsection of Section 981 for the compensation of victims.
 - (2) Victims are included in a list of types of persons who the Attorney General *can* transfer property too – they’re sixth on the list. 18 U.S.C. § 981(e)(6).
 - (a) That is a recent development. In the original 1994 statute, subsection (e)(6) only allowed the “restoration” of forfeited property to the victims of specific crimes, which did not include mail fraud unless a “financial institution” was affected.
 - (b) Broader permission was granted by the Civil Forfeiture Reform Act of 2000, Pub. L. 106-185 § 6, 114 Stat. 202.
 - (3) But still today, the Attorney General’s only obligation set forth in Section 981 is to share with State and local law enforcement agencies.
 - iii) Criminally forfeited assets are disposed of in the discretion of the Attorney General, “making due provision for the rights of any innocent persons.” 21 U.S.C. § 853(h). The Attorney General is also “authorized” to grant “mitigation or remission” of forfeiture. *Id.* at § 853(i)(1).
 - (1) Mitigation and remission are governed by 28 C.F.R. pt. 9.
 - (2) The regulations allow persons with an ownership interest in forfeited property to petition for its return, if they are not culpable for the offense according to various criteria, and victims.

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- (a) A “victim” is anyone who “incurred a pecuniary loss as a direct result of the commission of the offense underlying a forfeiture,” except for drug users. *Id.* pt. 9.2(v).
 - (b) To receive compensation, a victim must be able to demonstrate the amount of their pecuniary loss with documentary evidence, and that it was the “direct result of the illegal acts and is not the result of otherwise lawful acts that were committed in the course of a criminal offense.” *Id.* pt. 9.8(a)(1)-(2).
 - (3) General creditors are expressly denied a share of forfeited property unless “he or she otherwise qualifies as a petitioner,” which means that they are a “victim” or an “owner” of the subject property. *Id.* pt. 9.6(a).
 - (4) And Part 9 otherwise has its own system for dividing forfeited property up among qualifying owners and claimants, distinct from the system of priorities set forth in the bankruptcy code. *Id.* pt. 9.6.
- iv) Since the Scott Campbell, Stephanie Roper, Wendy Preston, Louarna Gillis, and Nila Lynn Crime Victims’ Rights Act of 2004, Pub. L. 108-405, 18 Stat. 2260, 18 U.S.C. § 3771 has also required the Department of Justice to exercise their “best efforts” to accord crime victims their “right” to restitution.
- v) The Department of Justice has interpreted this as an obligation to use civil and criminally forfeited property to satisfy defendant’s restitution obligation to victims.
- (1) Restitution derives from another change worked by the amendments to the criminal law of mid-2000, 18 U.S.C. § 3663A, which mandates that a criminal sentence must include an order requiring the defendant to return property to victims of his crimes and make restitution for their losses.
 - (2) “Victim” for Section 3663A purposes includes anyone “directly and proximately harmed as a result of the commission of” the offense, including, where the offense involves a scheme or conspiracy, “any person directly harmed by the defendant’s criminal conduct in the course of the scheme, conspiracy, or pattern. . . .” 18 U.S.C. § 3663A(a)(2).
 - (3) The restitution and forfeiture sentences are cumulative, not duplicative. *See United States v. Taylor*, 2009 WL 2857971 (5th Cir. 2009); *United States v. Emerson*, 128 F.3d 557 (7th Cir. 1997); *United States v. Feldman*, 853 F.2d 648 (9th Cir. 1988).
 - (4) If fraud proceeds have been traced, they will generally be returned to the victim as part of the restitution order in the defendant’s sentence, instead of being forfeited –
 - (a) The concepts of “traceable” and “substitute” assets are discussed in greater detail below. It is interesting to observe, though, that whether a fraudster pays once or twice turns on whether the defrauded property can be found.

- (i) If the victim’s property can be traced, then the victim will obtain a restitution order requiring the defendant to “return the property to the owner,” 18 U.S.C. § 3663(b)(1)(A), while the government is only entitled to orders criminally and civilly forfeiting the defendant’s interest in that same property. But the defendant can only give identified property up once.
 - (ii) On the other hand, if the victim’s property cannot be traced, the victim will obtain a restitution order requiring the defendant to pay an amount equal to the value of the property, 18 U.S.C. § 3663A(b)(1)(B), while the government will be entitled to orders allowing it to criminally forfeit any property of the defendant it can locate, 21 U.S.C. § 853(p). Those orders will be cumulative rather than duplicative.
- (5) Section 3663A(c), however, allows the government to bring a motion asking the Court to *not* order restitution, because doing so would be “impracticable.” *E.g., In re W.R. Huff Asset Management Co., LLC*, 409 F.3d 555 (2d Cir. 2005). If that motion is granted, then the forfeited assets will be distributed through 28 C.F.R. pt. 9, and the Attorney General will likely seek to appoint a trustee or receiver to oversee their distribution. *See* Ltr. from Richard Weber to Lev Dassin, dated April 10, 2009.
- vi) Why would the Department of Justice prefer this result?
 - (1) As long as the Department of Justice maintains that the innocent trade creditors of Ponzi schemes are beneficiaries of fraud rather than crime victims, 18 U.S.C. § 3771 would seem to require the government to prefer the forfeiture system, which benefits crime victims – which is to say, victims of the particular crimes the government chooses to charge and prosecute – at the expense of other creditors, regardless of how competing claims would be resolved under the commercial law.
 - (2) The rule of the bankruptcy courts is the opposite, that Ponzi scheme victims may who received payments in connection with the scheme must repay that money so it can be distributed to creditors *pari passu*. *E.g., In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1 (S.D.N.Y. 2007).
- f) What property is forfeitable?
 - i) There are two relevant statutes, for civil and criminal forfeiture, 18 U.S.C. §§ 981-82 :
 - (1) Each allows for the forfeiture of property “involved in,” “traceable to,” “derived from,” “obtained directly or indirectly, as the result of [a] violation,” or “which represents or is traceable to the gross receipts obtained, directly or indirectly, as a result of such violation,” depending on which criminal statute in particular was violated.
 - (2) Sections 981 and 982 use similar language. There are important differences in how the two statutes treat fraud proceeds, discussed in greater detail below.

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- (3) Those differences, however, have been muted by more recent revisions to the forfeiture laws. 28 U.S.C. § 2461(c) requires that if a defendant is indicted for an offense authorizing *either* criminal or civil forfeiture, the government can include notice of forfeiture in the indictment, and the defendant's sentence may then include the criminal forfeiture of all property forfeitable either criminally *or civilly*.
 - (4) So the entire scope of Section 981 civil forfeiture is applied to the criminal defendant *in personam* in his or her criminal proceeding.
 - (5) § 983(a)(3)(C) authorizes the government to bring civil forfeiture claims along with a criminal proceeding, so once the defendant's rights in the property are adjudicated, the criminal proceeding will then take on an *in rem* character.
 - (6) So the criminal forfeiture charge of the indictment will cover civilly forfeitable property, and there will typically also be an *in rem* civil forfeiture charge as well.
 - (7) There is also a "tracing" statute that applies to fungible property that is difficult to trace in civil forfeiture, 18 U.S.C. § 984, and there is a "substitute assets" statute that applies in criminal forfeiture when crime proceeds are no longer in the defendant's possession, 21 U.S.C. § 853(p).
- ii) Particular crimes:
- (1) Forfeiture in Ponzi cases centers on two federal crimes, wire/mail fraud, and money laundering.
 - (2) Wire/Mail Fraud (18 U.S.C. §§ 1341, *et. seq*)
 - (a) Before 2000, there was no criminal forfeiture of fraud proceeds generally. The criminal forfeiture statute, 18 U.S.C. § 982, only authorizes forfeiture in connection with a wire or mail fraud violation if the violation involved an asset of the FDIC or other conservators or receivers of financial institutions. *Id.* § 982(a)(3); *see also United States v. Wall*, 285 Fed. Appx. 675 (11th Cir. 2008).
 - (b) 28 U.S.C. § 2461(c), enacted in 2000, however, requires that a criminal sentence include the forfeiture of any property civilly forfeitable. The civil forfeiture statute, 18 U.S.C. § 981(a)(1)(C), authorizes the forfeiture of property "derived from proceeds traceable to" an offense constituting "specified unlawful activity," as defined in 18 U.S.C. § 1956(c)(7)(A), which in turn incorporates "any act or activity constituting" a RICO predicate offense as defined in 18 U.S.C. § 1961(1), which in turn includes mail and wire fraud. *See United States v. Taylor*, 2009 WL 2857971, at *6 (5th Cir. 2009). Fraud proceeds thus became criminally forfeitable to the government, and the exception written into Section 982 become irrelevant.
 - (c) There have been challenges to the government's use of criminal forfeiture to seize fraud proceeds, but all three Circuits to confront the

issue have found that Section 2641 did authorize those forfeitures. *See United States v. Wall*, 285 Fed. Appx. 675 (11th Cir. 2008); *United States v. Day*, 524 F.3d 1361 (D.C. Cir. 2008); *United States v. Jennings*, 487 F.3d 564, 584-85 (8th Cir. 2007); *United States v. Vampire Nation*, 451 F.3d 189, 199 (3d Cir. 2006).

(3) Money Laundering (18 U.S.C. § 1956).

- (a) Section 1956 allegations are common. The allegation is usually that a transfer of fraud proceeds through an entity with legitimate operations was intended to conceal the source of the money, and that payments to Ponzi victims are transfers for the purpose of promoting illegal activity.
 - (i) Substantively, the government may be applying the statute too broadly.
 - (ii) The crime of money laundering, 18 U.S.C. § 1956(a)(1), is, in relevant part, conducting a financial transaction involving the proceeds of an unlawful activity “with the intent to promote the carrying on of specified unlawful activity” or knowing that “the transaction is designed in whole or in part . . . to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity . . .”
 - (iii) In the typical Ponzi scheme cases of recent years, the transfers at issue do not have a separate money laundering purpose distinct from the scheme itself.
 - (iv) A transaction can only violate the “conceal or disguise” provision of Section 1956(a)(1)(B) if it was made for the actual the purpose of “concealing” or “disguising.” *Regaldo Cuellar v. United States*, 128 S. Ct. 1994, 2004 (2008).
 - 1. Transferring crime proceeds to spend the money may not satisfy that requirement. *Id.* at 2002 & n. 4 (citing cases).
 - 2. The requirement under *Cuellar* is that the purpose, and not merely the effect, of the transfer must have been concealment. So, a transfer of fraud proceeds to the fraudster may not constitute a Section 1956(a)(1)(B) violation.
 - (v) And with respect to the allegation that transferring Ponzi monies to earlier victims “promotes” the fraud in violation of Section 1956(a)(1)(A), in *United States v. Santos*, 128 S. Ct. 2020, 2027-28 (2008) (Scalia, J.), a plurality of the Court seemed to say that applying Section 1956 in this way would create what it called a “merger” problem. There, the underlying crime was an illegal gambling offense carrying a five-year maximum prison term, but the government alleged that payments to winners were money laundering transactions because they were intended to “promote” the gambling. Justice Scalia, writing for four justices, noted that if

Section 1956 is applied in this way then it converts an offense with a potential five-year term into one with a 20-year term, although he viewed this as a sentencing problem rather than one of substantive law. *Id.* (holding that paying the expenses of the underlying crime is not “promoting” that crime as that term is used in Section 1956(a)).

1. Justices outside the plurality agreed. *See also id.* at 2035 (Breyer, J., dissenting) (suggesting that money laundering and the underlying criminal offense must be separate but declining to endorse a definition of “promotes”); *id.* at 2023 (Stevens, J., concurring in judgment) (expressing concern about the expansion that would result if the payment of the expenses of a criminal operation constituted a Section 1956(a) violation); *see also United States v. Bucci*, 2009 WL 2902709, at *11 (1st Cir. 2009) (analyzing the *Santos* opinions’ positions on the “merger” problem).
2. But the Court could not concur on a single interpretation of the statute to resolve the problem.
 - a. Some subsequent Courts have held that under *Santos*, the term “proceeds” in Section 1956, as where the underlying offense is fraud, means whatever profit is retained or obtained by the fraudster. *E.g.*, *United States v. Yusuf*, 536 F.3d 178, 186-87 (3d Cir. 2008); *see also United States v. Levesque*, 546 F.3d 78, 82-83 (1st Cir. 2008) (remanding for the District Court to consider in the first instance whether under *Santos* the term “proceeds” always means “profits” for forfeiture purposes). If that is the rule then, payments of new victims’ money to old victims could not violate Section 1956. Payments of victims’ money to the fraudster could violate Section 1956, but only if the transfers had the distinct purpose of hiding the origin of the money, as opposed to simply obtaining the money, under the *Cuellar* line of cases. *See Gotti v. United States*, 2009 WL 197132, at *2-*3 (E.D.N.Y. Jan. 28, 2009).
 - b. Other Courts, however, have held that *Santos* only applies in illegal gambling cases. *E.g.*, *United States v. Howard*, 309 Fed. Appx. 760 (4th Cir. 2009). And still others have taken a middle line, holding that under *Santos*, whether Section 1956 applies to transfers of the gross receipts, or only the profits, of a particular crime depends on whether the first interpretation would create a “merger problem.” *E.g.*, *United States v. Kratt*, 579 F.3d 558 (6th Cir. 2009).

- i. One Court, *United States v. Demarest*, 507 F.3d 1232 (11th Cir. 2009), avoided the question by finding that, since there was no majority opinion in *Santos*, a criminal defendant could not claim that a jury instruction was *plainly* erroneous as inconsistent with *Santos*.

- (vi) So the effect of *Santos* is an open question, and there is a serious issue of whether the money laundering laws are being appropriately applied in some Ponzi scheme cases to begin with.

- (b) Assuming a transfer was violative, forfeiture is authorized of any property “involved in a transaction or attempted transaction . . . or any property traceable to such property,” 18 U.S.C. § 981(a)(1)(A), and any property “involved in such offense, or . . . traceable to such property,” *id.* § 982(a)(1).
 - (i) The government’s current position on what is property “involved in” a Section 1956 offense, is that if the fraud is operated through an entity that also operates legitimate businesses, the entire entity, and all of the entity’s assets, are forfeitable as property “involved” in money laundering. Ltr. from Lev Dassin, to Hon. Jed S. Rakoff, Hon. Miriam Goldman Cederbaum & Hon. Stuart M. Bernstein, dated Apr. 20, 2009.
 1. The government cites two authorities for this proposition, *United States v. Baker*, 227 F.3d 955, 969-70 (7th Cir. 2000), and *United States v. Schlesinger*, 396 F. Supp. 2d 267, 273 (E.D.N.Y. 2005) (citing cases).
 2. In *Baker*, the defendant used legitimate sex businesses as a cover for a prostitution business, and was convicted of laundering the proceeds of the business and violating the Travel Act, 18 U.S.C. § 1952, in that customers had paid for prostitution services using credit cards and ATM machines operated by the defendant’s businesses. The defendant’s sentence included the forfeiture of the entire operation, including its legitimate aspects – because the nature of the legitimate businesses was to act as a front for the illegitimate ones.
 3. Similarly, in *Schlesinger*, the defendant owned a clothing business, and was convicted of money laundering and mail/wire fraud for (a) causing the business to submit fraudulent fire insurance claims, and (b) using the business to accrue liabilities to creditors, diverting the proceeds to the defendant, while concealing the defendant’s ownership. The Court found that *the building in which the clothing business operated* was forfeitable because *the business* had been integral

to the defendant's money laundering. The Court did not, however, address the issue of whether the building was non-forfeitable as owned by a company rather than the defendant. The Court said that the only issue before it was whether whatever interest the defendant had in the property should be forfeited, and if the company had an interest it would have to raise that issue in an ancillary hearing. 396 F. Supp. 2d at 273.

4. The government also occasionally cites *United States v. Huber*, 404 F.3d 1047, 1056 (8th Cir. 2005), on the same point. But *Huber* was a *real* money laundering case. The defendant operated a farming business. He had others file false claims for government farming benefits, which they then passed to him purportedly as payment for materials used in farming. He then shared the proceeds with those persons. The Court allowed the government to obtain a criminal forfeiture order for money damages representing the amounts that the conspirators actually received, which the defendant had then laundered (taking a cut for himself).
 5. *See also United States v. Trost*, 152 F.3d 715 (7th Cir. 1998) (where a defendant was convicted of laundering money through a bank account, the *entire contents of the account* were forfeitable as "involved" in money laundering); *United States v. McGauley*, 279 F.3d 62, 75-77 (1st Cir. 2002) (when illegitimate funds are commingled with legitimate funds for the purpose of concealing the nature or source of the illegitimate funds, the legitimate funds are "tainted" as involved in money laundering and forfeitable in connection with an 18 U.S.C. § 1956 conviction).
- (ii) The question in *Baker* and *Trost* and similar cases is not merely what property the *defendant* must forfeit, but rather what property is civilly forfeitable regardless of who currently owns it or owned it when it was "involved" in money laundering. These cases are saying that if a fraudster passed money through an account that a third party had money in, or through a business that a third party invested in or that owed money to creditors, the money in the account and the assets of the business were "involved" in money laundering and are all therefore forfeitable to the government.
- (iii) Several Courts have also suggested that the Civil Forfeiture of Fungible Property Act, 18 U.S.C. § 984 (discussed below), displaced the rule that crime proceeds passing through an account "taint" clean funds in the account as "involved" in money laundering. *See United States v. All Funds Currently on Deposit*, 832 F. Supp. 542, 559-60 (E.D.N.Y. 1993); *United States v.*

\$3,148,884.40, 76 F. Supp. 2d 1063, 1067-68 (C.D. Ca. 1999). Instead, “clean” funds in an account may be forfeitable only according to the terms of the Act, which includes a one-year statute of limitations. This issue remains unresolved.

- (c) In *United States v. Santos*, Justice Breyer observed that the “merger problem” was “essentially a problem of fairness in sentencing,” and that the Guidelines were already trending in the direction of tying money laundering sentences to the offense level of the underlying crime. 128 S. Ct. 2020, 2035 (Breyer, J., dissenting). In Ponzi fraud cases, the sentencing enhancement driven by the size of the loss tends to overwhelm any effect of the money laundering account on the defendant’s term of imprisonment. *See* UNITED STATES SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1); *see also id.* § 3d1.2 (grouping). It is therefore not clear what advantage the government gains by including money laundering counts in Ponzi cases, other than to try to take advantage of the expansive view of forfeiture set forth in the *Baker* and *Trost* line of cases.
 - (i) Again, a defendant who is pleading guilty to fraud charges carrying a large sentence because of the amount of the loss, who will be asset-less anyway through forfeiture and civil suits by victims, has little incentive to fight the additional money laundering count.
 - (ii) A Ponzi fraudster who pleads guilty to overbroad charges may benefit himself, through a sentencing reduction for acceptance of responsibility, at the expense of creditors who do not get a share of forfeited property.

iii) Traceability & Substitute Assets

- (1) As a general matter, the government must establish that property is the proceeds of a crime or “traceable” to crime proceeds.
 - (a) Where the property is fungible, such as money in an account, the government can trace using its choice of a pair of methods, the “rise to the top” and “fall to the bottom” rules. *See United States v. Banco Cafetero Panama*, 797 F.2d 1154, 1159-60 (2d Cir. 1986).
 - (b) These methods were borrowed from the common law of trusts, *see United States v. Content of Account No. 059-644190-69*, 253 F. Supp. 2d 789, 792 (D. Vt. 2003), but the *Banco Cafetero* rule was far more advantageous to the government.
 - (c) The common law rule is that when assets are commingled, a Court may exercise its equitable discretion to allow claimants to trace particular assets as their own, so that a constructive trust can be imposed on them, but the default “tracing” method is *pro rata* sharing among claimants. *See also In re 1031 Tax Group, LLC*, 2007 WL 2455176 (Bankr. S.D.N.Y. 2007); *In re Foster*, 275 F.3d 924, 927-28

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(10th Cir. 2001); RESTATEMENT (FIRST) OF RESTITUTION § 213 (persons whose funds were commingled share in the commingled fund *pro rata*).

- (d) Under *Banco Cafetero*, the government got to choose, and equitable treatment of other claimants was irrelevant.
- (e) A comparison of the commercial law rule and the rule under *Banco Cafetero*:
 - (i) The fundamental problem is that fungible property has passed through some holding place, usually a bank account, where it was commingled with the property of others, transfers were made out of the account, and now there are multiple claimants to a finite pool insufficient to satisfy all of their claims.
 - (ii) On the one hand, in the civil regime the default rule is the same as the rule in bankruptcy, *pro rata* distribution (setting aside priority). The bankruptcy laws give priority to some government claims, like tax claims, but not to the government's forfeiture claims.
 - (iii) In the forfeiture regime, on the other hand, the government takes before anyone else, and not in proportion to any harm inflicted on it, or even on anyone else.
- (2) The government can also, however, seek the forfeiture of other property if it cannot trace. There are two statutes at issue, 18 U.S.C. § 984, which applies in civil forfeiture, and 21 U.S.C. § 853(p), which applies in criminal forfeiture.
- (3) In civil forfeiture, Section 984 eliminates the requirement to "trace" fungible property beyond a "place or account" that contains sufficient fungible property to satisfy the government.
 - (a) In other words, if the government traces \$100,000 in crime proceeds to a bank account, the government can seek the forfeiture of up to \$100,000 found in that account, regardless of what transactions took place in the account between the deposit of the crime proceeds and the commencement of the government's forfeiture action. See *United States v. United States Currency Deposited in Account No. 1115000763247*, 176 F.3d 941, 945-46 (7th Cir. 1999); *United States v. All Funds Presently on Deposit*, 832 F. Supp. 542, 557-58 (E.D.N.Y. 1993).
 - (i) As discussed above, there was traditionally no 5th or 14th Amendment right against civil forfeiture because civil forfeiture targets "guilty property." No court has yet considered whether Section 984 implicates the 5th or 14th Amendment protection against taking without compensation when it is applied to property in which someone other than a criminal defendant has an interest.
 - (b) There are limits on Section 984's scope.

- (i) One Court held that it does not appear to apply in criminal forfeiture proceedings, even brought through Sections 2461(c) and 981. *See United States v. Jennings*, 487 F.3d 564, 586 (8th Cir. 2007). The government, however, disagrees with that rule and now often cites Section 984 in the criminal forfeiture provisions of criminal indictments. *E.g., United States v. Qadri*, 2009 WL 2700280, at *1 (D. Hawai'i 2009).
 - (ii) There is a one year statute of limitations, *see United States v. \$8,221,877.16 in United States Currency*, 330 F.3d 141, 159 (3d Cir. 2003), subject to the equitable tolling principles that would apply in an admiralty case (whatever those are), *see United States v. All Funds Distributed To, or On Behalf of, Weiss*, 345 F.3d 49, 55 (2d Cir. 2003). Most Circuits have not yet decided whether the limitations period is tolled by the filing of a forfeiture complaint or also by the seizure of assets. *See United States v. \$79,650 Seized from Bank of Am.*, 2009 WL 331294 (E.D. Va.).
 - (c) Some Courts have also held that if Section 984 does not apply because the limitation period has passed, then the government can still take advantage of the advantageous tracing rules of *Banco Cafetaro*. *United States v. One Parcel of Real Property*, 34 F. Supp. 2d 107, 117-18 (D. R.I. 1999); *United States v. Contents in Account No. 059-644190-69*, 253 F. Supp. 2d 789, 794-95 (D. Vt. 2003).
- (4) In criminal forfeiture proceedings, the analogous rule is the “substitute asset” provision of the federal narcotics laws, 21 U.S.C. § 853(p).
- (a) The rule is that if crime proceeds “as a result of any act or omission of the defendant” cannot be located, or were transferred to a third party, or were commingled, then the government can seize other “property of the defendant.”
 - (b) So if the government cannot satisfy the tracing requirement, it can simply take whatever it wants – but only from the defendant. It is narrower than Section 984 and does not appear to allow the government to seek the forfeiture of other persons’ property.
 - (c) Section 853(p) does apply in proceedings seeking the criminal forfeiture of Section 981 property under Section 2641. *United States v. Gallion*, 2009 WL 1702166, *7-9 (E.D.Ky. June 17, 2009); *United States v. Capoccia*, 2009 WL 273301, *2-3 (D. Vt. Feb. 4, 2009).
 - (d) But it does not apply in civil forfeiture proceedings – a third party’s interest in property cannot be forfeited as substitute property. *See In re Moffitt, Zwerling & Kemler, P.C.* 875 F.Supp. 1152, 1162 (E.D. Va. 1995) (“[C]riminal forfeiture of substitute assets is available against a defendant, but not against a third party”), *aff’d in part and rev’d in part on other grounds*, 83 F.3d 660 (4th Cir. 1996).

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- (5) Sections 984 and 853(p) are particularly relevant in the case of property acquired before the offense was committed, which cannot be crime proceeds. See *United States v. Capoccia*, 503 F.3d 103, 116 (2d Cir. 2007).
- (a) Such property may only be forfeitable as “involved” in a crime, if it is not forfeitable under the substitute assets or tracing statutes.
- iv) Money Judgements in Criminal Forfeiture
- (1) The government often seeks for the criminal forfeiture order to contain a money judgment against the defendant, without regard to Section 853(p).
- (2) This is odd. Section 982 identifies properties (crime proceeds, property traceable to crime proceeds, etc.) which may be forfeited criminally, and Section 853(p) says that if such properties have been hidden or commingled by the defendant then the government can take other property of the defendant’s instead.
- (3) One Circuit has held, though, that money judgments are permissible in criminal forfeiture even if Section 853(p) does not apply because, they say, “Nothing in the relevant statutes suggests that money judgments are forbidden.” *United States v. Day*, 524 F.3d 1361, 1377 (D.C. Cir. 2008).
- (a) Other Circuits have reached similar conclusions in interpreting criminal forfeiture statutes other than Section 981. E.g., *United States v. Hall*, 434 F.3d 42, 58 (1st Cir. 2006) (approving of a money judgment criminal forfeiture order for drug trafficking in violation of Section 853, not addressing the availability of one under Section 982); *United States v. Casey*, 444 F.3d 1071 (9th Cir. 2006) (same).
- (b) The government also sometimes cites *United States v. Vampire Nation*, 451 F.3d 189, 201-02 (3d Cir. 2006), on this point. In that case, the Court actually rejected the argument that a criminal forfeiture sentence must be limited to the amounts in the defendant’s possession. The Court said that a money judgment for criminal forfeiture of fraud proceeds was permissible. But the Court was careful to say that it was not authorizing a general money judgment. Rather, it was authorizing a money judgment “limited by the provisions of” Section 853(a) to crime proceeds, property used in the commission of a crime, and property forfeitable under Section 853(p). *Id.* at 201-02; cf. *United States v. Baker*, 227 F.3d 995, 970 (7th Cir. 2000) (authorizing an *in personam* money judgment but suggesting that it might only be satisfied against traceable assets or substitute assets).
- (c) It is dubious to apply cases allowing money judgments for Section 853 drug traffickers to Section 982 forfeitures. Section 853 targets drug traffickers. It contains one subsection, o, calling for its broad construction, and other, d, imposing a presumption that *any* property of a person convicted under Section 801 *et seq.* is subject to forfeiture, in certain circumstances. Section 982, however, incorporates only the

procedures of Section 853, and excludes subsection d. *See* 18 U.S.C. § 982(b)(1).

- (i) Cases applying the pre-1984 RICO forfeiture statute, which specifically allowed for an *in personam* judgment regardless of tracing, are similarly inapplicable. *E.g.*, *United States v. Robilotto*, 828 F.2d 940, 948-49 (2d Cir. 1987); *United States v. Ginsburg*, 773 F.2d 798, 799, 801 (7th Cir. 1985) (*en banc*).

g) Rights of Third Parties

- i) There is no provision in the forfeiture laws for third parties with claims on property targeted in a forfeiture action to challenge whether (a) the defendant actually committed their crime of conviction, or (b) the property was actually used in the offense. *See* Fed. R. Crim. P. 32.2(b)(2); 21 U.S.C. § 853(k) & (n).
- ii) Rather, the procedure is that after a preliminary criminal and civil forfeiture order is imposed in connection with a defendant’s sentencing, then third parties asserting an interest in the property can seek to assert their rights.
- iii) In practice, this means that someone else claiming an interest arrives only after either a jury has found that property constitutes crime proceeds, or more likely the defendant has pleaded to a crime and that the property is crime proceeds. A third party’s ability to challenge the propriety of a forfeiture is thus pragmatically limited, since the only opportunity to do so occurs after the judge has included the forfeiture in the defendant’s criminal sentence.
- iv) Bases for asserting a right to forfeited property are narrowly limited
 - (1) Regarding criminal forfeiture, 21 U.S.C. § 853(n)(6) allows third parties to assert either (a) that their interest in property was superior to the defendant’s at the time of the offense, or (b) that they are a *bona fide* purchaser for value, without knowledge that the property was subject to forfeiture.
 - (a) The First and Tenth Circuits have also held that a different rule applies to property the government is obtaining as “substitute assets.” *See* Heather J. Garretson, *Federal Criminal Forfeiture: A Royal Pain in the Assets*, 18 S. CAL. REV. L. & SOC. JUST. 45, 64-65 (2008). Those Circuits say that while crime proceeds and property traceable to crime proceeds become property of the government at the time of the offense, substitute property does not.
 - (b) If that is so, then someone else with a post-offense interest in substitute property, like a *bona fide* giftee or whomever else, may be able to resist forfeiture. *E.g.*, *United States v. Wittig*, 525 F. Supp. 2d 1281, 1288 (D. Kan. 2007); *see also United States v. Jarvis*, 499 F.3d 1196, 1204 (10th Cir. 2007).
 - (c) But other Courts disagree. *E.g.*, *United States v. McHan*, 345 F.3d 262, 270-72 (4th Cir. 2003); *United States v. Alhindi*, 297 Fed. Appx.

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244, 246 (4th Cir. 2008); *United States v. Loren-Maltese*, 2006 WL 752958, at *1 (N.D. Ill. Mar. 21, 2006).

- (2) Regarding civil forfeiture, 18 U.S.C. § 983(d) says that an “innocent owner’s interest in property shall not be forfeited under any civil forfeiture statute.”
- (a) “Innocent owners” under that subsection include (a) persons who had an interest in property superior to the defendant’s at the time of the offense and had no knowledge of the conduct giving rise to forfeiture, and (b) *bona fide* purchasers, for value, without knowledge that the property was subject to forfeiture.
 - (b) The civil forfeiture “innocent owner” concept extends beyond Section 853(n)(6) in one relevant respect, which is that under Section 983(d)(3)(B)(iii) the claimant does not have to show that they acquired “for value” property that is not crime proceeds or traceable to crime proceeds.
 - (c) That seems to mean that the government cannot use Section 984, or the concept of property “involved” in a money laundering offense, to forfeit the property of a *bona fide* giftee.
 - (i) But, the government may still be able to benefit from the advantageous *Banco Cafetero* tracing rules.
 - (d) For the sake of precision, there are additional bases for third parties to challenge civil forfeiture, involving family homes and the like, which do not appear relevant in the commercial context.
- v) Creditors have no right to challenge forfeiture – and the criminal defendant’s bankruptcy estate’s ability to challenge forfeiture is necessarily limited by the criminal defendant’s conviction and/or guilty plea.
- (1) In the case of criminal forfeiture, §853(k) purports to impose an absolute bar on challenges to forfeiture outside of a §853(n) proceeding. Some courts have applied this to prevent avoidance actions against the defendant. *In re American Basketball League, Inc.*, 317 B.R. 121, 129 (Bankr. N.D. Cal. 2004).
- h) Today’s sophisticated Ponzi fraudsters typically operate through one or more entities with at least some legitimate operations. These entities are not, however, generally indicted. What rights do they have in forfeiture?
- i) Forfeiture cases have addressed corporate veils only in the context of front corporations without legitimate assets. The rule has been that if a third party is able to demonstrate that it had “dominion and control” over property, then that person is not a mere “straw owner.” *See United States v. Totaro*, 345 F.3d 989, 995 (8th Cir. 2003). But no Court has yet applied this rule to corporations used by Ponzi fraudsters. *Cf. United States v. Lester*, 85 F.3d 1409, 1410 n. 1 (9th Cir. 1996) (noting, in a case in which the government sought the forfeiture of real estate owned by a limited partnership, one partner

of which was a corporation owned by the defendant, that since both parties had ignored the intervening corporate veils the court would proceed on the same basis).

4) Bankruptcy

- a) The rules of tracing and constructive trust provide a useful starting point and contrast between the forfeiture and bankruptcy systems.
 - i) Assets held by a bankrupt in trust, express or constructive, are not part of the bankruptcy estate. They will not be distributed *pari passu*, but instead returned to their equitable owners, and the trustee does not have standing to avoid the transfer of trust assets. *See In re Cannon*, 277 F.3d 838, 850 (6th Cir. 2002).
 - ii) It is therefore not uncommon for claimants to assert that they are not mere creditors, but that the debtor was instead holding money for them in trust. If trust assets are commingled, then their trust “character” is destroyed, and a claimant to the assets is merely a general creditor unless he or she can trace his assets so that the Court imposes a constructive trust over them. *See In re Schick*, 234 B.R. 337 (Bankr. S.D.N.Y. 1999).
 - iii) Similarly, property stolen by fraud is generally held not to be the property of the fraudster, but merely held in constructive trust for the victim, if it is traceable. *United States v. \$4,224,958.57*, 392 F.3d 1002, 1004 (9th Cir. 2004) (*citing* Scott on Trusts §462.4 (4th ed. 1989) and RESTATEMENT (FIRST) OF RESTITUTION §160 (1937)).
 - iv) The default tracing rule, however, is that multiple claimants to a fund share in that fund *pro rata*, unless a Court determines that it is equitable to apply some other tracing mechanism. And in the case of Ponzi schemes, where claimants’ funds were all commingled and in inadequate pool remains, Courts hold that it would be inequitable to allow tracing, because compensation would then turn on the fortuity of transfers in and out of the account. They therefore decline to impose constructive trusts so that the commingled assets are instead distributed among claimants, including Ponzi victims, *pari passu*. *See S.E.C. v. Credit Bancorp, Ltd.*, 290 F.3d 80 (2d Cir. 2002); *see also S.E.C. v. Byers*, 2009 WL 2185491, at *9 (S.D.N.Y. 2009) (reviewing authorities in other circuits).
 - v) In forfeiture, the opposite rule applies in most Circuits. Courts routinely find that property is not forfeitable because it was taken from a third party by fraud and the criminal defendant therefore only held it in constructive trust. *See United States v. Shefton*, 548 F.3d 1360, 1365 (11th Cir. 2008); *United States v. \$4,22,958.57*, 392 F.3d 1002, 1004-05 (9th Cir. 2004); *United States v. Marx*, 844 F.2d 1303, 1308 (7th Cir. 1988); *United States v. Campos*, 859 F.2d 1233, 1238-39 (6th Cir. 1988); *United States v. Schwimmer*, 968 F.2d 1570, 1574, 1582 (2d Cir. 1992); *but, see United States v. BCCI Holdings (Luxembourg), S.A.*, 46 F.3d 1185, 1190-91 (D.C. Cir. 1995).

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- (1) The government's power to trace under Section 984, *Banco Cafetero*, and Section 853(p) is broader than a civil litigant's. So there may be property that the government can claim in forfeiture as the proceeds of a fraud, which the victim of that fraud is unable to claim.
 - (a) That is the property the government can distribute to crime victims *pro rata* if it obtains an order avoiding restitution under 18 U.S.C. § 3663A(c).
- vi) So, the result in forfeiture is precisely the constructive trust free-for-all that every Circuit to have considered the question has rejected as inequitable—plus the vagaries the forfeiture and tracing rules described above.
- b) In bankruptcy, the Trustee's power to recover assets in Ponzi cases stems from the preference and fraudulent transfer laws.
 - i) The fraudulent transfer laws are far more important than the law of preference because of the longer limitations period applied to actual fraudulent transfer claims.
 - ii) This is, however, an unintended application of those laws.
 - (1) The fraudulent transfer laws are often traced back to the Fraudulent Conveyance Act of 1571, 13 Eliz. Ch. 5, § 2 (Eng. 1570). *E.g.*, *Eberhard v. Marcu*, 530 F.3d 122, 129-30 & n. 4 (2d Cir. 2008). They actually had their origin hundreds of years earlier. George Lee Flint, Jr., *Secured Transactions History: The Fraudulent Myth*, 29 N.M. L. REV. 363, 380 (1999).
 - (2) The original evil targeted by the statutes was that debtors would transfer land to a trust or to a friend or relative, flee to a sanctuary jurisdiction, and live off the income of the land. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law & Its Proper Domain*, 38 VAND. L. REV. 829, 829 (1985). The 1377 statute made such transfers “void” and allowed creditors to execute against the transferred property. Flint, Jr., 29 N.M. L. REV. at 380. The statute was broadened in 1488 to apply to chattels generally, and then again in 1571 to any transfer made for the purpose to “delaye hinder or defraude Creditors.” *Id.* Under the 1571 statute, like its predecessors, a violative transfer was void, in the sense of being *faux*, transfers that were shams and not real transfers. The statute gave creditors the right to levy a judgment on the transferred property. Baird & Jackson, 38 VAND. L. REV. at 830; *see also Lind v. O.N. Johnson Co.*, 282 N.W. 661, 665-66 (Minn. 1938) (discussing remedies for fraudulent conveyance). Ironically given the topic here, under the 1571 statute one-half of the fraudulently transferred property was forfeited to the government, while the other half was available to creditors. Flint, Jr., 29 N.M. L. REV. at 381.
 - (3) The fraudulent transfer and conveyance laws of today are direct descendents. Fact patterns that Courts invariably held to evidence fraud were codified as “constructively” fraudulent conveyances, and “badges of

- fraud” have been codified by most jurisdictions as well. *See Eberhard*, 530 F.3d at 129-30 & n. 4.
- (4) The constructive fraudulent conveyance laws also expanded the scope of the proscription to include *bona fide* gifts made by an insolvent, apparently because by the early 20th Century the commercial bar had simply concluded that bankrupts’ moral obligation to creditors overwhelmed whatever obligation they might feel to make gifts. *See Baird & Jackson*, 38 VAND. L. REV. at 831-32.
- iii) Today, Courts apply the rule that payments made to early Ponzi victims are presumptively intended to defraud creditors and therefore actual fraudulent transfers.
- (1) In a Ponzi scheme, the fraudster knows that later victims will, at some point, not be repaid, and makes payments to earlier victims only for the purpose of attracting, and defrauding, new victims. *See In re Independent Clearing House Co.*, 77 B.R. 843, 860 (D. Utah 1987); *In re Bayou Group, LLC*, 362 B.R. 624, 634 (Bankr. S.D.N.Y. 2007); *Cuthill v. Greenmark, LLC (In re World Vision Entertainment, Inc.)*, 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002).
- (a) At the start, fraudulent conveyance laws only applied to void transfers made with the intent of defrauding, delaying, or hindering *existing* creditors. Subsequent creditors did not have standing. Later, subsequent creditors were held to have a cause of action only if at least one debt outstanding at the time of the transfer remained outstanding when the debt to the subsequent creditor was incurred. *See Fleet Bank v. Dick Corp.*, 1991 WL 224077, at *3-*4 (Conn. Super. Ct. 1991). Today, although there exceptions, *see id.*, that distinction has disappeared. *See* 11 U.S.C. § 548(a)(1)(A) & (B); *In re Morse Tool, Inc.*, 108 B.R. 389 (Bankr. D. Mass. 1989) (holding that post-LBO creditors have standing to challenge LBOs as fraudulent transfers even if they extended credit with full knowledge of the LBO).
- (b) The change does not appear to have been intended to expand the scope of transactions deemed fraudulent.
- (c) The interpretation of “intent to . . . defraud . . . creditors” applied in Ponzi scheme presumption cases would seem inconsistent if the fraudulent conveyance laws still applied only to transfers in fraud of existing creditors.
- iv) Some Courts have gone further and held that *any payments* made by the fraudster, or the entity through which the fraud was conducted, which were made to “further” the scheme by, for example, maintaining the appearance of a legitimate operation, are intended to defraud creditors. *In re Manhattan Inv. Fund, Ltd.*, 397 B.R. 1, 12-13 (S.D.N.Y. 2007).
- (1) These cases reflect the Courts’ common conclusion about the equities, in fact the same analysis that informed *Credit Bancorp: Everyone who*

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extends credit to a Ponzi scheme is being defrauded, because the fraud of a Ponzi scheme is that the fraudster claims to be operating a profitable, solvent business when in fact he is using new victims' money to pay old victims, becoming only more insolvent as time goes on.

- (2) There is no reason the equities inherently favor Ponzi victims over other creditors of the fraudster, or vice versa.
 - (3) The Ponzi scheme presumption, and cases adopting an expansive view of it, are therefore consistent with the goal of the Bankruptcy System of achieving equity among creditors.
 - (4) Not clawing-back payments made by Ponzi schemes would be to favor one group of victims over another based on the mere fortuity of when they sought to withdraw their "investment" or collect on a trade debt.
- v) The clawback power is, however, far from perfect.
- (1) Because the clawback power applied in Ponzi cases was adapted from statutes enacted for other purposes, the power has boundaries unrelated to any discernable policy objective.
 - (2) One such boundary is a tendency to elevate the fraudster's lie in determining what transfers may be clawed back.
 - (a) *Matter of Cohen*, 875 F.2d 508 (5th Cir. 1989), a preference action, provides a vivid example.
 - (i) The power to avoid preferences under 11 U.S.C. § 547 only applies to transfers made by the debtor on an "antecedent debt," which is to say, to an existing creditor
 - (ii) In *Matter of Cohen*, the Ponzi scheme was a bogus brokerage in which the fraudster said that he was making purchasing and selling securities on the victims' behalf.
 - (iii) The Fifth Circuit ruled that victims *were* creditors with respect to the extent of the funds they had invested, so the repayment of those funds – the repayment of principal – could be avoided as a preferential transfer.
 - (iv) But, the Fifth Circuit also held that victims were *not* creditors with respect to transfers of bogus profits that had been paid by the fraudster, so those payments *could not* be avoided and recovered as preferential.
 - (v) The Fifth Circuit's theory was that the victims were creditors in the sense that they had a claim for restitution for fraud, but no other claim.
 - (vi) If the Ponzi scheme in *Matter of Cohen* had been structured as a traditional Ponzi scheme in which the fraudster contractually promises payments at a high interest rate, then by the Fifth

Circuit’s logic it would seem that there would have been a different result in that case.

- (b) The danger of analyses like the one in *Matter of Cohen* is that the shape of the remedy in bankruptcy is determined not by the fact of the defendant’s fraud, but rather by terms of it. The lie determines the outcome. That is not to suggest that *Matter of Cohen* is analytically incorrect; indeed, this thread runs through the law of Ponzi clawback.
 - (c) In fraudulent transfer and conveyance clawback, the issue arises when transferees claim that transfers to them cannot be recovered to the extent they gave “value,” in exchange for the transfer, which may include the satisfaction of an antecedent debt. 11 U.S.C. § 548(c) & (d)(2)(a).
 - (d) Some courts hold that reasonably equivalent value cannot have been given for “net winnings,” transfers of fictitious profits, at least where the fraudster claimed to be making investments on the victims’ behalf. *E.g.*, *In re Bayou Group, LLC*, 362 B.R. 624, 636 (Bankr. S.D.N.Y. 2007).
 - (e) Others hold that where the scheme involved a contractual right to interest, that is an antecedent debt whose satisfaction is “value” under the Code. *Daly v. Deputa*, 286 B.R. 480 (D. Conn. 2002); *Lustig v. Weisz & Assocs., Inc.*, 260 B.R. 243, 350-51 (Bankr. W.D.N.Y.), *aff’d*, 2002 WL 325000567, at *3-*6 (W.D.N.Y. June 21, 2002).
- (3) There are other unusual boundaries to the law of clawback as well.
- (a) The discussion above focused on intentional fraudulent conveyances because transfers made by Ponzi schemes are presumed to have been intentionally fraudulent. In such cases, the transferee has the burden of proving reasonably equivalent value. *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006); *Terry v. June*, 432 F.Supp.2d 635, 640 (W.D.Va. 2006). In a constructive fraudulent conveyance claim, however, in which the Ponzi scheme presumption does not apply, and which has a shorter statute of limitations, the Trustee has the burden of proving that less than reasonably equivalent value was received. *E.g.*, *AFI Holdings, Inc. v. Mackenzie*, 525 F.3d 700, 707 (9th Cir. 2008).
- vi) The balancing of equities in bankruptcy is opposed to that in forfeiture, and does not favor the direct victims of Ponzi scheme frauds.
- (1) A transferee can retain an intentionally fraudulent transfer to the extent they received in “good faith” and for “reasonably equivalent value.” A transferee did not, however, take in good faith if they were on “inquiry notice” and should have known of the fraudulent intent or insolvency, of the transfer. *E.g.*, *In re Enron Corp.*, 340 B.R. 180, 208 n. 25 (Bankr. S.D.N.Y. 2008) (“Bankruptcy courts have also held that a transferee who reasonably should have known of a debtor’s insolvency is not entitled to the ‘good faith’ defense . . .”), *rev’d on other grounds*, 379 B.R. 425

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(S.D.N.Y. 2007); *In re M&L Business Mach. Co., Inc.*, 84 F.3d 1330, 1338 (10th Cir. 1996) (adopting the “reasonably should have known” test); *In re Sherman*, 67 F.3d 1348, 1355 (8th Cir. 1995) (same); *In re Agric. Research & Tech. Group*, 916 F.2d 528, at 536 (9th Cir. 1990) (same).

- (a) Some Courts have held that a transferee on inquiry notice can still demonstrate good faith if they conducted a “diligent investigation.” *In re Manhattan Inv. Fund.*, 397 B.R. 1, 23 (S.D.N.Y. 2007); *In re Bayou Group, LLC*, 396 B.R. 810 (S.D.N.Y. 2008) (same); *In re M & L Bus. Mach. Co.*, 84 F.3d at 1335-36 (same).
 - (b) While the consensus of the bar seems to be that “good faith” is an objective standard, the cases are not entirely consistent with that conclusion. In *Bayou Group*, for example, the Court said that the transferee could attempt to demonstrate that he had redeemed for reasons other than inquiry notice of the transferor’s fraudulent intent. 396 B.R. at 848-49, 852.
- (2) The direct victims of Ponzi schemes – which is to say, the persons who were actually defrauded, who actually relied on fraudulent statements by the fraudster, and in many case who believed that they would obtain above-market returns for their investments – are less likely to be able to demonstrate “good faith” on an inquiry notice standard than an ordinary trade creditor.
- (a) So in *In re M & L Bus. Mach. Co.*, 84 F.3d at 1338-39, the astronomical rate of return offered by the scheme, along with the implausible explanation for how the company could pay the rates and other facts, demonstrated that bad faith on the part of the Ponzi investor.
 - (b) These facts are entirely irrelevant to whether the fraudster committed, for example, mail fraud, or whether the victim is entitled to restitution.
- c) Other differences between the regimes.
- i) The Trustee’s power to recover funds from accomplices may be limited by the *in pari delicto* and *Wagoner* doctrines, an issue that is still being resolved by the Courts.
 - (1) It is interesting to note that while the bankruptcy estate always has standing to sue directors, officers, and other control persons for breach of fiduciary duty because they are necessarily in *unequal* wrong with the debtor, *In re Granite Partners, L.P.*, 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996), some Courts would apply the same principles to hold that the accomplices can only be sued by creditors.
 - (2) In any event, the Department of Justice faces no such limitation in bringing conspiracy claims and civil and criminal forfeiture claims against accomplices.
 - ii) There may be more than one estate, which are difficult to combine.

- (1) The entity and individual fraudster, as in *Dreier*, may be under separate administration.
- (2) The Department of Justice can merge the proceeds of multiple seizures and prosecutions at its discretion.
- iii) The Trustee is more likely to be effective in claiming property held abroad
 - (1) The international regime of bankruptcy ancillary proceedings is well-established and cooperative. *See* 11 U.S.C. § 1505.
 - (2) Courts are generally disinclined to enforce the criminal laws of foreign governments.