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## Is Your Investment Fund A Ponzi Scheme?

Law360, New York (July 08, 2014, 10:42 AM ET) -- The Second Circuit Court of Appeals has defined a Ponzi scheme as:

a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1088 n.3 (2d Cir. 1995).[1]



Neil Steinkamp

No reasonable investor would purposely invest in a fraud, yet many times even sophisticated investors are unable to recognize the signs that an investment opportunity may in fact be a Ponzi scheme. In reality, Ponzi schemes are more prevalent than most realize and many investors often simply abide by the theory that "it won't happen to me." According to Ponzi Tracker:[2]

- At least 67 Ponzi schemes were exposed in 2013;
- The average Ponzi scheme was approximately \$44 million;
- Over 1,000 total years of sentences were handed down in 2013 to at least 117 individuals involved in Ponzi schemes;
- Males were the predominant perpetrators, constituting approximately 90 percent of the individuals sentenced; and,
- The total dollar amount of all Ponzi schemes in 2013 exceeded \$13 billion.

While Ponzi schemes are inherently deceptive, extremely complex and can be very difficult to observe as an investor or outsider, there are signs that may be spotted by a cautious and careful investor willing to engage in the appropriate level of due diligence. This article provides insight to sophisticated investors by discussing the hallmarks of a Ponzi scheme, reviewing recent enforcement activity, discussing the risks sophisticated investors often face in investing in a Ponzi scheme, and looking at a case study illustrating the challenges of identifying a Ponzi scheme and the red flags often associated with them.

### Recently Revealed Ponzi Schemes

- Michael Stewart and John Packard, the chief executives of Pacific Property Assets, were charged by the FBI with 11 counts of mail and wire fraud, three counts of bank fraud, and two counts of bankruptcy fraud for allegedly turning PPA into a Ponzi scheme after the

2007 real estate market collapse. The pair allegedly began raising new funds post-real estate crash to pay off their pre-cash investors, lenders and creditors.[3]

- Brent Williams and his son were convicted for conducting a \$100 million Ponzi scheme. The pair operated Mathon Entities and solicited funds from members of the Church of Jesus Christ of Latter-day Saints by promising high returns on short-term loans.[4]
- The heads of two companies operating under the names "CKB" and "CKB168" were charged with operating a \$20 million Ponzi scheme by marketing the company as a profitable distributor of Web-based children's educational courses. CKB raised over \$20 million from U.S. investors, mostly Asian-Americans and millions more worldwide.[5]
- Edwin Yoshihiro Fujinaga was charged with an \$800 million Ponzi scheme purportedly targeting Japanese investors through MRI International Inc. Fujinaga allegedly claimed that the funds raised would buy discounted medical accounts receivables (MARs) from medical providers that would be turned around and sold to insurance companies for full value.[6]
- Brian Dinning received a sentence of 12.5 years in 2013 for masterminding a \$2.5 million Ponzi scheme. The scam claimed funds would be invested in South African real estate, gold and diamond mines where some of the returns earned would be donated for wildlife conservation and missions in South Africa.[7]
- Adam Jay Boskovich and Gerard Cellette were charged with allegedly running a \$150 million Ponzi scheme in California without having stepped foot in the state using the company Minnesota Print Services Inc. The pair attracted investors by falsely portraying the company's contracts and services.[8]
- Jonathan Rosenberg and Richard Shusterman were indicted for allegedly perpetrating a \$275 million Ponzi scheme through three separate companies. The pair allegedly enticed investors with the opportunity to resell medical accounts receivable to hedge funds and other investors.[9]
- Gregory Podlucky, the former CEO of Le-Nature, a bottle water manufacturer, received a 20-year prison sentence for his orchestration of a \$685 million "loan-Ponzi" scheme that defrauded lenders and investors by falsely inflating the company's financial strength and business activity.[10]
- Doris Nelson was charged in January 2013 with conducting a \$135 million Ponzi scheme by soliciting investors across the U.S. and Canada to fund her short-term loan business, the Little Loan Shoppe. Nelson allegedly advertised the loans she made were insured and "risk-free" when in reality the loans she made defaulted at an unsustainable rate.[11]

- Shirley Sooy was charged in early 2013 with conducting a \$42 million Ponzi scheme by commingling collected money from victim companies that was to be used for freight bills and misappropriating millions of dollars of trust funds in the process.[12]

## Hallmarks of a Ponzi Scheme

There are two requirements typically necessary for a Ponzi scheme to be successful in the short run: (i) the scheme must be able to continually attract investments into the fund or business; and (ii) the scheme must be able to operate in a manner that conceals from regulators and investors its use of incoming investors' funds to pay existing liabilities. Because of this, Ponzi scheme operators tend to be extremely secretive with respect to their investment methods and business dealings.

Indeed, a common ex post discovery is that many Ponzi schemes take great care to obscure and otherwise falsify their books and records, rendering the typical pre-investment considerations irrelevant. This of course begs the question: How does one know whether an investment opportunity may actually be a Ponzi scheme?

There are several common characteristics and "red flags" that could be indicative of a Ponzi scheme:

- **The Promise of Lofty and Consistent Returns:** Ponzi schemes will often promise lofty returns or even normal but guaranteed returns, typically within a short time frame. For Ponzi schemes to attract the necessary investments with as few questions as possible they will often lure initial contributors with high potential returns. Next, the perpetrator will initially actually deliver (or purport to deliver) on these promised returns, in order to establish credibility and solicit additional investors. Unfortunately, this type of attraction works better if the perpetrator is known in a particular small knit community and presumed trustworthy. Indeed, affinity, or targeted fraud is one of the most common methods utilized by scammers.[13] From an aware investor's standpoint, if it seems too good to be true, it probably is.
- **Limited Access to Information:** Ponzi schemes will also limit investor access to information regarding the strategies and operations of the business and may provide vague indications as to how the money is invested.
- **Inability to Replicate Returns:** The stated returns are often significantly higher than those of other similar investments and/or there are inconsistencies or highly unusual explanations about the methods generating the returns.
- **Professional Services:** A firm's auditor or administrator is known to be related to the principal of the fund, or is atypically small and incongruently providing services to a fund with significant assets under management.

## From the Inside — What We Learned From Madoff, Stanford and Others

Ponzi schemes, while simple in theory, have grown more complex as worldwide investment barriers continue to fall and there is an ever-growing cadre of sophisticated investors seeking higher returns (while willing to sacrifice rationality) in a low-interest rate environment.

R. Allen Stanford, for example, who purported to sell high-yielding certificates of deposit, was

based in Houston, Texas, but controlled and operated banking institutions and investment accounts in Antigua and Europe. Madoff was based in New York, but his operations spawned an array of actual and synthetic "feeder funds" located across the globe. Many of Stanford's and Madoff's victims were U.S.-based, but many were also high-net worth individuals and funds located in Central America, South America and Europe. The majority of Stanford's and Madoff's victims believed they were investing in safe, but consistently high-yielding products or strategies.

Recent years have also seen larger Ponzi schemes than in years past. Stanford is estimated to have defrauded investors of \$2 billion - \$7 billion, and Madoff operated what is believed to be a \$19 billion fraud (or a \$65 billion scheme if fictitious profits are included) — the largest recorded Ponzi scheme to date.

As capital continues to flow internationally towards high-yield opportunities, and financial products mature and evolve in complexity, Ponzi schemes will similarly grow in size and sophistication. Potential victims, however, can do a lot to avoid these fraudulent investments.

## **A Case Study**

On June 29, 2012, Fletcher Asset Management (the "Fletcher funds"), a group of hedge funds run by a well-known fund manager, Alphonse "Buddy" Fletcher, filed for Chapter 11 protection in the Bankruptcy Court for the Southern District of New York. The Chapter 11 filing was allegedly brought about, in part, by complaints made by three Louisiana public pension funds (the "pension funds") that had tried unsuccessfully to redeem their more than \$100 million investment in the Fletcher funds and then retained Ernst & Young to investigate the Fletcher funds' books and records. The Fletcher funds proposed to satisfy the pension's redemption requests with promissory notes rather than cash, which raised alarms with the pension funds.

The eventual Chapter 11 bankruptcy trustee identified numerous alleged irregularities with respect to the Fletcher funds in a formal report and disclosure statement (the "Fletcher report") — allegations that are illustrative for helping sophisticated investors determine the legitimacy of new investment opportunities. The trustee noted in the Fletcher report that "the fraud here has many of the characteristics of a Ponzi scheme where, absent new investor money coming in, the overall structure would collapse."

According to the Fletcher report, the Fletcher funds reported no down months for a 127-month period from June 1997 through December 2007, even though the Fletcher funds' investment thesis was to invest in private investments in public equities (PIPE) whose values are correlated to the equity markets, which themselves had seen many ups and downs during that same 127-month period.

Moreover, the trustee claims to have found that the values that the Fletcher funds placed on its investments were "wildly inflated" to fraudulently generate more than \$30 million in fees and attract new investors. Although the trustee identified many structural and operational issues related to the Fletcher funds, the portfolio valuation process bears discussion starting with the Fletcher funds' fee structure, which was not typical of a private equity fund.

According to the trustee report, the Fletcher funds' fee structure charged weekly fees on realized and unrealized gains. This structure would be unusual for a private equity fund with an investment strategy to acquire investments that may have liquidity restrictions.

By virtue of a PIPE being a private investment, investors hold unregistered securities of the issuer at closing, and depending on the PIPE offering, an investor may or may not have the right to register their shares for sale to the public market. The typical fee structure for a fund holding illiquid investments is to charge investors quarterly based on invested capital and realized gains. This typical structure ensures a "cash-on-cash" return for the investor and that the manager and investor are on equal footing when investment returns are paid out. A fee structure in which the fund manager is paid before the investor may create an incentive for the manager to inflate the value of the fund investments.

Next, the trustee identified 10 investments in which the Fletcher funds allegedly reported “too good to be true” unrealized windfall profits on or close to the date in which the Fletcher funds acquired the investments. The trustee reported that the Fletcher funds marked these 10 investments at a weighted average of 2.7 times what it had just paid for them. Although valued at their highest marks at \$454 million, according to the trustee, the 10 investments had a realizable value of only \$60 million when they were sold or transferred out of the funds.

The trustee noted that when marking its portfolio, the Fletcher funds primarily relied on mathematical models (marked to model) and ignored current transaction prices at which securities similar to the Fletcher funds’ investments had recently traded. Using these market indicators — also referred to as comparable or precedent transactions — as a key valuation input and a sanity check against mathematical models is a standard valuation approach for funds that mark their portfolios to market in accordance with U.S. generally accepted accounting principles, or GAAP.

Interestingly, according to the Fletcher report, the Fletcher funds did have third-party vendors providing financial services to the Fletcher fund, such as an independent auditor and a fund administrator who had responsibilities with respect to the valuations. According to the Fletcher report, the outside service providers tended to rely heavily on the Fletcher funds’ own valuations and one such service provider, after receiving a U.S. Securities and Exchange Commission subpoena and doing an internal valuation of its work for the Fletcher funds, withdrew its audit opinion.

Also, surprisingly, the Fletcher funds used an independent valuation consultant to validate the periodic valuations of the underlying fund investments. Although use of an outside consultant to review portfolio valuations would ordinarily provide some level of comfort to an investor, the trustee raised a number of criticisms related to the independent valuation consultant.

First, Fletcher was the consultant’s only valuation client and the consultant lacked the necessary knowledge and expertise to independently mark the portfolio. Second, the consultant inappropriately applied mathematical models with faulty inputs, and failed to check them against the market value of similar investments, i.e., mark to model approach. Lastly, the consultant allegedly lacked independence in that it received fees for valuation services in excess of typical market rates for such services and had side business deals with the Fletcher funds.

## **Enforcement Highlights**

The threat a Ponzi scheme poses is not just that an investor will lose its invested capital when the scheme collapses, but that an investor who withdrew any return on their initial investment from their initial investments prior to the collapse will be subject to a “clawback” suit — a lawsuit filed by a bankruptcy trustee or receiver to recover funds previously distributed by the Ponzi scheme.

In order to compensate “net losers” in a Ponzi scheme, bankruptcy trustees will use clawback suits to try and recuperate “fictitious profits” received in excess of principal from “net winners” regardless of knowledge of the fraud. If the bankruptcy trustee has reason to believe that the “net winner” knew of or should have known of the fraud, the trustee will seek to recover not just the “net winnings” but also principal payments made to the defendant.

Clawbacks have been used since the 1920s, when Charles Ponzi’s own infamous scheme collapsed, but the use and number of these types of claims has grown in frequency since the 1980s. This trend is especially notable in regards to the clawback suits brought against unaware, innocent investors, who had no knowledge of the fraudulent nature of their investment arrangement.

For instance, Irving Picard, the Madoff bankruptcy trustee, has filed over 1,000 clawback suits against both institutions and single-party investors in an effort to reclaim some of the nearly \$20 billion in losses. There are, however, limitations for the use of clawbacks that deal with the time frame in which the bankruptcy trustee may reach back to reclaim profits and the fraudulent assumptions imposed in each of the specific cases themselves.[14]

As a result of the uncovering of Bernie Madoff's nearly \$20 billion and Allen Stanford's \$7 billion Ponzi schemes, the federal government and several regulatory agencies including the SEC, the Federal Trade Commission and the Federal Bureau of Investigation have joined forces to "root out and expose" Ponzi schemes and other investment scams within the United States.

In the latter half of 2010, the Financial Fraud and Enforcement Task Force concluded Operation Broken Trust, which brought more than 211 criminal and civil fraud cases involving over \$8 billion of direct investment scams. According to their report, the task force opened over 200 Ponzi scheme investigations and identified the top "Ponzi scheme hot spots" to be Los Angeles, New York, Dallas, Salt Lake City and San Francisco.[15] Since the government crackdown on white collar crime, several notable Ponzi schemes have come to light.

## Conclusion

Although Ponzi schemes are simple in theory, they have grown more complex and larger in recent years. Unfortunately, most investors still haven't learned the lessons that the mega-Ponzi schemes should have taught. Once again, in today's surging markets, investors may lower their guard when it comes to protecting against fraud. However, investors should be careful to recall these recently learned lessons:

- Go back to the basics: diversify, diversify, and diversify. It is not often prudent to put the majority of your investment and/or your retirement money into a single investment. Proper diversification will not only guard against market fluctuations, but may also help in case one of those investments turns out to be a Ponzi scheme;
- If an investment appears to be too good to be true, it generally is. Never believe that higher returns can be achieved without higher risk;
- No matter how well connected or highly recommended someone comes, always do your own due diligence. Request audited financial statements by reputable auditors and review/confirm underlying documents;
- Know where your money is. Ask for monthly statements and confirmation as to where your money is being held. Ideally, the money should be held in a reputable third-party custodial account; and
- Finally, if you suspect that your investment is a Ponzi scheme, withdraw your money and create a record as to what you contributed and what were your net gains. You may want to set the net gains aside in the event of a clawback action.

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[1] See also *Janvey v. Alguire*, 647 F.3d 585, 597 (5th Cir. 2011) (“A Ponzi scheme is a fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments.”) (citing *Black’s Law Dictionary* 1198 (8th ed. 2004)); *In re M & L Business Mach. Co., Inc.*, 84 F.3d 1330, 1332 n.1 (10th Cir. 1996) (“We have defined a Ponzi scheme as an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments. Typically, investors are promised large returns for their investments. Initial investors are actually paid the promised returns, which attract additional investors.”) (internal citation omitted).

[2] <http://www.ponzitracker.com/main/2013/12/23/2013-ponzi-schemes-in-review-nearly-3-billion-of-ponzi-schem.html>

[3] <http://www.fbi.gov/losangeles/press-releases/2014/founders-of-bankrupt-social-real-estate-investment-firm-indicted-in-wide-ranging-scheme-that-led-to-more-than-110-in-losses>

[4] “Former Employee of Deceased Friendswood Financial Advisor Convicted of Running Own Ponzi Scheme,” The Federal Bureau of Investigation, 19 February 2013.

[5] <http://www.ponzitracker.com/main/2013/10/17/sec-stops-20-million-pyramid-scheme-touting-youth-education.html>

[6] <http://theponzibook.blogspot.com/2013/10/october-2013-ponzi-scheme-roundup.html>

[7] <http://hamptonroads.com/2013/10/exlawyer-gets-prison-south-african-ponzi-scheme>

[8] <http://www.oregister.com/articles/cellette-533004-million-county.html>

[9] “Former Employee of Deceased Friendswood Financial Advisor Convicted of Running Own Ponzi Scheme,” The Federal Bureau of Investigation, 19 February 2013.

[10] [http://www.justice.gov/usao/paw/news/2011/2011\\_october/2011\\_10\\_20\\_03.html](http://www.justice.gov/usao/paw/news/2011/2011_october/2011_10_20_03.html)

[11] <http://www.ponziawbacks.com/tag/doris-nelson/>

[12] [http://www.nj.com/somerset/index.ssf/2014/05/former\\_nj\\_woman\\_accused\\_of\\_running\\_multi-million\\_ponzi\\_scheme.html](http://www.nj.com/somerset/index.ssf/2014/05/former_nj_woman_accused_of_running_multi-million_ponzi_scheme.html)

[13] The Marquet Report on Ponzi Schemes: A White Collar Fraud Study of Major Ponzi-Type Investment Fraud Cases Revealed from 2002-2011, MARQUET INTERNATIONAL (June 2, 2011).

[14] For example, under the Bankruptcy Code, a trustee may recover fraudulent transfers made within two years prior to the bankruptcy petition date. See 11 U.S.C. § 548(a)(1)(A). If the trustee also sues under state law, the look-back period is larger. For example, under Texas law, fraudulent transfers made within four years of the suit are actionable. See TEX. BUS. & COMM. CODE § 24.010. Under New York law, the look-back period is six years. See *Orr v. Kinderhill Corp.*, 991 F.2d 31 (2d Cir. 1993); see also N.Y. Debt. & Cred. L. art. 10, §§ 270-281 and N.Y. Civ. Prac. L. & R. § 213(8).

[15] "Operation Broken Trust: Historic Investment Fraud Sweep," The Federal Bureau of Investigation, Dec. 6, 2010.

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