10/7/2002	8302	24,191.97	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8303	3,000.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8304	4,987.50	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8305	3,500.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8306	32,625.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8307	3,250.00	Real Estate Holding Corp II	Taylor Coleman	Secura Fund Az.
10/7/2002	8308	10,500.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8309	9,000.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8311	6,000.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8312	2,025.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8313	7,280.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
10/7/2002	8314	67,929.71	Real Estate Holding Corp II	Taylor Coleman	ANMP LLC
10/7/2002	15766	7,680.00	Castle Megastore Corp.	Taylor Coleman	CFS Inc
10/7/2002	15767	22,500.00	Castle Megastore Corp.	Taylor Coleman	ANMP LLC
10/21/2002	8320	8,250.00	Real Estate Holding Corp II	Taylor Coleman	ANMP LLC
10/21/2002	8321	6,250.00	Real Estate Holding Corp II	Taylor Coleman	CFS Inc.
Total		**$1,838,850.70**			

A Simple Example in a Complex Web

One Castle loan known as 9815 SW Capitol Highway Trust purported to have two investors, Ralph Vescio and CFS. On June 27, 2001, Mr. Vescio wrote Check #101 to CFF for $255,096 (JCS000324 & 5) and CFS was given credit of $2,551 for a portion of its loan fees. On June 29, 2001, Castle executed a promissory note for $257,647 payable to NP Investments, Inc. (ANM128839)

The 9815 SW Capitol Highway loan was for all practical purposes a single investor loan. All of the cash to fund the loan came from investor Vescio. When it came time to make the interest payments to the investor the funds came from whatever pool of commingled funds American National controlled. Between August 9, 2001, and August 5, 2002, Vescio received monthly interest payments of $7,653 for a total of $99,487. (JCS000326)

Vescio received the monthly interest payments despite Castle's default on its loan in September 2001 and again in March 2002. (JCS000327)

Vescio received his August and September 2001 payments from CFS's communal Trust account. (ANM092856-7, ANM093092-3 and JCS000328-31) He received his October 2001 through February 2002 payments from a CFS communal general account. (JCS000332-47) Once again, and despite Castle's default in March 2002, **Vescio's payment came from CFS's Trust account. (JCS000348-52) In April 2002, his payment came from a second CFS communal general account. (ANM091575 & 6 and JCS000353-5) The May through August 2002 payments came from the ANMP communal general account. (JCS000356-81)**

Because of the commingling of funds in the various accounts controlled by American National entities, it is not possible to identify the precise source of the funds used.

It appears that Castle did make loan payments until August 2001. However, American National's internal analysis discloses the source of funds for the September and October 2001 and the March, April and May 2002 interest payments to Vescio came from the Roosevelt Warehouse loan. (JCS000327 & 382) The June through August 2002 payments to Vescio came from commingled sources. Castle's June through September 2002 interest payment checks for the 9815 SW Capitol Highway loan never cleared the bank despite several attempts to deposit them by American National. (ANM014558, 576, 607 and 634)

Extraordinary Efforts to Keep the Illusion Alive

From approximately March 2000, American National began to accumulate unpaid Castle fees. Castle began defaulting on its outstanding loans in June 2001. Despite Castle's default American National continued to make the scheduled interest payments to the investors through September 10, 2002.

The source of the funds to make the interest payments to old investors on defaulted Castle loans was from new investors (a central element of a Ponzi scheme). A contemporaneous attempt was made by the American National bookkeeper to allocate the use of funds based on disbursements to old investors from new investor funds pooled in a common account. The internal allocation of new investor funds demonstrates American National's intentional cover up of borrower defaults, lulling of existing investors into a false sense of borrower/investment performance and providing credibility to American National's new funds solicitation program based in part on its claims of an unblemished performance track record.

Commencing in April 2002, American National began raising money for the Roosevelt Street loan. **This loan appears to have been designed primarily to fund interest distributions for other earlier Castle loans.** A net total of $1,940,849 was raised from investors. 69% of the proceeds, $1,345,462 never went to Castle, but instead was used by American National to pay itself fees and make interest payments to its investors. 89% ($1,200,570) of the $1,345,422 was paid to other lending trusts. Only 22%, $431,642 was paid to Castle.

In November 2002, one last desperate attempt was made by Castle and American National to raise funds for the stated purpose of paying off the Roosevelt Warehouse loans from a new undisclosed lender. On November 13, 2002, American National without the knowledge or consent of its investors, quit claimed title to the property to Castle. The quit claim agreement between Castle and American National provided that if Castle did not refinance the property by December 15, 2002, it would quit claim the property back to American National. **The quit claim agreement is devoid of business judgment and left the American National investors without collateral on a defaulted loan. (ANM005113A & B)**

As illustrated in the following chart, other loans were "raided" to keep the Ponzi scheme alive by delivering the promised return to the old investors.

Date	Diverted From	Amount	Diverted To	Purpose
July 10, 2001	83rd & I-10 Trust	$18,400	Deer Valley Trust	Partial July 2001 default interest
July 14, 2001	Deer Valley Trust	8,000	Progress Drive Trust	July 2001 default interest
September 13, 2001	5501 E. Washington Trust	8,000	Progress Drive Trust	July 2001 default interest
September 13, 2001	5501 E. Washington Trust	31,250	Federal Way Trust	June & July default interest
September 13, 2001	5501 E. Washington Trust	45,000	Federal Way Trust	July 2001 default interest
September 13, 2001	5501 E. Washington Trust	10,614	Deer Valley Trust	Partial July 2001 default interest
September 14, 2001	5501 E Washington Trust	2,260	Deer Valley Trust	Partial July 2001 default interest
September 20, 2001	5501 E. Washington Trust	37,180	Deer Valley Trust	Partial July 2001 default interest
September 20, 2001	5501 E. Washington Trust	25,424	Deer Valley Trust	Partial August 2001 default interest
October 10, 2001	Deer Valley Trust	8,000	Progress Drive Trust	August 2001 default interest
November 10, 2001	Deer Valley Trust	13,750	Silverdale Trust	August 2001 default interest
February 6, 2002	Deer Valley Trust	8,325	I-17 & Dunlap Trust	October 2001 default interest
February 6, 2002	Deer Valley Trust	8,000	Progress Drive Trust	October 2001, default interest
February 14, 2002	Camelback 300 Trust	12,000	Deer Valley Trust	Partial late fees
May 20, 2002	Roosevelt Street Trust	29,721	222 N 44 Street Trust	September 2001 default interest
May 20, 2002	Roosevelt Street Trust	3,179	5501 E Washington Trust	Partial September 2001 default interest
June 3, 2002	Roosevelt Street Trust	6,560	5501 E Washington Trust	Partial September 2001 default interest
June 3, 2002	Roosevelt Street Trust	7,729	9815 S W Capitol Highway Trust	September 2001 default interest
June 3, 2002	Roosevelt Street Trust	16,861	222 N 44 Street Trust	Partial October 2001 default interest
June 3, 2002	Roosevelt Street Trust	1,350	7102 W Roosevelt Trust	September 2001 default interest
June 4, 2002	Roosevelt Street Trust	31,889	222 N 44 Street Trust	Partial October 2001 default interest
June 4, 2002	Roosevelt Street Trust	3,011	9815 S W Capitol Highway Trust	Partial October 2001 default interest

June 4, 2002	Roosevelt Street Trust	5,281	Deer Valley Trust	Partial December 2001 default interest
June 6, 2002	Roosevelt Street Trust	4,719	9815 S W Capitol Highway Trust	Partial October 2001 default interest
June 13, 2002	Roosevelt Street Trust	41,250	222 N 44 Street Trust	December 2001 default interest
June 13, 2002	Roosevelt Street Trust	13,824	5501 E Washington Trust	March 2002 default interest
June 13, 2002	Roosevelt Street Trust	12,300	Deer Valley II Trust	March 2002 default interest
June 13, 2002	Roosevelt Street Trust	7,729	9815 S W Capitol Highway Trust	March 2002 default interest
June 13, 2002	Roosevelt Street Trust	90,550	Federal Way Trust	October 2001 & March 2002 default interest
June 13, 2002	Roosevelt Street Trust	52,004	Deer Valley Trust	Partial December 2001 default interest
June 13, 2002	Roosevelt Street Trust	80,525	Deer Valley Trust	March 2002 default interest
June 13, 2002	Roosevelt Street Trust	2,735	Progress Drive Trust	Partial March 2002 late fees
June 13, 2002	Roosevelt Street Trust	37,500	I-17 Dunlap Trust	October, November & December 2001 & January, February & March 2002 default interest
June 13, 2002	Roosevelt Street Trust	17,100	7102 W Roosevelt Trust	October 2001 default interest
June 13, 2002	Roosevelt Street Trust	18,450	7102 W. Roosevelt Trust	May 2002 default interest
June 26, 2002	Roosevelt Street Trust	7,729	9815 S W Capitol Highway Trust	April 2002 default interest
June 26, 2002	Roosevelt Street Trust	8,325	I-17 & Dunlap Trust	March 2002 default interest
June 26, 2002	Roosevelt Street Trust	2,750	83rd & I-10 Trust	March 2002 default interest
June 26, 2002	Roosevelt Street Trust	53,750	222 N 44 Street Trust	April 2002 default interest
June 26, 2002	Roosevelt Street Trust	8,000	Progress Drive Trust	Partial March 2002 late fees
June 26, 2002	Roosevelt Street Trust	13,824	5501 E Washington Trust	April 2002 default interest
June 26, 2002	Roosevelt Street Trust	34,982	Deer Valley Trust	Partial April 2002 default interest
July 31, 2002	Roosevelt Street Trust	53,750	222 N 44 Street Trust	May 2002 default interest
	Roosevelt Street Trust	14,575	222 N 44 Street Trust	Partial September 2001 default interest
July 31, 2002	Roosevelt Street Trust	7,729	9815 S W Capitol Highway Trust	May 2002 default interest

July 31, 2002	Roosevelt Street Trust	13,824	5501 E Washington Trust	May 2002 late fees
July 31, 2002	Roosevelt Street Trust	2,750	83rd & I-10 Trust	April 2002 default interest
July 31, 2002	Roosevelt Street Trust	47,988	Deer Valley Trust	Partial April 2002 default interest
July 31, 2002	Roosevelt Street Trust	45,550	Federal Way Trust	April 2002 default interest
July 31, 2002	Roosevelt Street Trust	18,450	7102 W Roosevelt Trust	May 2002 default interest
July 31, 2002	Roosevelt Street Trust	6,000	Camelback 300 Trust	March 2002 default interest
July 31, 2002	Roosevelt Street Trust	13,750	Silverdale Trust	April 2002 default interest
July 31, 2002	Roosevelt Street Trust	12,300	Deer Valley II Trust	April 2002 default interest
August 27, 2002	Roosevelt Street Trust	2,750	83rd & I-10 Trust	May 2002 default interest
August 27, 2002	Roosevelt Street Trust	53,750	222 N 44 Street Trust	June 2002 default interest
August 27, 2002	Roosevelt Street Trust	5,580	I-17 & Dunlap Trust	April 2002 default interest
August 27, 2002	Roosevelt Street Trust	78,000	Deer Valley Trust	Broker fee on Friends loan
August 27, 2002	Roosevelt Street Trust	83,052	Deer Valley Trust	May 2002 default interest
August 27, 2002	Roosevelt Street Trust	9,000	Deer Valley Trust	Broker fee on Coulter & Lang
August 27, 2002	Roosevelt Street Trust	13,750	Silverdale Trust	May 2002 default interest
August 27, 2002	Roosevelt Street Trust	44,550	Federal Way Trust	May 2002 default interest
August 27, 2002	Roosevelt Street Trust	8,243	5501 E Washington Trust	Partial June 2022 default interest
August 27, 2002	Roosevelt Street Trust	14,995	Camelback 300 Trust	April, May & partial June 2002 default interest
August 27, 2002	Roosevelt Street Trust	8,000	Progress Drive Trust	May 2002 default interest
August 27, 2002	Roosevelt Street Trust	12,300	Deer Valley II Trust	May 2002 default interest
December 30, 2002	Camelback 300 Trust	50,975	Federal Way Trust	July & August default interest
Total		**1,471,441**		

American National employed a perverted sense of logic in its allocation of default interest. American National used new investor funds to pay old Castle loan investors to create the illusion the loans were performing. Following Ponzi scheme logic, American National concluded since the old Castle loan investors were receiving their normal interest payments they were not entitled to receive the default interest rate. American National claimed for itself the default portion of the interest payment. In addition, the logic ruse served as a basis for representations that the old Castle loans were performing and that investors were receiving their promised return. What the internal documentation of the ruse actually demonstrates is American National's Ponzi scheme and greed.

In addition to investor funds of one trust being used to make interest payments to investors of another trust, there were other transactions where funds raised for one trust were diverted for use by another. There were various reasons for the diversions as illustrated in the following schedule:

Date	Transferred From	Amount	Transferred To	Reason
October 31, 2000	Progress Drive Trust	26,600	Deer Valley Trust & Quartermain	Fees
August 1, 2000	Progress drive Trust	11,600	Anchorage	Points & fees
September 13, 2000	Progress Drive Trust	15,000	Quartermain	Broker fee
November 7, 2000	Deer Valley Trust	16,700	Anchorage	Anchorage fees
April 5, 2001	Deer Valley Trust	3,000	American National	Broker fee M,M&M loan
June 6, 2001	83 Ave & I-10 Trust	25,000	I-17 & Dunlap Trust	Payoff Delheim
June 19, 2001	Deer Valley Trust	100,000	I-17 & Dunlap Trust	Payoff Delheim
June 25, 2001	I-17 & Dunlap Trust	25,000	83 Ave & I-10 Trust	Transfer Kause investment
June 25, 2001	I-17 & Dunlap Trust	100,000	Deer Valley Trust	Payoff Delheim
June 28, 2001	83 Ave & I-10 Trust	160,000	7102 W Roosevelt Trust	Castle Loan
June 28, 2001	83 Ave & I-10 Trust	140,000	I-17 & Dunlap Trust	Castle Loan
July 2, 2001	83 Ave & I-10 Trust	60,000	7102 W Roosevelt Trust	Castle Loan
September 13, 2001	5501 E. Washington Trust	1,650	Federal Way Trust	Broker Fees
September 13, 2001	5501 E. Washington Trust	12,000	American National	Broker Fee on Barreras direct Castle Loan
September 13, 2001	5501 E. Washington Trust	2,700	Camelback Trust	Broker Fee to ANMP for Davis Replacement
September 14, 2001	222 N 44 Street Trust	31,972	Deer Valley Trust	Accumulated fees
September 20, 2001	5501 E. Washington Trust	109	American National	Broker fee - Davis replace Delheim
September 20, 2001	5501 E. Washington Trust	24,779	Deer Valley II Trust	Broker fee on Horan investment
September 25, 2001	5501 E. Washington Trust	5,640	American National	Broker fee –Davis replace Delheim
September 25, 2001	5501 E. Washington Trust	251	American National	Broker fee – Davis replace Delheim
October 10, 2001	Deer Valley Trust	13,750	Silverdale Trust	Fees
November 26, 2001	Deer Valley Trust	6,000	222 N 44 Street Trust	Broker fee due on Meka

December 5, 2001	Deer Valley II Trust	6,820	Deer Valley Trust	Broker fees
December 7, 2001	5501 E. Washington Trust	7,321	Deer Valley II Trust	Broker Fee on Horan
December 7, 2001	5501 E. Washington Trust	25,029	222 N. 44 Street Trust	Broker fees
January 11, 2002	Deer Valley Trust	100,000	222 N 44 Street Trust	Payoff Meka
January 30, 2002	222 N 44 Street Trust	100,000	Deer Valley Trust	Payoff Smith
January 30, 2002	Deer Valley Trust	100,000	Camelback 300 Trust	Payoff Smith
February 6, 2002	Deer Valley Trust	83,250	I17 & Dunlap Trust	Fees
February 12, 2002	Camelback 300 Trust	47,000	Deer Valley Trust	Payoff Osborn
March 29, 2002	222 N 44 Street Trust	100,000	Deer Valley Trust	Payoff Smith
April 3, 2002	222 N 44 Street Trust	6,000	Camelback 300 Trust	Griffin extension fee
April 8, 2002	222 N 44 Street Trust	12,000	Deer Valley Trust	Broker fees
April 24, 2002	Deer Valley Trust	7,000	Federal Way Trust	Payoff Schnoll & Grossman
May 5, 2002	Deer Valley Trust	5,980	Camelback 300 Trust	Segura partial extension fee
May 5, 2002	Roosevelt street Trust	13,700	Deer Valley Trust	Partial payoff of Dutson
June 24, 202	Roosevelt Street Trust	39,375	Deer Valley Trust	**Medina Interest Reserve**
June 24, 2002	Deer Valley Trust	39,375	Medina Trust	**Medina Interest Reserve**
June 24, 2002	Roosevelt Street Trust	40,670	Deer Valley Trust	**Amsterdam Interest Reserve**
June 24, 2002	Deer Valley Trust	40,670	Amsterdam Trust	**Amsterdam Interest Reserve**
June 26, 2002	Deer Valley Trust	50,000	Flynn Jackson	**Transfer Osborn & Durant**
June 26, 2002	Roosevelt Street Trust	70,000	Deer Valley Trust	**Pay down Owens investment**
July 31, 2002	Roosevelt Street Trust	15,920	222 N 44 Street Trust	Ofstie broker fee
October 31, 2002	5505 E. San Miguel Trust	812	San Miguel Trust	Broker fees
Total		**1,692,673**		

The misuse of investor funds in the Castle loan transactions was not limited to those previously cited. **Disgruntled or "favored" investors were allowed to withdraw all or a portion of their investment irregardless of the performance status of the related loan. Typically, new investor funds were used to replace old investors.** After the September 10, 2002 interest payment to Castle loan investors, American National acknowledged Castle's default. New investors' money flowed into Castle loans through December 2002. **During the period October**

2002 through January 2003, select old investors were allowed to withdraw their funds. In addition, American National entities withdrew funds to cover their operating expenses.

Entity	Amount
Federal Way Trust	214,013
Silverdale Trust	10,000
Deer Valley Trust	1,447,685
I-17 & Dunlap Trust	125,000
7102 W Roosevelt Trust	10,000
222 N 44 street Trust	400,000
5501 E Washington Trust	300,000
Deer Valley II Trust	40,000
Camelback 300 Trust	248,000
Roosevelt Street Trust	152,958
San Miguel Trust	368,000
DV Partners	293,850
Total	**3,609,506**

Between October 14, 2002 and January 24, 2003, Larry Dunning and Frank Caspare directed American National's bookkeeper to disburse $31,200 of Castle loan interest payments to six "select" investors and $9,000 to a "select" Amsterdam loan investor. (JCS000383) Correspondence to and from Larry Dunning during December 2002 and January 2003 illustrates his commitment to certain "select" investors and the diversion of funds from where it was to where it needed to be. (ANM036649, 62816 & 143040 and JCS000384)

Despite the deepening financial crisis, Eric Strasser instructed the bookkeeper to loan $40,000 of "trust funds" to Greg Harrington. Harrington's late repayment check was NSF. Harrington subsequently paid back $20,000 of the $40,000. Item 3 of the memo discloses the diversion of Colosimo's $200,000 principal repayment to cure a senior position default on the Secluded Lane loan and to cover payroll expenses for American National. Item 5 of the memo states "There are a lot of overdue bills to be paid and interest payments which you agreed to continue paying to certain lenders. Also, we need to pay Lyle Phillips another $25,000 and Rudolf Ouwens (Pensco) is looking to receive a $15,000 payment." (ANM143040)

PENTHOUSE LOANS

In July 2002, American National made three loans to Penthouse for a combined total of $5,500,000. (ANM128709-14) **Larry Dunning entered into an agreement with Penthouse to not record a lien against the two real properties securing the loan. Penthouse had other senior debt against the pledged properties.** According to the senior debt agreement, Penthouse could not further encumber the properties. Recordation of an American National junior lien against the two properties would have been a condition of default under the senior debt agreement. In addition to the recording dilemma created by the senior debt agreement, **one of the properties was subject to a judgment of foreclosure and the other property was cross collateralized for any deficiency.** Neither the nonrecordation agreement nor the existing

judgment of foreclosure was disclosed to prospective investors. By the end of 2002, the interest reserve had been exhausted and Penthouse defaulted.

WITH A LITTLE HELP FROM YOUR FRIENDS

1. Luther Durant

On or about April 15, 2002, Luther applied for a $100,000 loan from the National Bank of Arizona. (ANM046567) His personal balance sheet disclosed liquid assets of $2,500 of cash and $1,200 of marketable securities. Darrell Coulter was a Senior Vice President of National Bank of Arizona, a fractional owner/director of various American National entities and an American National loan investor, at the time of Luther's loan application. The unstated purpose of the loan was to provide Luther with $100,000 so that he could become an investor with Coulter in Boat Bed & Breakfast, LLC (BBB).

On BBB's Operating Agreement, Corporate Fiducial Services, Inc. (Owned by Larry Dunning), Luther and Pat Durant and Darrell Coulter are each listed as having invested $100,000 in BBB. (ANM046499-6522) To enhance Luther's ability to qualify for the loan, Larry Dunning had an American National entity loan of $200,000 to Luther on May 30, 2002. The loan was secured by Luther Durant's interest in the Deer Valley Trust (Castle loan). (ANM027791 & 2 and ANM027787) The purpose of the loan was to increase his liquid assets and overall assets without disclosing the offsetting liability to American National.

Luther deposited the $200,000 loan proceeds into his Johnson Bank account. Larry Dunning informed Luther his deposit printout would not work and that he needed the $200,000 deposit to be shown on a "Johnson Bank" letterhead statement. (ANM027789) On June 5, 2002 a representative of Johnson Bank sent a deposit statement to Larry Dunning on Johnson Bank letterhead confirming Luther Durant's $200,000 deposit on May 31, 2002. (ANM027790)

On June 10, 2002, Luther issued Check #2001 for $100,000 to Western Gulf Capital, Inc. drawn on his National Bank account. The check bore the notation for Boat Bed & Breakfast LLC. (ANM077695) The source of the $100,000 was National Bank's $100,000 loan to Luther. Also on June 10, 2002, Western+Gulf Capital, Inc. (WGC) executed a $100,000 promissory note to Luther Durant. The note makers, WGC and Larry Dunning, Individually, specifically refer to Durant's National Bank loan #0063018128. WGC and Larry Dunning note obligation terms were to mirror Luther's National Bank loan terms. (ANM077697)

On June 10, 2002, a second note was executed in favor of Luther Durant by WGC and Larry Dunning, Individually. It appears Dunning was trying to distance himself from Durant's false financial statements and any direct link to the National Bank loan to Durant. The second note made no reference to Durant's obligation to National Bank, the interest rate was 2% per month interest only, with the principal balance due and payable on or before August 1, 2007. (ANM077694) Upon receipt of the Durant funds WGC issued Check #1214 for $100,000 to ANMP. (ANM096814 and 5) ANMP applied the $100,000 proceeds from WGC to an obligation owed by Corporate Fiducial Service, Inc. to ANMP. (JCS000418)

To clarify the sequence of events; BBB borrowed money from Corporate Fiducial Services, Inc. to purchase a house in Mexico and to cover operating expenses, CFS did not have the funds to lend to BBB, so it borrowed funds from ANMP. CFS didn't have funds to repay ANMP, so WGC repaid ANMP for CFS. (JCS000422)

2. **Irene Segura**

On June 21, 2002 Irene Segura borrowed $200,000 from ANMP. The loan was secured by her interest in the Deer Valley Trust. (JCS000396) ANMP Check #1406 for $200,000 was issued to Irene Segura on June 26, 2002. (ANM036563) Irene Segura deposited the $200,000 into her Bank One account on June 27, 2002. (ANM036560)

On July 9, 2002, ANMP deposited Irene Segura's Check #2882 into their bank account. (JCS000397 & 8) The payment by Irene Segura represented repayment of the ANMP loan. As evidence of the sham nature of the transaction, Irene Segura was not required to pay interest on her loan. It appears the original intent of the transaction was to be similar to the Luther Durant loan transaction. When interviewed, Irene stated she did not feel comfortable with the proposed transaction and backed out of the whole thing.

3. **Luther Abrahamson**

On September 20, 2002, WGC and Larry Dunning executed a Promissory Note to Luther Abrahamson for $100,000. (ANM077691) The source of the funds loaned by Abrahamson was a $60,000 loan from Wells Fargo and a $40,000 loan from Flagstar Bank. (ANM033820 & 22) The intended purpose of the loans was Abrahamson's capital contribution to BBB. (ANM033822) When interviewed, Luther Abrahamson stated he was approached about borrowing the $100,000 from National Bank of Arizona. He declined the opportunity to borrow from National Bank of Arizona because he felt the offer "wasn't right". He chose to go to his own banks to borrow the money for his BBB investment.

Luther Abrahamson deposited the $100,000 with Century Title on September 20, 2002. On September 20, 2002, ANMP issued a deposit application to WGC as lender of $100,000 to Castle (San Miguel Trust dated September 20, 2002). Consequently, WGC used Abrahamson's escrow deposit as its deposit. (ANM005772) As of September 19, 2002, ANMP (CFS, ANMP, CFF and SECURA Fund Arizona) was holding $1,491,020 of NSF checks from Castle entities. (JCS000291)

4. **Joseph Colosimo**

On October 30, 2002, WGC and Larry Dunning executed a Promisory Note to Joseph Colosimo for $100,000. (ANM077692) WGC's accounting records and bank statement reflect a $100,000 deposit from Joseph and Theresa Colosimo on October 30, 2002. (ANM049458 and JCS00401) On October 30, 2002 WGC issued Check #1298 to ANMP for an investment in a Castle entity (San Miguel Trust). (ANM096964 & 5 and JCS000402-404) On October 29, 2002 ANMP had issued a deposit application to WGC as lender of $100,000 to Castle (San Miguel Trust dated September 20, 2002). (ANM005774)

As of October 21, 2002, American National (CFS, ANMP, CFF and SECURA Fund Arizona) was holding $1,838,851 of NSF checks from Castle entities. (JCS000291) **Despite the Castle entities' ongoing default on its outstanding loans commencing in May 2002, ANMP continued to raise funds from investors, make additional loan advances to Castle entities and make interest payments to investors on defaulted Castle loans.**

5. **Robert Blachowski**

On January 22, 2003, Robert Blackowski loaned $75,000 to the Secluded Lane Trust to be used to stop a sheriff's sale of the Secluded Lane property. The property had been foreclosed on by the senior lien holders. The loan was executed on behalf of Secura Innovative Investments, Inc. by David B. Stocker, Esq., Vice President; Larry W. Dunning, Individually and American National Mortgage Partners, LLC, Helen C. Hartze, Responsible Individual, Trustee for the 35824 N. Secluded Lane Trust. (JCS000394)

According to the "Agreement" Robert and Patricia Blachowski had borrowed the funds from National Bank of Arizona, which in turn they loaned to cure the senior debt default. Paragraph 8 of the Agreement states "WHEREAS, Trustee desires to borrow $75,000 from Lender for a period of 30 days, and is willing to pay Lender $80,000 plus interest payable to National Bank of Arizona, where lender borrowed said funds, at the end of 30 days; said note will be guaranteed by Secura Innovative Investments, whose net worth is approximately $1,000,000 and Larry Dunning, whose net worth is approximately $3,000,000". (JCS000395)

6. **Shelia Dunning**

In mid 2002, Larry Dunning in an apparent attempt to move further into the "shadows" sent a memo to Susan Rutledge, Eric Strasser and Doug Baxter. In the memo Larry Dunning stated that he founded the business in January 1999 and that he wanted to see certain organizational changes accomplished by July 1, 2002. The first item on his list stated "Because of my 'retirement' program, I am appointing an alter ego to fulfill my spot. We are employing Sheila Dunning, as a loan officer for past, present and future earnings that are attributed to our family's production effective July 1, 2002." (ANM110751 & 2)

SECURITIES FRAUD

1. On March 1, 2002, Larry Dunning, on behalf of himself and Frank Caspare, wrote a letter to Tony Pisacano soliciting him to participate with them in a scheme to circumvent Arizona residency requirements for an Arizona Only intrastate securities offering. In the letter, Dunning boasts that they (Dunning and Caspare) have over $12,000,000 outstanding in **investor** loans and that "no investor has ever lost principal or interest on our loans". (ANM063475-77)

2. Larry Dunning goes on to discuss their first planned securities offering, SECURA Fund Arizona, an intrastate offering for $15,000,000 which "only Arizona residents can invest in it". Dunning states Secura Fund Arizona's intrastate offering will be followed in a few months by a $15,000,000 SECURA Fund New York intrastate offering and later in the year by a $100,000,000 full SEC interstate offering.

a) **Pre-registration solicitation of a nonqualifying individual (nonresident) wherein the offeree is offered to invest in a proposed intrastate public offering on terms and conditions significantly different than those to be offered to prospective investors post registration.**

1) Larry Dunning continued on with the proposal to Pisacano. (ANM063475-77) "I (Dunning) am a resident of Arizona. Before the NASD broker begins selling the fund, we would, Frank and I, would like to borrow, and GUARANTEE some serious money from you, if you are interested". Dunning goes on to state "I will invest the funds in SECURA Fund Arizona".

2) "We need your answer soon, will not feel bad if you cannot do it. But we need to fund this concept prior to the NASD company taking over the sales." Dunning continued on with the proposal to Pisacano. (ANM063475-77)

b) **Filing of false financial statements/"Cooking the Books"/Promise of future earnings/Cover up.**

1) "I will invest the funds in SECURA Fund Arizona. SECURA will then purchase some existing notes from investors currently earning 36% annual interest secured by deeds of trust. SECURA will then pay me, the named investor, a 1.2% interest per month (14.4% annually), then on December 31, 2002 SECURA will pay an approximate additional 6% in one lump sum, for an annualized 20% annual return – ALL of which will go to you."

2) "When SECURA Fund New York opens, we will transfer your investment to you in that fund, and in your name, but with the same format in mind – an operating history prior to selling the fund in New York."

c) **Additional Inducement the "Icing on the Cake".**

1) "As an additional inducement or reward for participating in this concept, we will issue you 20,000 shares of the parent company, SECURA Innovative Investments, Inc., which will make you a partner of Frank and me."

2) Larry Dunning made a representation of the future value of the 20,000 shares of SECURA Innovative Investment, Inc. "When the parent goes public, your shares will be priced somewhere around $10 a share, depending upon the vagaries of the world at that time. So, in summary, you will receive about 20% annual interest plus an additional opportunity of $200,000 profit on the parent shares.

3. On March 31, 2002, Larry Dunning and Frank Caspare borrowed $200,000 from Anthony Pisacano. (ANM063474 & 77693) On March 13, 2002, Pisacano wire transferred $200,000 to WGC. (ANM049488) On March 18, 2002, Larry Dunning writes Check #1176 to Secura Fund Arizona, LLC drawn on WGC bank account for $200,000. The check bears the

notation "Capital Contr." (ANM096744 & 5) On March 19, 2002, Secura Fund Arizona, LLC issues Check # 991, converted to Cashier Check #001938428 for a loan to Castle for $100,000

On March 20, 2002, Secura Fund Arizona, LLC issued Check # 992 for $100,000 to Richard A. and Shirley Smith for the purchase of their interest in the FCG loan. (ANM016466) $100,000 was deposited in CFS, Inc. on March 21, 2002. CFS issued Check #1078 for $100,000 on March 27, 2002 to FCG, Inc. (ANM090866 & 7)

4. **Misrepresentation of a material fact.**

a) Guaranty Performance, Inc. (GPI) was incorporated on February 11, 2002. On several loans originated by the Company and funded by Investors, the Borrower paid a "credit enhancement fee" to GPI. Investors were told the "credit enhancement fee" guaranteed that investors would be repaid both principal and any accrued interest even if the Borrower defaulted. The "credit enhancement fee" was a marketing tool that lacked substance. In mid 2002 Larry Dunning wrote a memo to Susan Rutledge, Eric Strasser and Doug Baxter. Dunning stated in item f. **"Credit Enhancement has helped sell several $100,000s in the past few days, so I know it's going to be helpful." (ANM110751 & 2)**

GPI was never much more than a corporate shell. As fees were collected GPI mostly invested in loans originated by the Company. The financial records of GPI demonstrate it never had the financial ability to pay off any of its "guaranteed loans". GPI's total Assets/Revenue never exceeded $45,000. Since GPI's revenue was used to invest in loans its assets were illiquid and were subject to the same default risks they were purportedly guaranteeing. GPI was a sham guarantee designed to create an illusion of security that did not exist.

FALSE FINANCIAL STATEMENTS/CREATIVE ACCOUNTING/COOKING THE BOOKS

1. One of the striking features of the loans initiated by American National was their frequent failure to record liens against the properties purportedly securing the loans. **The high percentage of unrecorded liens and the obscuring of the existence of loans through the use of Illinois Land Trusts is an indication of intent rather than error.** Examination of Larry Dunning's and Greg Harrington's correspondence with various borrowers or prospective borrowers explains the role unrecorded loans and/or or Illinois Land Trusts can serve in a scheme to inflate the assets and understate the liabilities of a borrower.

a) On May 15, 2002, Greg Harrington sent Eric Strasser an email asking him about permissible accounting presentations. Harrington asked Strasser the following, "Also, need to know on GAAP **(Generally Accepted Accounting Principals)**, are you aware of the "exemption" that a public company can acquire a building for cost, for instance the Amsterday**(m)** Building that you financed for $750k, with a Marshal & Swift evaluation of $6.8MM, can be sold for instance to CSGI for $750K in cash and a balance in securities for a cost basis of $6.8MM is the Marshal and Swift (attached to this file)

sufficient to substantiate value, or is cost sufficient and what is the tax treatment, favorable? Is is(t) good cross collateral, and does the auditor have to reserve any type of opinion? Please let me know this a huge part of the business, **this makes pink sheet deal, SC deals overnight if we can book these assets accordingly." (JCS000419)**

On May 29, 2002, Eric Strasser emails Greg Harrington and said "Let's talk about the GAAP opinion. As far as I know, you're OK with what you want to do." (JCS000439)

b) On July 8, 2002, Ronald Kelly, President/CEO of FCG wrote Larry Dunning, CFF, LLC, a letter expressing his desire "to borrow $300,000 to facilitate the legal work, FCC filing, Audits, and due diligence." (JCS000162)

On July 18, 2002, Larry Dunning responds to Ron Kelly with a proposal to sell him the Amsterdam building for $1,000,000 and lend FCG $1,750,000.

Item 2. of the proposal states, **"we will prepare a $1,750,000 note and deed of trust/mortgage to be held for filing."**

Item 3. of the proposal states, **"We will prepare an Illinois Land Trust to be held for filing."**

The concluding paragraph of Dunning's letter goes on to explain the benefit of not recording as follows: **"by not recording the deed of trust and Illinois land trust-as long as no default occurs- You could put it on your books at full value and use it as 'collateral' for the building funds from a local institution which would be low interest with a $5,000,000 free and clear net worth."** (JCS000163) (Dunning had a bogus $5,600,000 appraisal for the property) (JCS000173)

August 8, 2002, Deal Summary states: **...."a preliminary title report will show that FCGI owns the $5,600,000 property Free and Clear in a trust in which it appears to be both trustee and beneficiary.** The rational explanation to any potential lender is that it is set up in that manner to isolate the property from any would be extraneous law suits. **"FCGI should be able to find lenders in the area that will finance the 'improvements' and provide a bankable 'take out' using the $5,600,000 as collateral which will allow FCGI to pay off the purchase price,".... (JCS000164)**

c) On October 5, 2002, Larry Dunning wrote a letter to Jean Gourd outlining a proposed joint venture, Depot, LLC.

It appears Dunning and Gnazio (an ANMP investor) would own 50% of Depot, LLC through an entity referred to as D'Artagon. D'Artagon would raise investor funds to loan Depot, LLC acquisition and construction funds. The lending investors would not have an ownership interest in Depot, LLC.

D'Artagon would receive its normal loan origination fee for furnishing the loans to Depot, LLC.

The lending investors would have a first mortgage on the project as collateral for their loan.

On the first full paragraph of page two of the letter, Dunning outlines his plan to deceive the lending investors and commercial financial institutions. Dunning states: "As financiers (us) of the project, we are going to get the land into the project so it looks as if there is no debt on it. We will do this by putting all of the construction loan on as if the land were free and clear." Dunning's previous established method of operation would indicate that he would accomplish the "illusion" of "free and clear" by not recording the lending investors note and deed of trust. Dunning's plan is founded on a premeditated plan to deceive the investors through a misrepresentation of a material fact.

Dunning's plan doesn't end with the proposed fraud upon the lending investors. He goes on to outline his plan to obtain permanent financing and interim financing from institutional lenders through material omissions of fact and/or material misrepresentations of fact. He states: **"The reason for this is that as soon as we have acquired the land (looking free and clear) and have raised enough money to pay for all the necessary costs accumulated by Gorco (you) and on behalf of Depot (you and us) and have begun constructing, we will then approach GMAC and others to give the project 'take out' financing. When we receive the 'take out', then we will approach lenders and local banks that do short-term financing for a construction loan."** Since Dunning proposes to hide the existence of the lending investors' loan, the members of Depot would represent an equivalent, material fictitious equity interest in the project in their financial disclosures to prospective commercial lenders. As detailed in the August 2002 FCG proposal, Luther Durant transaction in April 2002 and the 300 Acacia, Sedona transaction in July 2000, Dunning was no stranger to the concept of "creating" fictitious equity. Dunning explained his view of his investors when he stated: "You might look at our 'investors' the same as we look at your 'sub-contractors'. They both earn money for performing for us, but we all pay for their services, which are necessary for the success of our Join Venture via Depot, LLC." Full disclosure, fair dealing, fiduciary responsibility, honesty and integrity are conspicuous by their absence from Dunning's proposed joint venture.

2. **Joel Woldorf, CPA**

On January 4, 2000 Joel Woldorf, CPA commenced an audit of Ponchartrain Realty Fund, **Inc.** with a target completion date of January 10, 2000.

On January 8, 2000, Woldorf issued an 8 day Compilation Financial Statement. The January 8, 2000 transmittal letter is addressed To the Board of Directors of Pontchartrain Realty Fund, **LLC**. Pontchartrain Realty Fund, LLC did not have a board of directors, it had Members. Pontchartrain Realty Fund, Inc. had a board of directors.

The January 8, 2000, Balance Sheet is for Pontchartrain Realty Fund, Inc. and the Statement of Income and Statement of Cash Flows is for Ponchartrain Realty Fund, **LLC**.

Legal Representation letters were sent to Nevada and Louisiana attorneys. Since the Louisiana Company's name was changed to Pontchartrain Realty Advisors, Inc. on April 30, 1998, it doesn't appear this company is the audit subject. Pontchartrain Realty Fund, LLC was formed on January 7, 2000, and, as a consequence, could not have been the audit subject. Consequently, the Nevada Company had to be the audit subject.

On January 12, 2000, Woldorf billed the company $1,000 for Preparation of Financial Statements and Preparation of Audit. On March 3, 2000, Woldorf sent a follow up bill which included the $1,000 for Preparation of Financial Statements and Preparation of Audit.

On March 30, 2000, Woldorf sent a bill to Pontchartrain Realty Fund, Inc. and Creative Financial Funding, Inc. (affiliated entities). The billing included a new item "STATEMENT FOR CRATIVE FINANCIAL FUNDING LLC $250. (ANM053267)

3. **Randy Kiesel, CPA**

Between 1998 and July 30, 2002, Randy Kiesel performed nine (9) audits and one (1) compilation report on six (6) interrelated companies. During the course of my investigation, I briefly interviewed Randy Kiesel regarding his audits. Also, I have extensively interviewed the principals of the six related companies. Based on my investigation, I have concluded the companies audited by Kiesel produced false and misleading financial statements. It appears Kiesel never conducted any of the cited audits in accordance with generally Accepted Auditing Standards (GAAS).

Specific violations of GAAS include the following:

SAS 19 (AU Section 333) "Client Representations" Kiesel accepted Client Representations as .... "a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements". The auditor obtains written representations from management to complement his **other** auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain **corroborating information** concerning the matters that are also the subject of written representations". Kiesel performed no other auditing procedures nor did he obtain corroborating information.

SAS 31 & 48 (AU Section 326) "Evidential Matter" During the course of his audits, Kiesel did not obtain sufficient competent, evidential matter through inspection, observation, inquiries and confirmations to afford a reasonable basis for his opinion regarding the financial statements he purportedly audited.

SAS 45 (AU 3340) "Related Parties" It doesn't appear Kiesel made any attempt to identify related parties as contemplated by SAS 45. He did not evaluate the substance of related party transactions and overlooked significant details as to irregularities in their form.

SAS 53 (AU316) "The Auditor's Responsibility to Detect and Report Errors and Irregularities" It does not appear that Kiesel assessed the risk of material misstatements to the financial statements of any of the companies he audited during his planning of the engagements. There appears to be a general lack of due care in planning, performing and evaluating the results of audit procedures. Kiesel exhibited a lack of professional skepticism during his audit planning and performance. Kiesel's audit work product does not reflect the requisite "reasonable assurance" that material errors or irregularities would be detected. It does not appear that Kiesel ever performed an evaluation of internal control for any of the entities audited.

SAS 54 (AU317) "Illegal Acts by Clients" Kiesel should have discovered material improperly recorded transactions during the course of his audits. Management moved money from where it was to where it was needed, disregarding entity, form or purpose. For relevant audits, Kiesel should have discovered the October 5, 2001 Arizona Corporation commission enforcement action against CFF, CFS, Larry Dunning and Robert Rehm and the December 20, 2001 Cease and Desist action filed by the Arizona Banking Department against CFF and Frank Caspare . (ANM040361-9)

SAS 55 & 78 (AU319) "Consideration of Internal Control in a Financial Statement Audit" It does not appear Kiesel performed an evaluation of internal control for any of his audits. In any event he never obtained sufficient knowledge of the internal control system for any of the companies to plan the audits, assess control risk and determine the nature, timing and extent of substantive tests for financial statement assertions.

SAS 56 (AU329) "Analytical Procedures" Kiesel does not appear to have used any analytical procedures in his planning and overall review stages of his audits. Kiesel does not appear to have understood the plausible relationships between financial and nonfinancial data. He specifically didn't respond to unusual transactions or misstatements.

SAS 67 (AU330) "The Confirmation Process" To be effective, a confirmation request must be made of an **appropriate third party**. Kiesel made no effort to determine bona fide third parties. Confirmations obtained from independent third parties provide greater assurance of reliability for purposes of an independent audit. Confirmations from related parties do not provide any greater assurance of reliability than does a management representation letter.

Kiesel's audit conclusions were based almost entirely on "client representations". I found no evidence of any attempt by Kiesel to determine the substance rather than the form of the material related party transactions. It appears Kiesel knew who controlled all of the entities and who the related parties were. All of the entities had the same bookkeeper, shared common offices and were controlled by the same group of insiders. According to the Companies' bookkeeper, the only time Kiesel visited the Companies' offices was during his alleged audit of Creative Financial Funding, LLC. All other audits were done without an onsite visit or testing of records. Most of the other audits were done via fax transmission of accounting data or the Companies' CFO, Eric Strasser, visiting Kiesel at his office to go over the financial statement presentations.

In my opinion, Randy Kiesel's audits of the Receivership entities were not performed in accordance with GAAS and accordingly, the audited financial statement presentations are not presented in accordance with Generally Accepted Accounting Principals.

Valley Financial Funding, LLC 12/31/99 and 12/31/98 Audited Financial Statements Dated February 24, 2001 (ANM038423-30; ANM038413-22 and JCS000006-16):

1. Note D to the financial statements has no disclosure of the terms of the $170,000 related party loan or the purpose or terms of the $100,000 deposit. Apparently the note originated in 1998 and either had no principal reduction requirements, deferred principal reduction requirements or was in default. **72% of the company's assets were related party debts.** Neither Note D nor Note E adequately described the economic substance of the related party transactions.

2. Note H-Subsequent Event reported the company was sold in February 2000 (sold to Pontchartrain Realty Fund, Inc. a Nevada corporation). According to the purchase agreement, the sale occurred on September 15, 1999. (ANM038813-30) The February 2000 sale date conflicts with the January 8, 2000 compiled financial statement prepared by Joel Woldorf, CPA. (ANM037861-5)

3. Kiesel prepared audited financial statements for Valley for the years 1997 through 1999. Throughout that time Valley was a one member LLC and did not have a board of directors. All three of Kiesel's audit reports were addressed to the Board of Directors. (ANM038423, ANM038413 and JCS000007)

Creative Financial Funding, LLC September 30, 2001 Audited Financial Statements Dated December 6, 2001 (ANM047190-6):

1. In November 2000, Pontchartrain Realty fund, LLC sold its purported 100% ownership interest in Valley Financial Funding, LLC to Multivest, a Nevada LLC for $400,000 in 6% convertible debentures from its **proposed** public entity. (JCS000017 and JCS000018-29)

2. On January 5, 2001, Pontchartrain Realty Fund LLC transferred the $400,000 of Multivest debentures to Creative Financial Funding, LLC as its capital contribution. (ANM030252) I discussed the value of the debentures with Kiesel. He stated he obtained a client representation letter which satisfied him as to the value of the debentures. **Kiesel stated he had never seen the actual debenture, didn't know its terms nor did he do any test work to determine its fair market value.**

3. **Kiesel never questioned how the debenture would provide the start up company with working capital or liquidity. Kiesel knew this was a related party transaction but exercised no skepticism and subjected the transaction to no scrutiny.**

4. **Since related party transaction constituted $599,000 of $603,000 (99%) of reported assets of the company, the audit should have devoted a substantial effort and**

analysis of related party transactions and not blind reliance upon a management representation letter. (ANM030192-4)

5. Kiesel failed to disclose that the company made a series of advances (ANM065782, 3, 6, 7 and ANM048741 and 51) to a first lien holder in furtherance of its attempt to consummate the purchase of an office building located at 125 S. 52nd Street, Tempe, Az. for $1,295,000 from a related party (Corporate Fiducial Services, Inc.). The purchase contract was dated May 10, 2001. (JCS000035 and ANM065648-55)

6. **Kiesel failed to disclose a material related party subsequent event when on November 1, 2001 Larry Dunning sold Corporate Fiducial Services, Inc. to Creative Financial Funding, LLC for a $500,000 promissory note issued by Pontchartrain Reality Fund, LLC. (ANM030090 and 92)**

7. **Kiesel failed to disclose that Corporate Fiducial Services, Inc. made substantial payments to a third party lien holder in furtherance of Creative Financial Funding, LLC's purchase of 125 S. 52nd Street. (ANM065788 & 9, ANM065793, 7 & 8, 800, 6, 11, 12 and 16) Corporate Fiducial Services, Inc., as trustee, was the seller of the property.**

8. Kiesel's October 25, 2001 engagement letter for the September 30, 2001 audit was addressed to Larry Dunning (ANM047377 & 8). Dunning exercised control over the Company but was neither an owner nor officer of Creative Financial Funding, LLC. On October 31, 2001, Robert Rehm signed the engagement letter as President of Creative Financial Funding, LLC. (ANM047379 & 80) Kiesel sent the Confirmation requests to Robert Rehm. (ANM047389)

9. Kiesel obtained a representation letter from Creative Financial Funding, LLC dated December 6, 2001 on December 10, 2001. (ANM030192-4) Larry Dunning signed the management representation letter on behalf of Creative Financial Funding, LLC. According to the books and records of the company and the recorded documents with the Arizona Corporation Commission, Larry Dunning was never a member of the company. Larry Dunning appears to have exercised control over the company but did not by way of any official capacity. Kiesel obviously did not know his client, or perhaps, he knew the client was controlled by a person (Larry Dunning) who could not qualify for a banking department license because of a prior federal felony conviction for loan fraud.

10. On December 4, 2001, Kiesel obtained a confirmation from Robert Rehm, Member, Ponchartrain Realty, LLC for the amount owed on the $400,000 of 6% convertible debentures (Multivest) and a $153,125 loan to Pontchartrain Realty LLC. I don't understand the audit reason for confirming the Multivest debentures with Pontchartrain Realty Fund, LLC (a related party) and not Multivest, the issuer of the debenture. Even if Kiesel had confirmed the existence and amount of the debentures with Multivest, it would not have established the fair market value of the debentures. **Kiesel did not determine, acknowledge or address the default status of the debentures and the related impropriety of continuing to accrue interest on them. (ANM047388 & 9)**

11. I question the appropriateness of Kiesel's reliance on a confirmation received from a related party for the related party loan of $153,125. Kiesel did not determine the value of the loan, its purpose or its repayment terms. **If Kiesel had looked at Creative Financial Funding, LLC's books and records he would have discovered that $150,000 of the Receivable was, at best, a Stock Subscription Receivable. Normally stock subscriptions should have been presented as reduction in the capital section of the balance sheet rather than as a receivable. A Stock Subscription Receivable should only be presented as an asset when the receivable has been collected by the completion of the audit. Not only was it not collected by the completion of the audit, the transaction was reversed on December 31, 2002. The sole purpose of the transaction was to pump up the Assets and Equity of the Company. (ANM047389 and JCS000036 and 7)** The remaining $3,125 was a retainer paid to an attorney by Creative Financial Funding, LLC for an arbitration proceeding against Pontchartrain Realty Fund, LLC. The seller of Valley Financial Funding, LLC claimed that Pontchartrain Realty Fund, Inc. never paid for its purchase of Valley Financial Funding, LLC. (ANM037266 and JCS000038-9)

12. On December 4, 2001, Kiesel obtained a confirmation from Robert Rehm, President, American Money Power for a $22,406.39 obligation owed to Creative Financial Funding, LLC, a related party. My observations are similar to the ones stated in item 11 above. In addition, **all three entities shared the same bookkeeper and office address. (ANM047388)**

13. Kiesel prepared an Adjusted Trial Balance that included his adjusting entries. He sent the adjusted trial balance and adjusting entries to the Company's bookkeeper on January 7, 2002. **His entries included 9 months accrued interest on the Multivest Convertible Debentures (AJE 3 for $18,000). Interest was supposed to be paid semiannually. It should have been obvious the Debentures were in default.** The most interesting set of entries is AJE 2 wherein Kiesel sets up a Miscellaneous accounts payable for $40,652.22, recognizes advertising expense of $36,055.17 and adjusts retained earnings for $4,597.05. (ANM047381-85) The adjustments by their nature are questionable, Kiesel appears to have lacked independence and it appears Kiesel was auditing his own work.

Creative Financial Funding, LLC December 31, 2001 Compiled Financial Statements Dated February 11, 2002 (ANM047198-202):

1. According to the convertible debenture terms disclosed in the Valley Financial Funding, LLC purchase agreement between Multivest, LLC and Pontchartrain Realty Fund, LLC, the $400,000 of convertible debentures were supposed to make semi-annual interest payments. The December 31, 2001 Statement of Assets, Liabilities, and Members Equity - Income Tax Basis under Other Assets, Accrued Interest Receivable of $24,000. Kiesel would have known the debentures were in default at this time and should have raised questions about the representations presented in his audited financial statements for September 30, 2001. Kiesel should have known about the default prior to his completion of the September 30, 2001 audit on December 6, 2001.

2. Kiesel's engagement letter of February 5, 2002 was addressed to Larry Dunning. (ANM047375-6)

3. Kiesel performed an analysis of "Other Payables" in conjunction with his issuance of the compiled financial statements for the company. **His analysis includes a $35,332 adjustment to retained earnings with the following footnote "It appears that creative tax planning 101 has occurred here to minimize taxes in year 2000.** Check with Larry Dunning." Kiesel failed to address the issue in his September 30, 2001 audit of the company. Kiesel was referring to the tax return prepared by Joel Woldorf, CPA. (ANM065683 & 4)

American National Mortgage Partners, LLC February 14, 2002 Audited Financial Statements Dated February 26, 2002 (ANM047154-9):

1. **Note B-Debentures does not disclose the $250,000 of debentures was a related party transaction.**

2. The $250,000 of debentures are from the $400,000 of the Multivest debentures held by Creative Financial Funding, LLC and purportedly subjected to audit analysis when Kiesel did his September 30, 2002 audit of Creative Financial Funding, LLC. (JCS000042)

3. **There is no disclosure that the debentures were in default at the time of the transfer.**

4. Kiesel did not calculate or disclose $1,849 of accrued interest American National Mortgage Partners, LLC owed Creative Financial Funding, LLC. Had Kiesel actually performed an audit analysis of the subject debentures he probably would have correctly concluded the debentures were in default and no accrual of interest was appropriate on the debentures.

5. **Kiesel never examined the nebulous nature of the debentures. If he had he would have concluded there was no basis for assigning any value to them.**

6. American National Mortgage Partners, LLC was a one person (Frank Caspare) LLC. Frank Caspare made no direct capital contribution for his LLC interest. (JCS000042) **On February 14, 2002, Frank Caspare executed a $250,000 promissory note to Creative Financial Funding, LLC. (JCS000040-1) It appears the purpose of the promissory note was to acquire $250,000 of the Multivest debentures from Creative Financial Funding, LLC and then use the debentures as his capital contribution for American National Mortgage Partners, LLC. (JCS000043)**

7. Frank Caspare owned a 34% (ANM028615 & 6 and ANM030609 & 10) interest in Pontchartrain Realty Fund, LLC on February 14, 2002. There are conflicting records as to his actual ownership percentage on February 14, 2002. Pontchartrain Realty Fund, LLC owned 100% of Creative Financial Funding, LLC at February 14, 2002. It does not appear Kiesel acknowledged or applied any independent audit techniques to this related party transaction.

8. Kiesel's audit opinion is addressed to the "Members". Since it is a single member LLC it should have been addressed to the "Member".

9. Note A-Summary of Significant Accounting Policies: Income Taxes, states the Company will file its income tax return as a partnership. This statement is incorrect. A single member LLC does not file a partnership return. The company would be reported on Schedule C of the individual's tax return.

10. **Creative Financial Funding, LLC paid Kiesel's audit fees for American National Mortgage Partners, LLC; a clear indication of a related party. (ANM048680, ANM047371 and JCS000044)**

11. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Mortgage Management, LLC March 15, 2002 Audited Financial Statements Dated March 20, 2002 (ANM047271-6):

1. Secura Mortgage Management, LLC was wholly owned by Secura Innovative Investments, Inc. (ANM031451 & 2 and ANM031382)

2. Secura Innovative Investments, Inc.'s books and records do not show who the stockholders of the company are. (ANM031410 & 1 and ANM031382-7a)

3. **The capitalization of Secura Mortgage Management, LLC was achieved by the transfer of $150,000 of the Multivest convertible debentures and either the $250,000 Robert Rehm promissory note or the $250,000 Frank Caspare note held by Creative Financial Funding, LLC. (JCS000045 & 6 and 40 & 1) Consequently, Secura Innovative Investments, LLC should have been wholly owned by Creative Financial Funding, LLC not Secura Innovative Investments, Inc.** There appears to have been no audit of the related party transactions.

4. **At March 15, 2002, the Multivest Convertible Debentures were in default and throughout their history had never made the required semi annual interest payments.** In addition, had they been current there would have been 2 ½ months of accrued interest on March 15, 2002, due to Creative Financial Funding, LLC.

5. **The books and records of Creative Financial Funding, LLC show no disbursement of the $250,000 of loan proceeds to Robert Rehm. During my interview of Mr. Rehm he stated he never borrowed $250,000 from any of the entities and had not entered into any transaction that would have given rise to his execution of a $250,000 note to Creative Financial Funding, LLC. A search of the company files did not turn up an original signed note. The only documentation is a photo copy of the purported note. The transaction appears to be a clumsy attempt to manufacture equity and assets.**

6. On March 20, 2002, Robert Rehm, acting in an undisclosed capacity, executed the Management Letter on behalf of Secura Mortgage Management, LLC. (ANM031541 & 2)

7. **On March 27, 2002 Corporate Financial Services, Inc. paid Kiesel's fee for auditing Secura Mortgage Management, LLC. (ANM048135, 8a and ANM047363a & 4)**

8. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Mortgage Management, LLC May 24, 2002 Audited Financial Statements Dated May 28, 2002 (ANM047277-84):

1. Kiesel continues to accept the accrual of interest on the Multivest Debentures which have not made an interest payment since their inception. The Debentures have been in default since approximately July 1, 2001. The only audit technique Kiesel appears to have used was the obtaining of a Client Representation Letter that the Multivest Convertible Debentures were not in default. Kiesel had dealt with the Multivest Convertible Debentures since early 2001. He never observed any payments and he calculated the accrued interest. If he had read the terms of the Debentures he would have known they required semi-annual interest payments. Instead, Kiesel relied upon a Management Representation (that may or may not have been executed) by Eric Strasser, in an undisclosed capacity, on behalf of Secura Mortgage Management, LLC. (ANM031456 & 7)

2. **Note B-Note Receivable reported the $250,000 note receivable from a member plus accrued interest was repaid on May 24, 2004. In addition, the member contributed an additional $95,935 in cash to give the Company liquidity. An examination of the transaction reveals the $350,000 was an improper loan from ANMP's investor trust account. The source of $150,000 of the $350,000 was the payoff of the High Chaparral Loan.** $50,000 was a loan from Stocker to ANMP and $131,000 came from Barton's repayment of a loan from CORPORATE FIDUCIAL SERVICES. **The High Chaparral and Stocker loan proceeds should have been repaid to the respective loan investors. The High Chaparral loan investors did not know the loan was paid off. The Company continued to make interest payments to the investors as though the loan had been extended. A review of the source of the funds would have disclosed the true nature of the transaction and debunked any representation the $350,000 was a capital contribution.**

3. **On May 29 and 30, 2002 (the day after and the second day after the audit report date) Secura Mortgage Management, LLC issued four checks to transfer the $350,000 back to American National Mortgage Partners, LLC. (ANM049048, JCS000047, ANM095381-4 and ANM095377-80)**

4. The High Chaparral loan investors continued to receive interest payments on a no longer existing loan. The High Chaparral funds were not paid to the investors but were diverted.

5. **The $350,000 transaction was submitted to the Arizona State Banking Department on June 4, 2002 as evidence of the Company's capitalization. No disclosure of**

the May 29, 2002 back transfer of funds was made to the Banking Department. (ANM031435 & 6)

6. Secura Mortgage Management, LLC appears to be wholly owned by Secura Innovative Investments, Inc. (previously discussed).

7. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Innovative Investment, Inc. March 15, 2002 Audited Financial Statements Dated April 3, 2002 (ANM031497-503)

1. **Robert Rehm transferred the Sedona Residence to the Company. $400,000 of his purported equity was based on a forged $400,000 check. Larry Dunning attempted to cover up the forgery by persuading a compromised banker to write a $400,000 cashiers check when the issuing entity, Corporate Fiducial Services, Inc. had approximately $4,539.67 in its account. (JCS000048-53)**

2. Kiesel knew that all of the parties involved in the Sedona transaction were related parties.

3. If Kiesel had reviewed the Zion Bank loan documents executed by Rehm he would have discovered that Rehm represented that the property was to be used as a personal residence and the sale or transfer to Secura Innovative Investments, Inc. would have been in violation of the loan provisions. See Deed of Trust, Article 6, Principal Residence; Article 17, Transfer of Property (due on sale clause); Adjustable Rate Rider, Article B and Second Home Rider, Article 6. (ZIB000022)

4. The second position loan from National Bank of Arizona, a wholly owned subsidiary of Zion Bank, had similar provisions. (Article 6, JCS000140; Article 17, JCS000142; Article B, JCS000145 & 6 and Article 6, JCS000147)

5. **The second property transferred for stock was 998 East Indian School Road. There was no equity in the property. The property was over encumbered.**

6. **Kiesel doesn't appear to have audited the $250,000 shown on the balance sheet as a Note Receivable. It appears this is the Rehm note used to capitalize Secura Mortgage Management, LLC.**

7. A brief history of the Sedona property: September 28, 2000 Corporate Fiducial Services, Inc. transfers to Rehm (JCS000054); February 27, 2002 Rehm transfers to Secura Innovative Investments, Inc. (ANM056664 & 5); April 29,2002 Secura Innovative Investments, Inc. transfers to Rehm (ANM056662 & 3); April 30, 2002 Rehm transfers to Bed, Boat & Breakfast, LLC (ANM056660 & 1) and March 31, 2003 Bed, Boat & Breakfast transfers to Rehm. (ANM056659)

8. In Note B Kiesel reports the Sedona transaction occurred on March 15, 2002, via quit claim. The actual quit claim was executed on February 27, 2002 and recorded on March 15, 2002. It appears Kiesel used the March 15, 2002 date so that he would not have had to calculate interest expense for 16 days.

9. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Innovative Investment, Inc. April 15, 2002 Audited Financial Statements Dated April 24, 2002 (ANM047252-61)

1. Note B describes a related party transaction. ANM063474-77 discloses the true nature of the transaction.

2. **Note C-Note Receivable doesn't make sense. If Rehm loaned the Company $250,000 it would be a note payable, not a note receivable. Kiesel is describing the $250,000 Rehm note that may have been used to capitalize Secura Mortgage Management, LLC.**

3. Note B-Investments state a shareholder of the Company contributed $200,000 to the capital of the Company. On March 18, 2002, the Company's books reflect a $200,000 journal entry to the capital account. The purpose of the entry was to cover up the true source of the $200,000, Tony Pisacano. (JCS000055, ANM049488, ANM096744-5, ANM077693 and JCS000056)

4. **On April 29, 2002, the Company's attorney expressed his concerns to the Company's controller about Kiesel's audited financial statements. It appears the Company is engaged in a process of creating financial statements to satisfy questions raised by the Arizona Corporation Commission Securities Division. (JCS000057)**

5. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Fund Arizona, LLC April 15, 2002 Audited Financial Statement Dated April 25, 2002 (ANM047238-44)

1. **On April 15, 2002, $200,000 of notes receivable and its related accrued interest appear in the Company's financial statements. Kiesel completed his audit on April 25, 2002. He did not disclose that $100,000 of the $200,000 of notes receivable was from a related party, Corporate Fiducial Services, Inc. (ANM142502) Note B to the financial statements states the notes were investments in deeds of trust. The Corporate Fiducial Services, Inc. note was not secured by a deed of trust. (ANM142502)**

2. The other note receivable was from Castle Megastore Corporation, Deer Valley/ 25th. Ave, LLC and Taylor R. Coleman, Individually. (ANM142503)

3. **Note C of the financial statements state the source of the funds for the $200,000 of loans receivable was Secura Innovative Investments, Inc. The actual source of the funds was a wire transfer from Tony Pisacano to Western + Gulf, a Larry Dunning entity. (ANM049488)** Dunning then wrote a $200,000 check from Western + Gulf to Secura Fund Arizona, LLC not Secura Innovative Investments, Inc. (ANM096744 & 5) **On March 18, 2002 a journal entry for $200,000 was made on the books of Secura Innovative Investments, Inc. in an attempt to create the illusion that Secura Innovative Investments, Inc. had loaned $200,000 to Secura Fund Arizona, LLC and that Dunning and/or Western + Gulf made a $200,000 capital contribution to Secura Innovative Investments, Inc.**

4. Kiesel failed to disclose another related party note from Corporate Fiducial Services, Inc. for $15,000 dated March 21, 2002. (ANM142501).

5. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

Secura Fund Arizona, LLC July 23, 2002 Audited Financial Statements Dated July 30, 2002 (ANM047216-22)

1. At April 25, 2002, the Company's audited financial statements presented assets of $201,987. The liabilities included $20 of accounts payable, $880 of accrued interest payable and $200,000 of investor funds payable. Members Equity was reported as $1,087. How did Kiesel get from his April 25, 2002 audited financial data to his July 23, 2002, audit presentation? Did the Company create a new set of books to audit?

2. At April 25, 2002, the Company's audited financial statements disclosed interest income of $1,967 and interest expense of $880. The audited financial statements at July 23, 2002, disclosed no income and no interest expense. What happened to income and interest expense between April 25, 2002, and July 23, 2002?

3. According to the Company bookkeeper, Kiesel conducted his audit without ever visiting the Company's offices. Selected information was faxed to Kiesel.

BANK FRAUD/LOAN FRAUD/FORGERY

300 Acacia Drive, Sedona Arizona

"The house at 300 Acacia was our first foreclosure. I have been trying to make lemonade out of it ever since."(Larry Dunning memo paragraph e. ANM110752)

On July 16, 2000, Robert Rehm agreed to purchase a luxury house at 300 Acacia Drive, Sedona, Arizona from the 3414 N. 44 Street Trust dated December 17, 1999 for $1,400,000. (ZIB000413-19) Corporate Fiducial Services, Inc. was the trustee of the 3416 N. 44 St. Trust (ANM058489 and ZIB000419). The purchase contract contemplated a $400,000 down payment. Escrow account #43-43-03085-FL was opened at Security Title Agency. (JCS000206-8)

The following sequence of events was perpetrated by Corporate Fiducial Services, Larry Dunning and Robert Rehm because they didn't have the $400,000 to make the down payment on the Sedona House.

Robert Rehm purportedly deposited a Cashier's Check for $400,000 into the escrow account for the down payment on the Sedona House. Cashier Check #4791773020 was issued by Western Security Bank to Security Title Agency for $400,000 on July 28, 2000. The purported Remitter stated on the Cashier's Check was Robert Rehm. The Cashier's Check was signed by Marshall Boyce. (JCS000223)

Corporate Fiducial Services, Inc. issued Check #1099 on July 28, 2000, to Western Security Bank for the purchase of the Cashier's Check. Corporate Fiducial Services Check # 1099 bears the notation "For Robert Rehm". Larry Dunning was the signor of Check # 1099. (JCS000221 & 2)

At the time Larry Dunning wrote Check #1099 for the $400,000 Cashier's Check there was a maximum of $4,539.67 in CORPORATE FIDUCIAL SERVICES's Western Security Bank account. (JCS000224 and JCS000231-3)

According to Marshall Boyce, the Western Security Bank officer that issued the Cashier's Check, CORPORATE FIDUCIAL SERVICES didn't have sufficient funds in its account to cover the purchase of the cashier's check. **When I asked Marshall Boyce why he did it; he stated that he did it to accommodate a friend.** Marshall Boyce may not have known Larry Dunning's overall plan, he may not have known how his actions fit into the Sedona Property sale or loan fraud and he may not have known how his actions were aiding the developing Ponzi scheme. However, what Boyce did know was that Dunning did not have sufficient funds in his account at the time he executed and tendered Check # 1099 to purchase the cashier's check Boyce issued. In addition, **Boyce knew Robert Rehm was not the remitter of the $400,000.** Boyce believes he hand carried the $400,000 cashier's check to the title company and hand carried the title company's $400,000 check back to the bank to cover Dunning's $400,000 NSF check. **Boyce knew he was part of a sham real estate transaction. Boyce was a willing participant in Dunning's "Check Kiting Scheme".** Boyce should have known that he was aiding Dunning in a sham real estate transaction and, if a lender was involved, he was aiding a related loan fraud. **By his actions, Boyce provided crucial assistance to the developing Ponzi scheme.**

Upon receipt of the $400,000 Security Title Agency check (JCS000225 and 6), Boyce returned to Western Security Bank and deposited the $400,000 into CORPORATE FIDUCIAL SERVICES's checking account to cover the $400,000 Check #1099 written by Larry Dunning and in turn the Cashier's Check #4791773020 written by Boyce. The bank recording sequence clearly shows the insufficient funds check issued by Dunning occurred before the recording of the deposit of the Security Title Agency check. (JCS000222 & 26)

Robert Rehm applied for a loan through Darrell Coulter at National Bank of Arizona, a wholly owned subsidiary of Zions Bancorp. (JCS000227) Zions bank loaned Rehm $838,860 for the purchase of the Sedona House. (ZIB000271)

Darrell Coulter, in a memo dated September 28, 2000, facilitated the approval of Robert Rehm's loan with Zions by waiving a bank requirement for a second appraisal and approving the appraiser, Richard L. Cox, who performed the appraisal for CORPORATE FIDUCIAL SERVICES. (JCS000228)

As part of the loan review process by Zions, they requested proof of Rehm's $400,000 down payment and the source of those funds. (ZIB000377-412)

Rick Neuman, a loan officer with Valley Financial Funding, an ANMP affiliate, transmitted the requested documents to Zions on September 19, 2000. (ZIB000379)

CFS provided Nick Newman with the documents requested by Zions. (ZIB000377)

Item 3. of the CFS response reads "is the Beneficiary Agreement identifying Mr. Rehm as a 40% owner of: The Note from Castle to the 2nd Beneficiaries of which Mr. Rehm owned a 40% interest ($400,000)". (ZIB000377) **Altered Trust documents were provided to Newman and Zions as proof of Rehm's 40% $400,000 interest. (ZIB000410 and 11) ZIB000410 was photocopied from ANM004082. After it was copied, ownership %s' and Robert K. Rehm's name was added to the document. Robert Rehm has denied ever having a $400,000 investment in any Castle related loan at any time. During my interview of Robert Rehm, he denied ever having made a $400,000 down payment on the Sedona House or any knowledge of the altered Second Beneficiary document. (ZIB000410)**

If Rehm had a 40% ownership interest (he didn't) and if a Castle entity had made a $400,000 repayment (it didn't) then Rehm would have only been entitled to $160,000 of the $400,000 (40% of $400,000 not 100% of $400,000). (ZIB000392)

Item 5. of the CFS response was a photo copy of a Castle entity check and remittance advise for Check #002054 dated July 28, 2000 made payable to Corporate Fiducial Services, Inc. The remittance advice description field reads "LOAN REPAY-FEDWY LOAN-RK REHM". (ZIB000411) **This document is a forgery. The $400,000 bogus Castle entity check was represented as being deposited into CFS's Western Security Bank, bank account.** As previously described, Security Title Agency Check # 4327106 was the actual $400,000 check deposited into CFS's account on July 28, 2000.

At my request, on April 15, 2004, Vern Schweigert, Chief Restructuring Officer for the Castle entities, provided me with a copy of the original Castle entity Check #002054 for $20.00 written to the New Mexico Public Reg Comm on September 18, 2000. (JCS000205)

The difference in the issue dates between the real check and the bogus check was significant from a detection standpoint. The bogus checks apparent out of sequence issuance was a transactional red flag.

Whoever altered the check had to back date the altered check to match the date of the purported deposit. On September 18, 2000, CFS provided the bogus check to Nick Newman,

the loan officer from Valley Financial Funding (an affiliate of American National). In the haste to create the bogus check, the maker either was not concerned about using a non July sequenced check or overlooked this detail. Additional evidence of the bogus nature of the $400,000 Castle entity check is the missing MICR encoding of the $400,000 on the lower right hand corner of the check. (JCS000201-5)

To complete the purchase, Robert Rehm borrowed $161,000 from National Bank of Arizona. National Bank of Arizona recorded a second position lien against the Sedona property to collateralize its interest. On October 3, 2000, Security Title disbursed to CFS $170,872.97 representing the net sales proceeds. On October 3, 2000, CFS disbursed to Robert Rehm $166,698.30 of the net proceeds. (JCS000283)

2302 North 36th Street Returns for Another Round of Financing

On February 5, 2003, the property was transferred from Herb Fisher to Robert Rehm subject to only the $200,000 Gordon loan. (JCS000423 and 4 and JCS000430 and 1) The American National investor loan of approximately $365,000 was conspicuous by its absence.

On January 15, 2003, Robert Rehm, through Marshall Boyce, applied for a $375,000 loan with First International Bank. (FIB000645-7) The loan closed on approximately February 5, 2003. (JCS000425-9 and FIB000659-63 and 871)

The purpose of the loan was to pay off Gordon and provide additional funds to complete the repairs to the property.

On February 26, 2003, Marshal Boyce authorized a $27,000 construction draw. Marshal Boyce issued cashier Check # 24080 to Larry Dunning for the $27,000. (FIB000851 & 2)

On May 2, 2003, Robert Rehm submitted the sixth and final draw request to Marshall Boyce at First International Bank. **In the draw request, Rehm acknowledges the diversion of the previously disbursed $27,000 to Larry Dunning when he wrote "The $27,000 was supposed to be returned by Larry by the 26th of April but it looks like it may be another couple of weeks before we get it back." (FIB000839)**

The preceding report does not include an analysis of all American National transactions. The Receiver reserves the right to supplement or file additional reports based on his continuing analysis of the transactions. The Receiver reserves the right to amend this report based on the discovery of new additional information.

James C. Sell, Receiver
American National Receivership, et al

EXHIBIT 14

When A Ponzi Scheme Case Files for Bankruptcy

1. What Assets Are Left?

Delaware Bankruptcy Inn of Court presentation on February 19, 2013
By: Simon E. Fraser, Cozen O'Connor

Issues Regarding Proceeds of the Debtor's D&O Policy/ies

These days, virtually all business entities of any significance own "directors and officers" insurance policies ("D&O policies"). Generally speaking, these policies provide coverage for losses that the entity's key personnel (i.e. directors, officers, or other high ranking employees) ("executives") may suffer as a result of wrongful acts that they may commit in the course of their employment. These policies typically cover not only losses suffered via adverse adjudication or settlement, but also as a result of having to pay defense costs.

Although the primary purpose of a D&O policy is to provide coverage to executives, such policies frequently also provide coverage directly to the company (so-called "entity coverage"). When the company is covered as well as the executives, the company typically shares a common coverage limit with the executives. In other words, the insurer's payment of proceeds to the entity will reduce the coverage available to the executives on a dollar-for-dollar basis, and vice versa.

Proceeds from a D&O policy may represent a significant source of recovery for creditors of a bankrupt entity, either via direct actions against insured executives, or via the debtor's entity coverage. However, a number of thorny issues apply to parties seeking to benefit from a D&O policy (either as an insured, or as a creditor seeking to recover from an insured). This piece shall briefly discuss several important such issues.

I. To whom do the proceeds of a D&O policy belong?

A. When a company that owns a D&O policy commences a bankruptcy case, the policy itself becomes property of the company's bankruptcy estate. However, the ownership of the proceeds is a separate question.[1]

B. Where coverage exists for the executives only. If the policy covers only the executives (i.e. it does not provide entity coverage), the proceeds are considered to belong to the executives individually, and not to the estate. Consequently, creditors can proceed against the executives directly and seek to recover the proceeds via a settlement with, or judgment

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[1] The seminal case on the policy/proceeds ownership dichotomy is Louisiana World Exposition, Inc. v. Federal Insurance Co., 832 F.2d 1391 (5th Cir. 1987), in which the court held that a debtor's D&O policy was certainly property of the estate, but that the proceeds would not be considered estate property because they were payable directly to the executives.

against, the executives in their individual capacities. For their part, the executives would be free to look to the proceeds to satisfy their defense costs.

C. Where coverage exists for the debtor-entity as well as the executives. The situation is trickier if the executives share coverage with the debtor-entity. In general, where the executives and the entity all share common coverage, then the court will deem the proceeds to be estate property if their depletion by the executives would reduce the proceeds otherwise available to the estate.[2] If the proceeds are deemed to be estate property, then the automatic stay will prevent the executives from accessing any of the proceeds, and prevent creditors from recovering the proceeds via direct actions against the executives. But by that same token, if the proceeds are deemed to be estate property, then they would be available to creditors by virtue of creditors' direct causes of action against the debtor.

1. Bankruptcy courts frequently receive motions from executives seeking either stay relief to access D&O proceeds, or alternatively a declaration that the proceeds do not constitute estate property. In evaluating whether to permit executives access to shared coverage, the court will ask whether the debtor itself faces any direct claims that would be covered under the policy (i.e. will the debtor need to use any of the proceeds itself?). If the court finds that the debtor will not face any claims for which it may look to the policy, then the court will likely either grant the executives stay relief to obtain the proceeds, or rule that the proceeds are not estate property. Either way, the executives will be free to pursue the proceeds, and, likewise, creditors will be free to recover the proceeds via claims against the executives.

2. Some D&O policies contain so-called "priority of payment" provisions, which set out the priority of competing insureds to the shared limit. Typically, these provisions subordinate entity coverage to the coverage of the executives. Bankruptcy courts enforce such provisions in D&O policies. Where the debtor-entity and the executives are competing for shared proceeds, the court may point to the "priority of payment" provision and allow the executives access to the proceeds, despite the fact that their obtaining the proceeds would erode the debtor's limit, on the grounds that pursuant to the "priority of payment" provision, the executives' claim to the proceeds trumps the competing claim of the debtor.

3. The United States Bankruptcy Court for the District of Delaware has allowed executives access to shared coverage under D&O policies in situations where the debtor seemed unlikely to face any claims covered by the policies, and where the

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[2] See, e.g., In re Allied Digital Techs., 306 B.R. 505 (Bankr. D. Del. 2004) ("The Court concludes that when a debtor's liability insurance policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further when the liability insurance policy only provides direct coverage to the directors and officers the proceeds are not property of the estate. However, when there is coverage for the directors and officers and the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution.").

policies contained "priority of payment" provisions subordinating the entity's coverage to the executives' coverage. In In re Downey Financial Corp., 428 B.R. 595 (Bankr. D. Del. 2010), the court held that D&O proceeds payable to the executives were not property of the debtor-entity's estate, where the debtor's right to the proceeds was subordinate to the rights of the executives, and where the debtor did not appear to face any claims that would be covered under the policy's entity coverage. The court added that even if the proceeds were estate property, it would grant the executives stay relief in order to access the proceeds. See also, Miller v. McDonald (In re World Health Alternatives, Inc.), 369 B.R. 805 (Bankr. D. Del. 2007) (under similar circumstances, refusing to enjoin the debtor's D&O insurer from paying proceeds to executives); In re Allied Digital Techs., 306 B.R. 505 (Bankr. D. Del. 2004) (under similar circumstances, holding that D&O proceeds were not estate property and adding that even if they were, the court would grant executives stay relief to access proceeds).

II. Exclusions for fraud and related conduct

A. D&O policies typically exclude coverage for losses flowing from acts constituting fraud and related conduct. Obviously, in the context of a Ponzi scheme, the debtor and its executives may very well have committed acts that would trigger this exclusion and bar coverage. As well as to the insureds, such a bar could be bad blow to creditors, who would otherwise be able to collect policy proceeds via judgments or settlements.

B. Who decides whether the exclusion applies, and may that determination be made in a collateral proceeding? Perhaps the most critical variables are the questions of who decides whether the fraud exclusion applies, and whether that decision must occur in the underlying litigation, or in a collateral proceeding brought for the specific purpose of determining whether the fraud exclusion applies. The answers to these questions depend on the language of the particular policy at issue. Some D&O policies require a final judicial adjudication that the fraudulent conduct occurred in order to trigger the exclusion. Other policies require merely a "determination" that fraud (or the particular excluded conduct) occurred. This distinction can be important, especially from the point of view of the insureds, because the insurer must continue to advance defense costs until the occurrence of the "determination" of whether coverage is excluded. Important also – from the perspective of creditors as well as insureds – is the fact that if a final adjudication in the underlying litigation is required, the fact that such litigation ultimately settles would mean that such "final adjudication" never occurs, and, consequently, that the fraud exclusion is never triggered.

C. A recently published opinion from the United States Court of Appeals for the Fifth Circuit in connection with the Allen Stanford Ponzi scheme illustrates the issues that arise regarding a D&O policy's fraud exclusion. There, the Stanford entities' D&O policy contained a so-called "money laundering" exclusion, which barred coverage for losses resulting from or in connection with "money laundering" (which was a defined term under the policy). Importantly, the policy provided, "Notwithstanding the foregoing Exclusion [i.e. the "money laundering" exclusion], Underwriters shall pay Costs, Charges and Expenses in the event of an alleged act or alleged acts until such time that it is

determined that the alleged act or alleged acts did in fact occur. In such event the Directors and Officers and the Company will reimburse Underwriters for such Costs, Charges and Expenses paid on their behalf." Pengergest-Holt v. Certain Underwriters at Lloyd's of London, 600 F.3d 562, 567 (5th Cir. 2010).

D. In the Stanford matter, the insurer itself purported to determine that the money laundering exclusion applied, and then took the position that coverage was barred pursuant to that exclusion. Predictably, the insureds responded by filing a motion for a preliminary injunction prohibiting the insurer from denying coverage, which the District Court granted. The insurer then appealed that decision to the Fifth Circuit Court of Appeals.

E. The court of appeals held that when a policy provides that coverage is excluded for claims arising from certain conduct, and requires a "determination" that such conduct "did in fact occur," such determination must be made by a court, as opposed to by the insurer itself. The court of appeals held that in order for an insurer to reserve for itself the right to make such a determination, the policy must set forth this point explicitly. In other words, the policy must explicitly state to the effect of, "the insurer shall make the determination of whether the acts occurred." In the absence of such explicit language, courts will interpret the need for a "determination" as referring to a judicial determination. This interpretation is in keeping with the general rule of interpreting insurance policies in such a way as to favor coverage.

F. The next question facing the court of appeals was whether the judicial determination of whether money laundering had occurred could be made in a collateral proceeding, initiated for the sole purpose of determining the applicability of the exclusion. Or, whether the determination must be made in the underlying proceeding (i.e. the proceeding that triggered the insured's need for coverage in the first instance). In its opinion, the court of appeals set out the following rule of thumb:

> When a D&O policy requires a "final adjudication" to trigger an exclusion, courts have consistently held that the adjudication must occur in the underlying D&O proceeding, rather than in a parallel coverage action or other lawsuit. The distinction is important because under a "final adjudication" clause, some courts bar insurers, after settlement of the underlying case, from litigating "whether the settled claims were in fact attributable to defendants' dishonest acts." Read this way, a final adjudication exclusion limits the insurer's recourse if the parties settle—the most likely outcome—or if the insured is otherwise absolved of liability or guilt in the underlying action. . . .
>
> In contrast, courts have generally imbued "in fact" language with a broader scope than "final adjudication," holding, for example, that the term requires a final decision on the merits in either the underlying case or a separate coverage case, or an admission by the insured. These cases do not require a final adjudication by the fact finder in the underlying case, but rather offer it as a coequal alternative to having a court make the assessment in a separate coverage proceeding. In bargaining for "in fact" language, then, the insurer reserves the

right to litigate the coverage question outside of the underlying action for which insurance coverage is sought.

Id. at 572-73.

G. Because the policy owned by the Stanford entities required merely a "determination" that money laundering had "in fact" occurred, as opposed to a final judicial adjudication on the subject, the court of appeals held that such a determination could be made in a collateral proceeding, instituted for the specific purpose of determining whether the exclusion applied. The court of appeals then remanded the matter to the district court in order for the district court to conduct such a collateral proceeding and determine whether the conduct of Stanford and his cohorts rose to the level of "money laundering" for purposes of the policy. The district court did ultimately find that "money laundering" had occurred, and consequently ruled that coverage was barred under that exclusion.

H. As well as, obviously, for the insureds, this outcome was also a bad blow for Stanford creditors, who otherwise would have been able to collect the D&O policy proceeds via judgments against, or settlements with, the insureds. If the policy had required a final judicial adjudication (instead of merely a "determination") that money laundering had occurred, then the court of appeals would have held that the exclusion is not triggered until such an adjudication is made in the underlying criminal action against the insureds. Depending on the outcome of that underlying matter, the policy's money laundering exclusion may never have been triggered with respect to some of the insureds.

I. Note regarding interpretation of policy language. It is important to bear in mind that court decisions regarding the interpretation of policy language depend upon the exact language of the particular policy at issue. Even small variations in the wording of a particular policy may lead to a different outcome than what happened in a given case concerning a different policy.

State law applies to the interpretation of an insurance policy. Under the laws of most, if not all, states, insurance policies are construed against the insurer, and in the event of any ambiguity, courts will favor an interpretation that provides, as opposed to excludes, coverage. Depending on the applicable law, other rules of construction and particular quirks may apply. Consequently, parties should be aware of the applicable state law regarding the interpretation of insurance policies.

III. "Insured vs. Insured" Exclusions

A. Many D&O policies exclude coverage for claims based on causes of action brought by one insured against another insured. In a bankruptcy context, the debtor-in-possession or trustee may wish to sue individual executives for breaches of fiduciary duty and related causes of action. If the applicable D&O policy provides for coverage of the debtor-entity, and contains an "insured vs. insured" exclusion, then the insurer may argue that the debtor-in-possession or trustee, having stepped into the shoes of the debtor-entity, is effectively an "insured," and that coverage is excluded for any claims in connection with suits against the insured executives.

B. The case law is split on whether "insured vs. insured" exclusions apply to suits brought on behalf of a debtor's bankruptcy estate against insured executives, where the D&O policy in question also provided coverage to the debtor-entity. Cases where the court held that an "insured vs. insured" exclusion did not bar coverage under a D&O policy include: Wilson v. Vanderlick (In re Central La. Grain Coop., Inc.), 467 B.R. 390 (Bankr. W.D. La. 2012) (holding that "insured vs. insured" exclusion did not bar coverage for chapter 7 trustee's suit against debtor's former executives, stating that, "a duly appointed bankruptcy trustee is not the insured debtor for purposes of the insured versus insured exclusion," and noting that reason for exclusion's existence – to bar coverage in the event of collusion between insureds – is not implicated in context of suit by trustee.); Grafenauer v. Mukamal (In re Laminate Kingdom, LLC), No. 07-10279, 2008 WL 704396 (Bankr. S.D. Fla. March 13, 2008) (holding that "insured vs. insured" exclusion did not bar coverage in connection with suit brought by chapter 7 trustee against executive, and noting that if parties had wished, they could have drafted policy explicitly to exclude coverage for suits brought by bankruptcy trustees); Cohen v. National Union Fire Ins. Co. of Pittsburgh (In re County Seat Stores, Inc.), 280 B.R. 319 (S.D.N.Y. 2002) (holding that coverage was not excluded where chapter 11 trustee brought breach of fiduciary duty claims against debtor's executives, reasoning that "[a] bankruptcy trustee is a legal entity separate and distinct from the debtor" and so could not be equated with the "insured" for purposes of the "insured v. insured" exclusion).

C. Cases where the court held that an "insured vs. insured" exclusion did bar coverage under a D&O policy include: Biltmore Assocs., LLC v. Twin City Fire Ins. Co., 572 F.3d 663 (9th Cir. 2009) (holding that "insured vs. insured" exclusion did bar coverage under D&O policy where post-confirmation trust sued debtor's former executives); Terry v. Federal Ins. Co. (In re R.J. Reynolds – Patrick Co. Mem'l Hosp., Inc.), 315 B.R. 674 (Bankr. W.D. Va. 2003) (holding to the same effect, also in context of suit by post-confirmation trust against executives, and stating, "A pre-petition debtor is the same entity as a debtor-in-possession . . . ."); Reliance Ins. Co. of Ill. v. Weis, 148 B.R. 575 (Bankr. E.D. Mo. 1992) (holding to the same effect, in context of suit brought by post-confirmation "plan committee" against executives).

D. Delaware courts have addressed the issue on at least two occasions. In Cirka v. National Union Fire Ins. Co. of Pittsburgh, No. 20250-NC, 2004 WL 1813283 (Del. Ch. Aug. 6, 2004), the Delaware Court of Chancery held that a D&O policy's "insured vs. insured" exclusion did not apply to a suit filed by the official committee of unsecured creditors in the bankruptcy case of debtor-in-possession Integrated Health Services against certain executives. However, the court stated in dicta that if the debtor-in-possession, as opposed to the committee, had brought the suit, the "insured vs. insured" exclusion would have applied and barred coverage. In Alstrin v. St. Paul Mercury Ins. Co., 179 F.Supp.2d 376 (D. Del. 2002), the District Court for the District of Delaware held that the "insured vs. insured" exclusion in the D&O policy in question did not bar coverage in connection with a suit brought by the chapter 11 estate representative (appointed under Rule 2012(a)) against executives of the debtor.

IV. "Bankruptcy" or "Insolvency" Exclusions

A. Some D&O policies contain so-called "bankruptcy" or "insolvency" exclusions. Generally, these exclusions bar coverage for claims relating to or arising from the bankruptcy or insolvency of an entity or individual. As one might imagine, these exclusions can have a drastic impact on parties' abilities to recover proceeds in a bankruptcy context. Of course, the exact scope of this impact depends upon the wording of the particular policy. These exclusions are often worded to apply to losses flowing from the insolvency of an investment firm or related sort of business, so that the insurer does not have to provide coverage for losses in connection with a failed investment.

B. In Associated Community Bancorp, Inc. v. Travelers Cos., Inc., No. 09-1357, 2010 WL 1416842 (D. Conn. April 8, 2010), certain aggrieved Madoff investors sued a certain bank and related entities, including an officer personally, for trusting Bernard Madoff with the investors' funds. The bank and other defendants notified their D&O carrier of the lawsuit, but the D&O carrier refused to cover the defense costs. The policy excluded coverage for "Loss [including Defense Costs] on the account of any claim made against any Insured based upon, arising out of or attributable to the insolvency, receivership, bankruptcy, or liquidation of, or financial inability to pay, by any investment company, or any broker or dealer in securities or commodities."

   The spurned insureds sued their D&O insurer for its failure to provide coverage. However, the court held that the insurer was justified in refusing coverage, because, *inter alia*, the claims fell squarely within the policy's insolvency exclusion. The court explained, "[A]ny reading of the plain language of the insolvency exclusion excludes coverage of the investors' claims. The underlying lawsuits are certainly connected with, incident to, or flow out of Madoff's insolvency. Had Madoff not become insolvent and lost the investors' money, the investors would have had no damage and thus no reason to file suit against [the insureds]. Therefore, there is a causal connection between the insolvency and the claims. The language of the exclusion is broad – it covers 'any claim' arising out of the insolvency of 'any investment firm.' A plain reading of the exclusion gives it a 'definite and precise meaning,' which excludes coverage of just these sorts of claims." Associated Community Bancorp, 2010 WL 1416842 at *4.

C. Other examples of cases where courts enforced insolvency exclusions include Transamerica Insurance Co. v. South, 975 F.2d 321 (7th Cir. 1992) (enforcing insolvency exclusion in connection with investors' suit against investment advisor in connection with insolvency of entity with which advisor had invested clients' funds); Smith v. Continental Cas. Co., No. 07-1214, 2008 WL 4462120 (M.D. Pa. Sept. 30, 2008) (enforcing insolvency exclusion in connection with investors' suit against financial planner in connection with bankruptcy of entity into which financial planner had steered investors' funds).

D. In matters involving Ponzi schemes, an exclusion of this sort would obviously pose a significant (and perhaps insurmountable) impediment to a creditor's ability to recover D&O proceeds from culpable parties.

What Causes of Action Are Available to the Trustee

Delaware Bankruptcy Inn of Court presentation on February 19, 2013
By: Robert W. Mallard, Dorsey & Whitney (Delaware) LLP

When a Ponzi scheme unravels, the result is almost always a bankruptcy filing and the appointment of a trustee to replace the Ponzi fraud perpetrator. As with other types of bankruptcy cases, prosecution of avoidance actions provides a major source of recovery for the bankruptcy estate. Prosecution of common law causes of action also provides assets for the bankruptcy estate as well as providing remedies to rectify some of the harm caused by the fraudster(s). The following lists the typical causes of action available to a trustee when a Ponzi scheme files for bankruptcy, along with some of the major nuances, but not all of the many nuances, that differentiate these causes of action in Ponzi bankruptcy from a "regular" bankruptcy. This presentation will not cover the defenses to any of the listed causes of action.

Avoidance Actions Under Section 5 of the Bankruptcy Code

Fraudulent Transfer Claims

Actual Fraudulent Transfer: Section 548(a)(1)(A)

Section 548(a)(1)(A) provides for recovery of transfers that the transferor "made . . . with actual intent to hinder, delay, or defraud . . . ." 11 U.S.C. § 548(a)(1)(A) (2010). If the transferor made a transfer with fraudulent intent, section § 548(a)(1)(A) is satisfied; and the intent or understanding of the transferee is not relevant.[3] Courts have held that there is a presumption of fraudulent intent where a debtor operates a Ponzi scheme.[4] This presumption applies in the recovery of commissions as well as other types of transfers.[5] Once the trustee establishes actual fraud, the transferee must then pursuant to Section 548(c) prove that it took the transfers for value and in good faith.[6]

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[3] *See In re Bayou Group, LLC*, 439 B.R. 284, 304 (S.D.N.Y. 2010); Marc Hirschfeld and George Klidonas, *Avoidance Actions in Ponzi Scheme Bankruptcy Cases*, available at http://www.bakerlaw.com/files/Uploads/Documents/News/Articles/BUSINESS/2011/ABA_HIrschfield_Klidonas_April-2011.pdf; Kathy Bazoian Phelps, *New Issues in Fraud: Causes of Action and Defenses*, available at http://www.theponzibook.com/ABI_2012_BBW_Phelps_Fraud_Materials.pdf;

[4] *See, e.g., Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund, Ltd.)*, 359 B.R. 510, 517–18 (Bankr. S.D.N.Y. 2007), *aff'd in part, rev'd in part*, 397 B.R. 1, 22–26 (S.D.N.Y. 2007); see, e.g., *Donell v Kowell*, 533 F.3d 762, 770 (9th Cir. 2008); *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008)("[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to hinder, delay or defraud").

[5] *Picard v. Cohmad Securities Corp. (In re Bernard L. Madoff Inv. Sec. LLC)*, 454 B.R. 317, 330 (Bankr. S.D.N.Y 2011).

[6] *See Bayou Group, LLC*, 439 B.R. at 308.

Constructive Fraudulent Transfer: Section 548(a)(1)(B)

Section 548(a)(1)(B) provides for recovery of transfers of an interest in property for which the transferee does not provide "reasonably equivalent value" while the debtor is insolvent. 11 U.S.C. § 548(a)(1)(B) (2010). Again, the intent or understanding of the transferee is not relevant.

With respect to both actual and constructive fraudulent transfers, an investor in a Ponzi scheme cannot provide value for transfers above the amount invested, because the majority of courts hold that transferees who receive "fictitious" profits do not have a section 548(c) defense. Investors of principal typically do not provide "value" because their money perpetuated the fraud, although a good faith investor generally would, nonetheless, be entitled to a claim of rescission to recover up to the amount of his investment.[7] A split of authority exists as to whether a trustee can recover commissions paid to brokers as fraudulent transfers.[8] One side holds that a Ponzi scheme has no legitimate purpose so the broker cannot provide any value in perpetrating the fraud.[9] The other side holds that a narrower look at the relationship between the debtor and broker is required to measure "what was given and received" because "money is valuable even when used for illegal purposes."[10]

State Law Fraudulent Transfers

A Trustee may also use section 544 of the Bankruptcy Code to recover fraudulent transfers under state law. The main benefit of section 544 is access to a longer look-back period available under state law, rather than the 2 year look-back period available under the Bankruptcy Code. The same underlying analysis is the same as that used for fraudulent transfers under Section 548.

Preference Actions: Section 547

A trustee in a Ponzi bankruptcy case may use section 547 to recover preferential transfers. As with other regular bankruptcy cases the trustee must prove:

1) the transfer (to the creditor) occurred within the applicable 90-day or one-year period;
2) the debtor was insolvent at the time of the transfer, was rendered insolvent by the transfer or was left with unreasonably small capital as a result of the transfer; and

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[7] *See In re Bayou, Group, LLC*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008) ("Bayou II"); *see Armstrong v. Collins*, U.S. Dist. LEXIS 28075, at *67 (S.D.N.Y. Mar. 24, 2010); *Picard v. Estate of Chais (In re Bernard L. Madoff Inv. Sec. LLC)*, 445 B.R. 206, 225 (Bankr. S.D.N.Y.

2010).

[8] Phelps, at 5-6.

[9] *See, e.g., Warfield v. Byron*, 436 F.3d 551, 560 (5th Cir. 2006) ("It takes cheek to contend that in exchange for the payments he received, the [debtor's] Ponzi scheme benefited from his efforts to extend the fraud by securing new investments.").

[10] In re Churchill Mortgage Inv. Corp., 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000).

3) the transfer was a return of principal (existence of an antecedent debt).

The distinction in a Ponzi case is that with respect to an investor, a prior investment is considered antecedent debt up to the amount of the investment. Thus, the trustee may only recover amounts transferred to the defendant up to the amount of the investment. Transfers on account of fictitious profits are not considered made on account of antecedent debt. A Ponzi debtor is considered insolvent as a matter of law starting with the inception of the scheme.[11]

Of importance in a Ponzi case where the money trails are very complex and involve many parties, once a trustee establishes a fraudulent or preference transfer, the trustee may use section 550 of the Bankruptcy Code to seek recovery from multiple entities. The trustee must bring such an action within one year of the avoidance of the transfer, and the transfer is not subject to avoidance if the subsequent transferee shows that it has defenses under Section 550(c).

The trustee in the *In re Petters Company, Inc., et al.*, Ponzi case (Case No. 08-45257) pending in the Bankruptcy Court for the District of Minnesota, commenced a complaint against numerous entities, including initial transferees, immediate and/or mediate transferees, seeking to avoid transfers as actual and constructive fraudulent transfers under both sections 548 and 544, as well as preference transfers under section 547. In addition, the complaint also contains causes of action under: Section 542 for turnover and an accounting; Section 502 for disallowance of claims; Section 506(d) to avoid liens asserted by some of the defendants; Section 510(c) for equitable subordination; and claims for unjust enrichment/equitable disgorgement. See the attached complaint, *Kelley v. Opportunity Finance, LLC*, Adv. Pro. No. 10-04301 (Bankr. D. Minn. 2010).

The *Petters* complaint is a good example of the very complex nature of the Ponzi schemes and the number of entities that may be involved, including parties that were aware of the Ponzi scheme, investors, and unknowing recipients of the fraudulently obtained funds.

Common Law Causes of Action

In addition to causes of action under Section 5 of the Bankruptcy Code, trustees have at their disposal causes of action under common law. First, a trustee must determine that it has standing to pursue such common law causes of action because a trustee can only assert claims where it stands in the shoes of the estate. A trustee has standing when the claim belongs to the estate pursuant to Section 541(a), and not to individual creditors of the estate.[12] Some courts have held that a trustee may obtain standing to pursue causes of action that belonged to creditors, when the creditors unconditionally assign the claims to the estate.[13] The following are some of

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[11] *In re Carrozzella & Richardson*, 286 B.R. 480, 486 (D. Conn. 2002).

[12] *In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000); Kathy Bazoian Phelps, *The Impact of Standing and In Pari Delicto Doctrines on Claims for Relief Brought in Ponzi Scheme Cases*, available at http://www.abiworld.org/committees/newsletters/litigation/vol8num1/ponzi.pdf; Hon. Steven Rhodes and Kathy Bazoian Phelps, *Claims for Recovery Against Professionals and Insiders in Ponzi Cases*, available at http://www.abiworld.org/committees/newsletters/litigation/vol8num1/ponzi.pdf.

[13] *See, e.g. Logan v. JKV Real Estate Servs. (In re Bogdan)*, 414 F.3d 507, 512 (4th Cir. 2005).

the common law causes of action available to a trustee with standing to assert such causes of action.

Malpractice and Professional Negligence

A trustee may have a malpractice and/or professional negligence claim against professionals that, pursuant to the particular state law, failed to exercise the skill and care that a practitioner in such field would have used in similar circumstances and cause damage to the debtor.[14]

Negligent Misrepresentation

A claim for negligent may be brought by a trustee against professionals who misrepresented information to the debtor upon which the debtor relied in doing business with the professional. To establish a claim, the plaintiff must have been in privity with the professional.[15]

Deepening Insolvency

To the extent a cause of action based upon "deepening insolvency" is recognized by the applicable state law, a trustee may assert this cause of action against the debtor's officers, directors or outside professionals on the theory that their fraudulent actions wrongfully prolonged the debtor's life, incurred debt beyond the debtor's ability to pay, which forced the debtor into bankruptcy.[16] Delaware does not recognize an independent cause of action based upon the theory of deepening insolvency.

Fraud

A trustee may have a cause to assert a claim for fraud, or fraudulent misrepresentation against third parties or professionals when, *inter alia*, the defendant's conduct caused harm to the debtor, and the debtor was justified in relying on the misrepresentations.[17] State law will determine the elements a trustee must prove to establish fraud. In the context of a Ponzi scheme and lawyers or accountants may have created false legal documents or financial statements.

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[14] Phelps, at 6-7; *See Seitz v. Detweiler, Hershey and Assocs., P.C. (In re CitX Corp.)*, 448 F.3d 672, 677 (3d Cir. 2006); *Mosier v. Stonefield Josephson, Inc.*, 2011 U.S. Dist. LEXIS 124058, at *18 (C.D. Cal. Oct. 25, 2011) (citations omitted).

[15] *In re Colonial Ltd. Partnership Litigation*, 854 F. Supp. 64, 102 (D. Conn. 1994) (quotations omitted) (denying defendant's motion to dismiss and noting that, "plaintiffs allege that Arthur Andersen knew members of the class would rely on the representations contained in the PPMs in deciding whether to invest in the limited partnerships.").

[16] *Official Comm. Of Unsecured Creditors v. R.F. Lafffferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001).

[17] *See, e.g., Armstrong v. American Pallet Leasing Inc.*, 678 F.Supp.2d 827, 876 (N.D. Iowa 2009); *Waslow v. Grant Thorton L.L.P. (In re Jack Greenberg, Inc.)*, 240 B.R. 486, 521 (Bankr. E.D. Pa. 1999).

Aiding and Abetting Fraud and Breach of Fiduciary Obligations

A trustee may bring aiding and abetting causes of action against third parties who were involved in the Ponzi scheme.[18] A defendant must knowingly participate in the Ponzi scheme for the purpose of assisting another in performing the wrongful acts and substantially assists in enabling the fraud to progress.[19] Courts have held that pleading "knew or should have known" is not sufficient to allege actual knowledge for an aiding and abetting cause of action.[20]

Conspiracy

A trustee may have a conspiracy claim when the defendant caused, *inter alia*, damage to a debtor by acting in concert to take funds from the debtor or working together to perpetuate the life of the insolvent debtor with the intend of taking further funds from the debtor and/or taking on obligations they knew the debtor could not perform.[21]

Breach of Fiduciary Duty

A trustee may bring claims against directors and officers of a debtor involved in perpetrating a Ponzi scheme. A trustee can establish a breach of fiduciary duty claim by showing: (1) the existence of a fiduciary relationship giving rise to a fiduciary duty, (2) breach of that duty, and (3) damage proximately caused by the breach.[22] In addition, self-dealing and using corporate assets for personal gain, such as the case in Ponzi schemes, are hallmarks of breaches of fiduciary duty.[23] With respect to a Ponzi scheme, the debtor's insiders perpetrating the scheme often make transfers to friends and family or make significant charitable contributions that do not bringing any value to the corporate entity itself but instead benefit the benefactor.[24]

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[18] Phelps, at 11-12.

[19] *Casey v. U.S. Bank Nat'l Assoc.*, 127 Cal. App.4th 1138, 1144, 26 Cal. Rptr.3d 401, 405 (2005) (citation omitted); *Neilson v. Union Bank, N.A.*, 290 F. Supp. 2d 1101, 118-19 (C.D. Cal. 2003) ("federal courts have found that the phrase 'knew or should have known' does not plead actual knowledge."); *See Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 52-53 (2d Cir. 2005) (concluding that it was unnecessary to resolve the issue of the defendant's knowledge because there was insufficient evidence of substantial assistance, and that even if the defendant knew of the fraud, it had no separate duty to disclose it.).

[20] *Id.*

[21] *See, e.g., Drabkin v. L & L Construction Assocs., Inc. (In re Latin Investment Corp.)*, 168 B.R. 1, 6 (Bankr. D.C. 1993).

[22] *See, e.g., Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Stanziale v. Nachtomi (In re Tower Air, Inc.)*, 416 F.3d 229, 239-41 (3d Cir. 2005); *LaSala v. Bordier et Cie*, 519 F.3d 121, 130 (3d Cir. 2008) (applying Delaware law).

[23] *Pepper v. Litton*, 308 U.S. 295, 311 (1939).

[24] Fine v. Sovereign Bank, 634 F.Supp.2d 126, 145 (D. Mass. 2008) (a director and agent of debtor has a duty of loyalty which is breached by misappropriating money from the company for his own purposes).

In addition to directors and officers of the debtor, under some state laws, a breach of fiduciary duty claim may be asserted against a broker, a corporate broker's controlling shareholder, officer or director.[25]

Substantive Consolidation Issues

Delaware Bankruptcy Inn of Court presentation on February 19, 2013
By: L. Katherine Good, Richards, Layton & Finger, P.A.

Substantive Consolidation Generally

What is substantive consolidation? "Substantive consolidation, a construct of federal common law, emanates from equity. It 'treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor.'" In re Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005) (quoting Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir. 2005)).

Legal Standards

Second Circuit: In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988). The court identified two factors which could justify substantive consolidation: 1) whether creditors dealt with the entities as a single unit and did not rely on their legal separateness or 2) whether the affairs of the debtors are so entangled that consolidation would benefit all creditors.

Third Circuit: In re Owens Corning, 419 F.3d 195 (3d Cir. 2005). The court emphasized five principles to be advanced: 1) "limiting the cross-creep of liability by respecting entity separateness," 2) remedying harms caused by debtors rather than creditors, 3) "mere benefit to administration" should not warrant substantive consolidation, 4) substantive consolidation is an extreme remedy and its use should be rare, and 5) substantive consolidation may be used defensively to remedy harms but should not be used offensively. Id. at 211. The court then used these standards to formulate the following to part test: "what must be proven (absent consent) concerning the entities for whom a substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity boarders and treated them as one legal entity or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." Id. at 211.

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[25] *Lautenberg Foundation v. Madoff*, 2009 U.S. Dist. LEXIS 82084, at *50 (D.N.J. Sept. 9, 2009) ("a fiduciary duty exists between a broker and a client "where the customer has delegated discretionary trading authority to the broker .").

Eighth Circuit: In re Giller, 962 F.2d 796 (8th Cir. 1992). Court adopted a standard considering three factors: "1) the necessity of consolidation due to the interrelationship among the debtors; 2) whether the benefits of consolidation outweigh the harm to creditors; and 3) prejudice resulting from not consolidating the debtors." Id. at 799.

Ninth Circuit: In re Bonham, 229 F.3d 750 (9th Cir. 2000). The court adopted the test articulated by the Second Circuit Court of Appeals in Augie/Restivo Baking Co.

Eleventh Circuit: Eastgroup Prop. v. S. Motel Ass'n Ltd., 935 F.2d 245 (11th Cir. 1991); In re Reider, 31 F.3d 1102 (11th Cir. 1994). The court applied the test articulated by the D.C. Circuit Court of Appeals in Auto-Train Corp.

D.C. Circuit: In re Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987). A prima facie case for substantive consolidation is established by (1) showing a substantial identity between the entities to be consolidated; and (2) that the consolidation is necessary to avoid some harm or realize some benefit. A creditor may then object to consolidation, and the court may order substantive consolidation if the benefit outweighs the harm. Id. at 276.

Substantive Consolidation in Ponzi Scheme Cases

Issues Presented

Substantive consolidation of debtors with non-debtor entities

Some courts permit substantive consolidation with non-debtor entities. In re Bonham, 229 F.3d 750 (9th Cir. 2000); In re S & G Financial Services of South Florida, 451 B.R. 573 (Bankr. S.D. Fla. 2011).

Others require an involuntary petition to be filed against the non-debtor entity. In re Pearlman, 462 B.R. 849 (Bankr. M.D. Fla. 2012).

Partial substantive consolidation

The bankruptcy court in Pearlman held that partial consolidation was at odds with the goals of substantive consolidation and refused to grant a partial substantive consolidation. In re Pearlman, 450 B.R. 219 (Bankr. M.D. Fla. 2011).

The bankruptcy court for the Central District of California suggested in dicta that less than complete consolidation may be warranted in certain circumstances. Gill v. Sierra Pacific Construction (In re Parkway Calabasas Ltd.), 89 B.R. 832, 837-38 (Bankr. C.D. Cal. 1988).

Published Decisions involving Substantive Consolidation and Ponzi Schemes

In re Bonham, 229 F.3d 750 (9th Cir. 2000). The debtor and certain companies formed by the debtor obtained investments or borrowed money, promising large returns or interest for the purpose of purchasing frequent flyer miles, using those to purchase airline tickets and selling those tickets to the public. The operations were never profitable and new investments were used to pay returns on prior investments. Applying the test articulated in Augie/Restivo Baking Co., the court found that the affairs of the debtor and two non-debtor corporations were hopelessly entangled. The court also found that substantive consolidation would remedy the harm caused by fraud and would benefit all creditors and harm no creditors. The court ordered substantive consolidation.

In re Pearlman, 450 B.R. 219 (Bankr. M.D. Fla. 2011). Louis J. Pearlman, the founder of The Backstreet Boys, N'Sync and other boy bands, operated a Ponzi scheme in Florida. The trustee sought partial substantive consolidation of Pearlman's case with certain affiliated debtors and non-debtors. The court granted the motion for substantive consolidation with the affiliated debtors on the basis that the entities were run as substantially the same entity and there would be "extreme difficulty in segregating the assets and liabilities." The court, however, refused to grant partial consolidation that was sought to preserve certain "wrong payor" constructive fraud claims was inappropriate, holding that partial substantive consolidation is "inherently incompatible with the goals of consolidation." In a subsequent opinion, the court held that consolidation of debtors with non-debtor entities was not permissible. In re Pearlman, 462 B.R. 849 (Bankr. M.D. Fla. 2012).

In re Baker & Getty Financial Services, Inc., 78 B.R. 139 (Bankr. N.D. Ohio 1987). The court consolidated the cases of two individuals and three corporations based on the extensive commingling of assets, the inadequate documentation of transfers, and the disregard of corporate formalities and that the consolidation would benefit the overwhelming majority of creditors. The court determined that the one creditor objecting to consolidation did not actually rely on the assets of the individual debtor in extending credit and would therefore not suffer prejudice by the consolidation.

What Issues Come Up in Ponzi Bankruptcies that Don't Typically Arise in Non-Ponzi Bankruptcies?

Delaware Bankruptcy Inn of Court presentation on February 19, 2013
By: Christine W. Kim, Skadden, Arps, Slate, Meagher & Flom LLP

Highlighted below are several issues that arise in Ponzi bankruptcy cases that do not typically arise in non-Ponzi bankruptcy cases.

Futility of a Fresh Start

Ponzi cases frustrate one of the purposes of Bankruptcy – to provide a fresh start for the debtor – because the debtor has engaged in fraud.

- One important implication of a finding that a debtor has orchestrated a Ponzi scheme is that a "Ponzi Scheme Presumption" may apply in fraudulent transfer cases, meaning that it is presumed that the Debtor had the "actual fraudulent intent

necessary to avoid a transaction pursuant to § 548." DeAngelis v. Rose (In re Rose), 425 B.R. 145, 152 (Bankr. M.D. Pa. 2010).

- If a court determines that this presumption applies in a fraudulent transfer context, that court may then presume fraudulent intent in considering whether discharge should be denied under Bankruptcy Code section 727. See, e.g., In re Bonham, 224 B.R. 114 (Bankr. D. Alaska 1998). These findings, however, will depend on another Ponzi-specific issue: Whether or not the debtor's business can be characterized as a Ponzi scheme.

Confusion over What Constitutes a Ponzi Scheme

The Bankruptcy Code does not define what a Ponzi scheme is, and many courts have employed differing definitions for Ponzi schemes.

- In determining whether to grant the US Trustee's request to deny a chapter 7 discharge, the Bankruptcy Court for the Middle District of Pennsylvania grappled with this very issue. See In re Rose, 425 B.R. 145. The Court ultimately denied discharge but did not apply a presumption of fraud because the trustee was not able to establish that the debtor was running a Ponzi scheme despite the debtor's use of new lenders' money to pay existing lenders. One of the hurdles the Court faced was finding "a clear definition of the term 'Ponzi scheme.'" Id. at 152. The Court ultimately concluded that there was little evidence of a formal scheme and that the debtor's use of his new lenders' money "seems little different than repeated cash advances." Id. at 155.

Claims Allowance/Distribution Issues

In addition to not defining what a Ponzi scheme is, the Bankruptcy Code does not establish distinct classes of claims that arise in Ponzi cases. Instead, bankruptcy courts are left to use their equitable powers to manage claims allowance and distribution issues.

- In In re Taubman, the Court exercised its equitable powers under Bankruptcy Code section 105, 502(b)(1), 502(j), and 510(c)(1) to approve the trustee's request to bifurcate all proofs of claim into two groups – one group to represent actual pecuniary loss and another group to represent "any amount in excess of actual pecuniary loss" and determined that the latter group would only receive distribution after all claims in the former group had been paid in full." 160 B.R. 964, 982 (Bankr. S.D. Ohio 1993).

Creditors and Crime Victims

The claims allowance and distribution process in Ponzi bankruptcy cases is also complicated by the fact that the many, if not all, creditors are victims of a crime. Ponzi scheme creditors are typically separated into two groups – "net losers" are those who incurred actual monetary losses and "net winners" are those who recouped their initial investment and profited from the Ponzi scheme. See, e.g., In re Rothstein Rosenfeldt Adler, P.A., 464 B.R. 465, 467 (Bankr. S.D. Fla. 2012).

- Although bankruptcy courts use their equitable powers to shape the claims allowance and distribution process, sometimes it seems that an inequitable outcome results. In Rothstein, for instance, the Court denied a group of creditors' motion to abate, which sought to stay the chapter 11 trustee's prosecution of pending adversary proceedings against net losers. Id. The Court reasoned that the movants' did not propose a

feasible method by which the trustee could be precluded from pursuing claims against "innocent" net losers. Id. at 468. The movants failed to provide a definition for innocent net losers and the Court refused to assume that net losers acted in good faith – an affirmative defense that net losers would otherwise have to assert and establish in a fraudulent transfer action. Id. The movants also did not suggest when the proposed abatement could end or how the Trustee could pursue actions against certain net losers. Id. at 469. Moreover, the Court noted that the movants' request would "effectively remove from the Trustee one of the key powers entrusted to trustee—the ability to pursue claims on behalf of the estate for the benefit of all creditors" and cause the Court to contravene the trustee's business judgment in bringing these actions. Id. The Court also dismissed the movants' assertion that the trustee's actions should be stayed because the Securities and Exchange Commission ("SEC") and trustees in other Ponzi bankruptcy cases generally do not pursue avoidance actions against net losers. Id. at 470. The Court pointed out that in the Madoff case, one of the trustee's guidelines in bringing such actions included determining "whether there were facts or circumstances suggesting that the transfer recipient lacked good faith" – which guideline the trustee in the instant case also employed in his analysis. Id. at 470-71. The Court additionally distinguished the numerous "mom and pop" investors in the Madoff case from the instant case, which featured "a limited number of generally sophisticated parties who received rates of return commonly over 100% on purportedly pre-suit settlements of employment-related claims." Id. at 471.

Conflict and Cooperation among Competing Authorities

The Bankruptcy Court is not alone in its attempt to equitably unwind a Ponzi scheme. Recent Ponzi cases have involved bankruptcy courts, district courts, regulatory agencies and the Federal Government, which all share that goal.

- Scott Rothstein's assets were seized by the Federal Government before he was charged with money laundering, fraud and racketeering and before his creditors filed an involuntary bankruptcy petition against his law firm, Rothstein Rosenfeldt Adler P.A. ("RRA"). See Jacqueline Palank, *Prosecutors, Trustees Fight for Dominance in Ponzi Bankruptcies*, THE WALL STREET JOURNAL (Jan. 3, 2011), http://online.wsj.com/article/SB10001424052748704111504576059613947208394.html. Federal forfeiture laws permit the Federal Government to seize proceeds of crimes and distribute those proceeds without judicial oversight. Id. Bankruptcy trustees may then find themselves in a position where they are before District Courts to challenge the forfeiture of certain assets. Id. For example, in connection with the Rothstein Ponzi scheme, the chapter 11 trustee liquidating Rothstein's firm challenged the Federal Government's seizure of funds in accounts titled to the firm. U.S. v. Rothstein, No. 09-60331-CR, 2010 WL 2730749 (S.D. Fla. July 9, 2010). There, the Court decided that it would be inequitable to impose a constructive trust over those funds: "It would be patently inequitable to return that money to RRA's estate when it can be returned directly to the clients and qualified investors." Id. at *10. It should be noted, however, that the Court also pointed out that the United States represented to the Court that all forfeited property, less administrative costs, would be used to reimburse victims through restitution and that the Court would exercise judicial oversight over that process. Id. at *9.

- U.S. v. Petters also exemplifies the tensions of having multiple authorities able to assert control over unwinding Ponzi schemes. Civil No. 08-5348 ADM/JSM, 2011 U.S. Dist. LEXIS 7206 (D. Minn. Jan. 25, 2011). There, the bankruptcy trustee argued that a receivership should be dissolved so the bankruptcy court could distribute the assets therein. See id. The District Court rejected this argument, reasoning, "The less flexible forum of bankruptcy court is disfavored in circumstances such as these where the economic damage has been caused by fraud, because 'the bankruptcy court would have less flexibility in determining the most equitable approach to distribute assets to victims [as opposed to all creditors].' Instead the 'overriding goal . . . should be fairness to the defrauded investors.'" Id. at *32-33 (internal citations omitted).
- In contrast, the District Court overseeing the Madoff case found that a bankruptcy court was uniquely qualified to unwind Madoff's Ponzi scheme. See SEC v. Madoff, 08 Civ. 10791 (LLS), 2009 U.S. Dist. LEXIS 30712 (S.D.N.Y. Apr. 10, 2009). There, the Court ruled that Madoff's victims were able to force Bernard Madoff into bankruptcy over the objections of the SEC, the US Attorney for the Southern District of New York, and the Trustee overseeing the liquidation of Bernard L. Madoff Investment Securities LLC under SIPA. The District Court stated:

> No opponent to the relief sought by the motion offers as familiar, comprehensive, and experienced a regime as does the Bankruptcy Code for staying the proliferation of individual lawsuits against Mr. Madoff individually, marshaling his personal assets other than those criminally forfeitable, and distributing those assets among his creditors according to an established hierarchy of claims.
>
> A Bankruptcy Trustee has direct rights to Mr. Madoff's individual property, with the ability to maximize the size of the estate available to Mr. Madoff's creditors through his statutory authority to locate assets, avoid fraudulent transfers, and preserve or increase the value of assets through investment or sale, as well as provide notice to creditors, process claims, and make distributions in a transparent manner under the procedures and preferences established by Congress, all under the supervision of the Bankruptcy Court.
>
> The concern that appointment of a Bankruptcy Trustee will increase administrative costs or delay recovery by victims is speculative, and outweighed by the benefits to Mr. Madoff's victims of a Bankruptcy Trustee's orderly and equitable administration of his individual estate. Indeed, the Department of Justice itself contemplates contracting with a special master, trustee, or receiver to aid it in the distribution of forfeited property.

Id. at *3-5.

- The judges overseeing the overlapping actions may also actively coordinate. In U.S. v. Dreier, the District Court overseeing the criminal action against Dreier worked

with the Bankruptcy Court presiding over the bankruptcy cases of Dreier and Dreier LLP, as well as the judge overseeing the civil enforcement action against Dreier commenced by the SEC. 682 F. Supp. 2d 417, 418 (S.D.N.Y. 2010). Ultimately, "[t]he government struck a deal with the trustees in the bankruptcies of disgraced New York attorney Marc Dreier and his law firm Dreier LLP in which the trustees agreed not to challenge the forfeiture in exchange for $9.5 million and dozens of pieces of seized artwork." Palank, *Prosecutors*.

A brief note on federal criminal forfeiture law. Federal criminal forfeiture law allows federal prosecutors to commence forfeiture proceedings for certain tainted assets:

> (1) any property constituting, or derived from, any proceeds the person obtained directly or indirectly, as the result of such violation;
>
> (2) any of the person's property used or intended to be used, in any manner or part, to commit, or to facilitate the commission of, such violation; and
>
> (3) in the case of a person convicted of engaged in a continuing criminal enterprise in violation of section 848 of this title, the person shall forfeit, in addition to any property described in paragraph (1) or (2), any of his interest in claims against, and property or contractual rights affording a source of control over, the continuing criminal enterprise.

U.S. v. Parrett, 530 F.3d 422, 429 (6th Cir. 2008) (quoting 21 U.S.C. § 853(a)). The Federal Government's interest in such assets relates back to "when the defendant commits the act giving rise to forfeiture." Id. at 430 (citing 21 U.S.C. § 853(e)). It should be noted, however, that there is a circuit split as to whether the Federal Government's interest in so-called substitute assets – assets which, "as defined by 21 U.S.C. § 853(p), are not directly traceable to the underlying offenses for which [the defendant] was indicted, but could be used to satisfy a judgment under certain circumstances (detailed in the statute)" – also relates back to the date of the defendant's criminal act. Id. at 430; see also Dreier, 682 F. Supp. 2d 415, 420.

Ethical Issues

This section summarizes three cases in which law firms were sued or sanctioned in connection with Ponzi-related cases.

- In Peterson v. Winston & Strawn, LLP, the bankruptcy trustee of the estates of two hedge funds that invested in the Petters Ponzi scheme sued Winston & Strawn. Case No. 11 c 2601, 2012 U.S. Dist. LEXIS 147653 (N.D. Ill. Oct. 10, 2012). Winston & Strawn had represented the two funds, as well as Greg Bell, the funds' manager who was responsible for investing the funds' assets and attracting new investors. Id. at *2. In late 2003, the funds issued a confidential information memo that discussed various restrictions Bell had to abide by. Id. at *3. However, in dealing with Petters, Bell failed to adhere to those restrictions. Id. Less than two years later, Bell hired the firm to represent his investment management companies as well as the funds. Id. at *4. The trustee alleged that shortly thereafter Bell informed the firm that he was not complying with the fund's investment restrictions but continued to do

business with Petters because he trusted Petters. Id. The following year, the firm drafted a revised memo for the funds, which included the same investment restrictions put in place in late 2003. Id. At that time, Bell continued his investment management services for the funds. Id. at *5. The trustee then alleged that in late 2007, Bell told the firm about his concerns about Petters' business. Id. In 2008, Bell then hired the firm to represent him in his individual capacity. At this time, the firm continued to serve as counsel to the funds and Bell's investment management companies. Id. The trustee contended that the firm committed legal malpractice because it breached its duties to the funds to disclose Bell's failure to comply with the funds' investment restrictions and to exercise due care in addressing Bell's companies' obligation to comply with those restrictions. Id. at *6. The trustee also alleged that the firm was negligent in drafting the revised memo, which the trustee argued created the false impression that Bell was in compliance with the memo. Id. The trustee additionally alleged that Winston & Strawn also failed its duty to disclose Bell's concern about Petters in 2008. Id. In this case, Winston & Strawn was successful in asserting an in pari delicto defense that barred the trustee's claims. Id. at 14. "The defense of in pari delicto is an equitable one, prohibiting a plaintiff from maintaining a claim where he bears equal fault for his alleged injury." Id. at *7. The Court determined that the trustee, standing in the funds' shoes, could not pursue these claims against the firm because the firm's knowledge of the alleged activities originated with Bell, whose knowledge and acts were imputed to the funds. The Court reasoned that Bell's knowledge and conduct was imputed to the funds because he was the funds' agent and was acting within the scope of his employment (i.e., investing the funds' assets and not stealing from the funds). Id. at *10-11. The Court also rejected the trustee's argument that the in pari delicto defense should not apply where the plaintiff was acting negligently. Id. at *14. Although such a defense, under Illinois state law, does not apply in situations where the plaintiff committed intentional misconduct, the trustee failed to allege that the firm's conduct did not arise to anything more than negligence and the trustee admitted that Bell's actions were negligent. Accordingly, the Court concluded the trustee's position was of equal culpability to Winston & Strawn's. Id.

- In August 2012, a District Court in Miami sanctioned Greenberg Traurig LLP ("Greenberg Traurig") "for 'negligently' failing to turn over documents to Coquina Investments" as part of the discovery process. David Voreacos, *TD Bank, Greenberg Traurig Sanctioned Over Documents*, Bloomberg (Aug. 4, 2012), http://www.bloomberg.com/news/2012-08-04/td-bank-greenberg-traurig-sanctioned-over-documents.html. Greenberg Traurig represented Toronto-Dominion Bank ("TD Bank"), which was sued by Coquina Investments for allegedly aiding the Ponzi scheme run by Scott Rothstein. Id. The District Court determined that the firm failed to adequately search for the bank's "Standard Investigative Protocol" which should have been turned over to Coquina Investments. Id. The protocol contained guidelines on whether to report suspicious activity. Id. The firm represented at trial that the bank did not have such a protocol, but the District Court found clear evidence that the firm received a copy of the document before trial. Id. Greenberg Traurig was ordered to pay Coquina Investments' attorneys' fees. Id. The District Court additionally sanctioned TD Bank "for 'willfully' concealing evidence relevant to [the] trial" Id.

- In 2009, Blank Rome settled a malpractice suit brought against it by the bankruptcy trustee for American Business Financial Services for $20 million. See *Blank Rome Settles ABFS*

Malpractice Case, PHILADELPHIA BUSINESS JOURNAL (Aug. 7, 2009), http://www.bizjournals.com/philadelphia/stories/2009/08/03/daily51.html?page=all. In that case, The trustee alleged that Blank Rome assisted ABFS management in perpetrating a Ponzi scheme; drafting more than 30 disclosures for regulators that it knew contained false and misleading information regarding ABFS' financial condition; counseled ABFS management to attempt to hide deficient public disclosures; defended company officers from allegations of running a Ponzi scheme when it knew or should have known the allegations were true; and withheld material information from the bankruptcy court and ABFS creditors that the company's reorganization effort had already failed while seeking and obtaining court approval for costly financing that "wasted" $100 million. Id. Blank Rome denied any such knowledge and intent to mislead regulators. Id. Blank Rome insisted that any documents it assisted with preparing did not concern the debtor's financial health. Additionally, "Blank Rome said that only in an act of client advocacy did it submit a letter to the New York Post in May 2002 defending ABFS regarding a scheme described in the publication, and had no knowledge of any such scheme." Id.

EXHIBIT 15

PONZI SCHEME AVOIDANCE ISSUES

I. PONZI SCHEMES – INVESTOR ISSUES

Innocent investors in a collapsed Ponzi scheme are typically viewed as tort creditors holding a claim for restitution for their investment. Donell v. Kowell, 533 F.3d 762, 774-75 (9th Cir. 2008) ("when Kowell and the other innocent victims gave money to Wallenbrock, they were not actually investors, but rather tort creditors with a fraud claim for restitution equal to the amount they gave."). While the only fair and equitable way to treat victims would be to fully repay each one of them, this is normally impossible. Therefore, courts endeavor to find the most equitable way to distribute a debtor's assets.

Defrauded investors typically fall into one of three categories: (a) those who received nothing in return for their investment; (b) those who received some value after making their investment, but less than the amount they invested; and (c) those who received value in excess of the full amount of their investment. Each category of aggrieved investors has different positions with respect to what should be recoverable, even if it comes at the expense of others. Thus far, courts have not developed a consistent model for recovery for each category. See, e.g., SEC v. Forte, 2009 U.S. Dist. LEXIS 116802, at *13 (E.D. Pa. Dec. 15, 2009) (rejecting argument that a return of principal should not be recovered from good faith investors); SIPC v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010), aff'd, 654 F.2d 229 (2d Cir. 2011) (finding investors should not be permitted to claim unpaid fictitious profits but leaving open the issue of whether a trustee could recover such profits actually paid to investors).

A. Components of an investor's claim

Investor claims generally include the following components. The treatment of each component depends upon the distribution methodology adopted by the court (see section B below).

1. Principal – in other words, all amounts invested and not returned.

2. Profits – fictitious amounts that were promised, but remain unpaid.

(i) A majority of courts have found clams for fictitious profits should be disallowed because it would allow recovery of arbitrary amounts or would be inequitable. See, e.g., In re New Times Sec. Servs, Inc., 371 F.3d 68, 88 (2d. Cir. 2004) (finding that fictitious amounts were not appropriate since it "would allow customers to recover arbitray amounts that necessarily have no relation to reality"); Official Cattle Contract Holders Comm. v. Commons (In re Tedlock Cattle Co.), 552 F.2d 1351, 1353 (9th Cir. 1997) (holding that trustee may use an "equitable" theory in excluding fictitious profits in a claim); CFTC v. Equity Fin. Grp., *LLC*, 2005 U.S. Dist. LEXIS 20001, at *77 (D.N.J. Sept. 2, 2005) (holding that it would be

inequitable to "recognize[e] profits or other earnings in claims for distributions that would the detriment to later investors").

(ii) The minority view is that investors should be compensated for the time value of the use of their funds. See, e.g., Lustig v. Weisz &Assocs., Inc. (In re Unified Commercial Capital), 2002 WL 32500567, at *8 (W.D.N.Y. June 21, 2002)(finding value where payments to creditors "were not simply payments of nonexistent profits, but of a contractually provided-for, commercially reasonable rate of interest on what amounted to a loan").

B. Distribution Methodologies[1]

1. Overview

Investors in a failed Ponzi scheme are often pitted against each other, and typically advocate for a particular distribution methodology that favors their particular facts. For example, an investor that never received anything after investing is likely to favor a distribution method that requires investors who received value from the debtor to give it all back, so that the "pot" can then be divided ratably among all investors. Investors that received value, on the other hand, will naturally resist giving it back. Instead, they often advocate for a distribution scheme that permits investor claims for lost profits, such as those shown on their account statements. In response, courts have developed several different distribution methodologies.

2. Net Investment Method

Under the net investment method, an investor's claim consists of the amount of principal invested, less any distributions paid by the debtor. Under this approach, investors may not assert a claim for their lost profits or account statement balances. Courts adopting the net investment method treat account statements as works of fiction. *See*, e.g., In re Bernard L. Madoff Inv. Sec., LLC, 654 F.3d 229, 235 (2d Cir. 2011) (in SIPA proceeding, holding that "the Net Investment Method [is] more consistent with the statutory definition of "net equity" than any other method advocated by the parties or perceived by this Court. There was therefore no error.... Use of the Last Statement Method... would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations."); Barnard v. Albert (In re Janitorial Close-Out City Corp.), Adv. No.11-8952-AST (Bankr. E.D.N.Y. Feb. 8, 2013) (granting summary judgment on trustee's claim to avoid and recover payments to investor in excess of cash investment).

3. Last Statement Method

Under the last statement method, an investor's claim is for the balance reflected on its last prepetition account statement. Investors that have received payments from the debtor

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[1] For a thorough overview, see Kathy Bazoian Phelps and Hon. Steven Rhodes, *The Ponzi Book: Unraveling Ponzi Scheme* § 20.04 (2012).

typically argue in favor of this method. Some courts have utilized the last statement method. See CFTC v. Richwell, Ltd., 163 B.R. 161 (N.D. Cal. 1994) (adopting receiver's plan to distribute Ponzi scheme assets under which certain investors' claims based upon account statements).

4. Other Variations

Some courts employ other methodologies, such as the "Rising Tide" method. Under the Rising Tide method, investors are permitted to retain prepetition distributions made to them, but those distributions are treated as a postpetition distribution by the trustee or receiver. Investors that received nothing prepetition receive a larger share postpetition than other investors. See SEC v. Huber, No. 12-1285 (7th Cir. Nov. 29, 2012) (Posner, J.), at *12 (approving receiver's use of rising tide method).

C. Investor Claims and Section 502(d)

Assume that an investor received some prepetition distributions on its investment, but not nearly enough to cover its full investment. Assume further that the trustee asserts that some or all of those distributions are recoverable as fraudulent transfers. Does Section 502(d) require the disallowance of the investor's claim until it repays the asserted fraudulent transfers? Judge Walsh has answered this question in the negative. See Zazzali v. AFA Financial Group, LLC, 477 B.R. 504, 517 (Bankr. D.Del. 2012). A Ponzi scheme trustee therefore must obtain a judgment on an avoidance claim before asserting a disallowance claim under Section 502(d). Interestingly, although an investor facing an avoidance claim may successfully challenge bankruptcy court jurisdiction under Stern v. Marshall, when the avoidance claim is coupled with a Section 502(d) claim, the challenge may fail. See SIPC v. Bernard L. Madoff Inv. Sec. LLC, 12 MC 115 (S.D.N.Y. Jan. 4, 2013), at *14 ("whenever the Bankruptcy Court must resolve a § 502(d) claim brought by the Trustee, it may also finally decide avoidance actions to the extent that those actions raise the same issues as the § 502 (d) claim and thus would "necessarily" be resolved by it.").

D. Strategic and Ethical Considerations

1. Collective action

Similarly-situated investors may find it useful for their respective counsel to consult and coordinate in the pursuit of common issues and goals. In that regard, bankruptcy courts have recognized and upheld the common interest doctrine. See In re Leslie Controls, Inc., 437 B.R. 493 (Bankr. D. Del. 2010) (common interest doctrine applied to debtor's prepetition legal analysis shared with creditors committee and future representative in plan development).

2. Privilege

A bankruptcy trustee inherits the attorney-client privilege if the debtor is a corporation. See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343, 358 (1985) (bankruptcy trustee inherits debtor corporation's attorney-client privilege). The trustee

can waive the privilege, and thereby compel the disclosure of privileged information. Outside investors who "bought in" on the basis of prospectuses or private placement memoranda prepared by company counsel may benefit from such waivers. On the other hand, company directors and insiders who may be implicated if their communications with company counsel are disclosed cannot prevent the trustee's waiver simply because it may result in their incrimination. *Id.*, 471 U.S. at 353–54 (goal of uncovering insider fraud "would be substantially defeated if the debtor's directors were to retain the one management power that might effectively thwart an investigation into their own conduct.").

II. PONZI SCHEME AVOIDANCE ACTIONS – ORDINARY CREDITORS

In bankruptcy, Ponzi schemes are like a virus - infecting everything they touch. Even commonplace, non-investor transactions, such as routine dealings with trade creditors and banks, are typically subject to heightened scrutiny. As a result, these otherwise unremarkable transactions often give risk to preference or fraudulent transfer claims brought by a bankruptcy trustee or estate representative.

A. Preference Claims

Typically, it is not difficult for a debtor or trustee to establish a *prima facie* preference action under section 547(b) in a bankruptcy case for payments made to a creditor within ninety days (or, for an insider, one year) of the filing of a bankruptcy petition and the same is true in Ponzi scheme cases. Rather, the big issue in Ponzi scheme preference actions is whether the ordinary course of business defense may be used to shield a preference defendant from liability.

As most bankruptcy attorneys are well aware, under section 547(c)(2), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), to establish the ordinary course of business defense, the defendant has the burden of proving that: (a) the debt satisfied by the transfer was incurred by the debtor in the ordinary course of the business and financial affairs of the debtor and the transferee (typically the defendant); and (b) either the transfer was: (i) made in the ordinary course of business or financial affairs of the debtor and the transferee (the "Subjective Payment Test"); or (ii) made according to ordinary business terms (the "Objective Payment Test"). See 11 U.S.C. § 547(c)(2)(A)-(B). Before BAPCPA, in addition to showing the debt had been incurred in the ordinary course of business, a defendant had to satisfy both the Subjective Payment Test and the Objective Payment Test- under BAPCPA a defendant need only satisfy one of these tests.

Courts generally agree that an investor who received payment on account of its investment cannot successfully maintain an ordinary course of business defense under section 547(c)(2) of the Bankruptcy Code. See e.g., Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Investments Assocs., Inc.), 48 F.3d 470, 475 (10th Cir. 1995); but see In re American Continental Corp., 142 B.R. 894, 900 (D.Arizona 1992). What is less clear, however, is whether a third-party creditor, such as (by way of example only) a telephone company or trade vendor, can assert an ordinary course of business defense.

Some courts adopt a bright line test, concluding, as a matter of law, that the ordinary course of business defense is unavailable to any preference defendant in a Ponzi scheme case. E.g., Danning v. Bozek (In re Bullion Reserve of North America), 836 F.2d 1214, 1219 (9th Cir. 1988), cert. denied, 486 U.S. 1056, 100 L. Ed. 2d 925, 108 S. Ct. 2824 (1988) ("transfers made in a 'Ponzi' scheme are not made in the ordinary course of business"); Grauity v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.), 819 F.2d 214, 217 (9th Cir. 1987); Henderson v. Buchanan, 985 F.2d 1021, 1025 (9th Cir. 1993); In re Taubman, 160 B.R. 964, 991 (Bankr. S.D. Ohio 1993) (same); Wider v. Wootton, 907 F.2d 570, 572 (5th Cir. 1990) (same). In support of this rule, courts reason, among other things, that a Ponzi scheme is not a legitimate business and, therefore, no transfer can be made in the ordinary course of "business" of such a debtor under section 547(c)(2). See Grauity, 819 F.2d at 216-17. These decisions also appear to be driven significantly by policy considerations - namely, discouraging preferential payments to creditors in the context of an illegal Ponzi scheme and promoting an equality of distribution among creditors in such a case. See id. at 217. Under this test, non-investor creditors would appear to be precluded from asserting an ordinary course of business defense regardless of, among other things, any particularized circumstances surrounding the payment or the nature of the goods or services provided by the defendant.

Other courts apply a more flexible test that would permit non-investor creditors to assert the ordinary course of business defense in certain Ponzi scheme cases. See Sender v. The Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Investments Assocs., Inc.), 48 F.3d at 475 (*dictum)*; In re M & L Business Machine Company, Inc., 84 F.3d 1330, 1332 (10th Cir. 1996); In re American Continental Corp., 142 B.R. 894, 900 (D.Arizona 1992); accord Breeden v. Northeast Binding Sys. (In re Bennett Funding Group, Inc.), 253 B.R. 316, 319-23 (Bankr. N.D.N.Y. 2000) (permitting ordinary course of business defense to be asserted even though at least a portion of the debtor's business consisted of a Ponzi scheme); cf. Harder v. JPPCS, Inc. (In re Graff), 454 B.R. 745 (Bankr. W.D. Mo. 2011) (in a non-Ponzi scheme case in which fraud may have been involved, the court permitted the defendant subcontractor to assert an ordinary course of business defense even though the debtor may have been involved in improper activities in connection with the preference payment).

The question then becomes, assuming, arguendo, that the ordinary course of business defense may be asserted by a non-investor creditor, how should that defense be analyzed and applied? The jurisprudence on this issue is uneven. Dictum in the Hedged-Investments case suggests that, if the transfer arises from a run-of-the-mill credit transaction, a regular ordinary course of business analysis should suffice. There, the court stated that:

> the purposes of § 547(c)(2) clearly are served by permitting its application to noninvestor-creditors whose transfers are received in the ordinary course of business. Again, the purposes of § 547(c)(2) are to leave undisturbed normal financial relations, because doing so does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy, see 11 U.S.C.A § 547 at 141, and to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee. 4 Collier on Bankruptcy, P 547.10 (15th ed. 1991). If, for instance, a Ponzi scheme uses telephone services, is billed for that service, and pays the phone company, disallowing the avoidance of that payment following a bankruptcy

> petition is consistent with the purposes of § 547. In addition, it is consistent with the over arching purpose of the preference provision to avoid a creditors' rush to the bank to dismember a debtor as it slides into bankruptcy. . . . Because such a transfer would be according to ordinary business terms as well as in the ordinary course of business, it would be defensible against a preference avoidance action.

Hedged-Investments Assocs., 48 F.3d at 476. This analysis was embraced in Graff, where the court emphasized that the source of the funds used to pay a defendant is not relevant to a *prima facie* preference action or to any defenses asserted in the action. See Graff, 454 B.R. at 754. While Graff may be a fraud case, it is not a Ponzi scheme case. In Graff, although the debtor was alleged to be involved in some type of malfeasance or misfeasance pertaining to the funds that it was supposed to use to pay the defendant as well as the funds it actually used to make the payments, the debtor ran a legitimate business and not a Ponzi scheme. It is unclear whether the Graff court's analysis or conclusions would have differed had the debtor been running a pure Ponzi scheme business, although *dictum* in the opinion suggests that result would have remained the same.

By comparison, in Bennett Funding the court permitted a preference defendant to assert an ordinary course of business defense, but only to the extent that the transfers at issue related to a portion of the debtor's business that had some economic substance and profit potential. See 253 B.R. 321-23. In Bennett, the debtor was in the office equipment leasing business and in fact leased equipment to third parties. The creditor sold office equipment to the debtor to be used in the debtor's leasing business and the debtor made the alleged preference transfer to pay for the equipment. The debtor's fraudulent scheme involved obtaining payments from investors secured by the leases – but the security was illusory as the debtor either pledged the same leases to multiple investors or falsified the leases altogether. Still, because at least part of the leasing business was real and not a fraud, the court permitted a preference defendant who transacted with the facially valid leasing arm of this business to assert an ordinary course of business defense.

B. Ordinary Creditors' Intent: Ponzi-Scheme Presumption and Good Faith / For Value

There are two types "fraud" giving rise to fraudulent transfers under the Bankruptcy Code: intentional fraud under section 548(a)(1)(A) ("actual intent to hinder, delay, or defraud") and constructive fraud section 548(a)(1)(B) (debtor received less "than reasonably equivalent value," and was insolvent). Intentional fraud typically must be proved by establishing certain "badges of fraud" which provide circumstantial evidence that the transferor had the request fraudulent intent. See Zazzali v. Mott (In re DBSI, Inc.), 2011 WL 115876, at *3 (Bankr. D. Del. 2011) (listing badges of fraud :"(1) the relationship between the debtor and the transferee; (2) consideration for the conveyance; (3) insolvency or indebtedness of the debtors; (4) how much of the debtor's estate was transferred; (5) reservation of benefits, control or dominion by the debtor over the property transferred; and (6) secrecy or concealment of the transaction").

Once fraud is established, the burden shifts to the defendant-transferee, who must establish that he or she took for value and in good faith. 11 U.S.C. § 548(c) ("[A] transferee . . .

that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that the transferee or oblige gave value to the debtor in exchange for such transfer or obligation."). An ordinary creditor that supplied goods or services on credit will argue that payment for such goods or services was value. See 11 U.S.C. § 548(d)(2)(A) ("'[V]alue' means property, or satisfaction or securing of a present or antecedent debt of the debtor. . . .").

Actual fraud can be difficult to prove, as it requires to trustee to prove several badges of fraud. Constructive fraud also has its hazards, as trustee must establish "less than reasonably equivalent value" and insolvency, both of which must usually be established by an expert witness. However, the so-called "ponzi-scheme presumption" – pursuant to which all transfers made in furtherance of a Ponzi scheme are presumed to have been made with fraudulent intent - may be a powerful tool for the trustee. Courts often discuss this presumption in determining creditor's good faith / for value defense.

In order to establish a presumption, the trustee must prove (1) Ponzi scheme existed and (2) that the transactions were part of the scheme. Usually, it will be difficult for an ordinary creditor to contest that the scheme existed (e.g., guilty plea by perpetrators, examiner report, etc.). An ordinary creditor will, however, dispute that his ordinary credit relationship with debtor was part of the Ponzi scheme. See Gold v. First Tennessee Bank, N.A. (In re Taneja), No. 10-01225, 2012 WL 3073175 (Bankr. E.D. Va. 2012) (refusing to apply Ponzi-scheme presumption where trustee did not establish the existence of a Ponzi scheme and, alternatively, trustee did not establish that the transferees were party to the scheme).

Generally speaking, in addition to establishing value, to obtain a finding of good faith, it must be determined whether, using an objective standard, the creditor was on inquiry notice of fraud and, if so, whether under an objective standard its investigation of the fraud was sufficient. See Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.), 397 B.R. 1, 22-23 (S.D.N.Y. 2007). In short, the Bear Stearns court had to determine "whether what Bear Stearns or should have known triggered a duty to investigate further and whether its investigation was reasonable under the circumstances." Id. at 23.

In the Bear Stearns case, Bear Stearns was broker for hedge fund that was operating a Ponzi scheme. Bear Stearns undertook some investigation, and found no "smoking gun." Court held that a reasonable fact-finder could find that Bear Stearns had made reasonably diligent inquiries and thereby preserved its defense. Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.), 397 B.R. 1 (S.D.N.Y. 2007). The jury ultimately found that Bear Stearns was in good faith, and dismissed trustee's case. Following a trial, the jury did, in fact, find that Bear Stearns had conducted itself in good faith. Gredd v. Bear Stearns Sec. Corp., 328 Fed. Appx. 709 (2009) (affirming trial court's jury change regarding good faith).

If fraudulent intent has been established, at least one bankruptcy court in the Southern District of New York held that the good faith defense may be defeated by the mere existence of a red flag putting the transferee on inquiry notice of "some infirmity in [the debtor] or the integrity of its management." In re Bayou Group, LLC, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), aff'd in part and rev'd in part, 439 B.R. 284 (S.D.N.Y. 2010). On appeal, however, the district court reversed the bankruptcy court's decision on the standard to be applied in determining good faith, finding it too broad and holding instead that "the great weight of

authority holds that [the relevant information putting a creditor on inquiry notice] is information suggesting insolvency or a fraudulent purpose in making a transfer." Bayrou Group, 439 B.R. at 314.

Assorted Case Law in the Third Circuit

1. DBSI (Bankr.D.Del. Aug. 27, 2012). The court can infer the necessary intent from the circumstances of the case, particularly the presence or absence of "badges of fraud." Lists 6 traditional badges. The court recognizes the Ponzi presumption, which posits that "all payments made by a debtor in furtherance of a Ponzi scheme are made with actual fraudulent intent." Yet, the presumption does not relieve the trustee of the burden to show that the transfers were made *in furtherance of* the Ponzi scheme. The court must focus precisely on the specific transaction or transfer sought to be avoided in order to determine whether that transaction falls within the statutory parameters of an actually fraudulent transfer. The court states this situation is identical with the World Vision case and also cites Bayou II to support its decision not to dismiss the intentional fraud claims. The court distinguishes the Sharp case.

2. SEC v. Forte, 2010 WL 939042, (E.D.Pa. Mar. 17, 2010). This case addresses Pennsylvania's intentional fraud statutory provisions regarding whether investors have to return principal in addition to profit in the context of approving a Consent Order. The court held that "the mere existence of a Ponzi scheme is sufficient to establish 'actual intent to defraud.'" The court also ruled that "good faith" is a defense and the investor must establish (1) innocence and (2) exchange of fair value. The court considers whether investors ignored "red flags" revealing the true nature of the investment so they could continue to receive profits – should the investor have known that the investment was too good to be true.

3. In re Rose, 425 B.R. 145 (Bankr.M.D.Pa. 2010). Here the court considers whether a debtor should be denied a discharge under a fraudulent transfer theory based on a Ponzi scheme. The court discusses fraudulent transfer cases and states that in fraudulent transfer cases, "many courts have applied the 'Ponzi Scheme Presumption' to support a finding of actual fraudulent intent necessary to avoid a transaction pursuant to § 548." The opinion includes cites to 5 cases.

4. In re Image Masters, 421 B.R. 164 (Bankr.E.D.Pa. 2009). In the context of a motion to dismiss, the court addressed intentional fraud claims under the Code and Pennsylvania statute. Here, a second company refinanced mortgages held by conventional mortgagees. The second mortgagee was supposed to make payments to the conventional mortgagees, who were sued by the trustee for the debtors.

The court held that the Code and Pennsylvania statute establish that a transferee who receives the transfer in exchange for value and in good faith has a defense to an action based on actual fraud. The defendants have the burden of proving that they took for value and in good faith. The court found that the defendants were not aware of the artifice and scheme of the debtors and that was no contractual relationship between the debtors and the defendants obligating debtors to make payments to the defendants. Further, nothing in the complaint

suggested that the defendants were in any way connected with the Ponzi scheme or that defendants acted with anything less than good faith. The court held, even accepting every allegation as true, that the defendants received the transfers for value and in good faith.

The court also held that a plaintiff must allege with particularity that the debtor made the transfer with actual intent to defraud a creditor, but that courts permit specific allegations of certain factors, known as badges of fraud to satisfy Rule 9(b). There are 11 badges listed. Only the insolvent badge was addressed and the court found that was insufficient to satisfy Rule 9(b). Further, regarding whether the conventional mortgagees knew or should have known about the Ponzi scheme, the court held that allegations of fraud based "on information and belief" did not satisfy Rule 9(b). Finally, the court held that the conventional mortgagees did not have a duty to investigate the debtor and that a mortgagee owes no fiduciary duty to a mortgagor. In sum, the complaint did not (1) contain factual allegations that showed the requisite intent or (2) connect defendants with the fraudulent scheme orchestrated by the debtors and its principal.

The trustee relied upon the fraudulent manner in which the debtors and their principal operated their Ponzi scheme to defraud the homeowners. The court did not agree with the proposition and instead agreed with the cases in which the court concluded that the general fraudulent intent underlying the Ponzi scheme was insufficient to establish the fraudulent transfer cause of action. Instead, a plaintiff must set forth factual allegations of fraudulent intent in connection with the specific transfer sought to be avoided and must show some direct connection between a defendant and a debtor's fraudulent Ponzi scheme.

The court in Actrade Fin'l, described a situation very similar: It is recognized that in an intentional fraudulent conveyance case the relevant inquiry is whether the transferee knew of the transferor's intent to defraud his creditors "in any way." The transferee "need not have actual knowledge of the scheme that renders the conveyance fraudulent"; constructive knowledge of a scheme to defraud will suffice. However, the trustee failed to allege with sufficient specificity facts that show that transferee was complicit with or had knowledge of an intentional scheme to defraud creditors of debtor. This is especially true when the transfer was to a third party who was neither an investor nor in any other way directly involved in the Ponzi scheme.

As the court explained at length in Balaber–Strauss: The statutes require an evaluation of the specific consideration exchanged by the debtor and the transferee in the specific transaction which the trustee seeks to avoid, and if the transfer is equivalent in value, it is not subject to avoidance under the law. Not every transaction which has the effect of "exacerbating the harm to creditors by increasing the amount of claims while diminishing the debtor's estate" is a fraudulent conveyance. Section 548 is not a catch-all provision. It allows the trustee to avoid only the transfers prescribed by the statute.

The Trustee's theory ignores the actual transaction between Debtor and defendant and the undisputed equivalence in value between the transfer and the defendant's services, and instead focuses on collateral conduct of the Debtors' management (the overall operation of the Ponzi scheme), which is extraneous to any particular transaction between Debtor and defendant. To say that defendant's transaction conferred no value on the Debtors is fiction insofar as the

particular transaction itself is concerned. Fraudulent conveyance law, under both state and federal statutes, is concerned with the reality of whether the transferee conferred equivalent value on the debtor *in the transaction sought to be avoided.* The fact that the debtor's enterprise as a totality is operated at a loss, or in a manner that is fraudulent, does not render actually or constructively fraudulent a particular transaction which in and of itself is not fraudulent in any respect.

The court recognizes that Judge Carey, when a Judge in this District, ruled that a plaintiff can rely upon the general fraudulent intent inherent in a Ponzi scheme to satisfy the "actual intent to defraud" element of an intentional fraudulent transfer. But his holding applied only when the transferee did not take the transfer in good faith and for reasonably equivalent value. See Liebersohn v. Campus Crusade for Christ, Inc. (In re C.F. Foods, L.P.), 280 B.R. 103, 111 (Bankr.E.D.Pa.2002) ("It is also reasonable, and, in this case, appropriate, to infer that, *except for transfers to a person who took in good faith and for a reasonably equivalent value* .... all other transfers made by the debtor during an on-going Ponzi scheme are part of the overall fraud.") (emphasis added). The court agreed with and endorsed the cases which expressly hold that the general fraudulent nature of the Ponzi scheme does not provide the requisite intent to support a cause of action for an actually fraudulent transfer.

5. In re Norvergence, Inc., 405 B.R. 709 (Bankr.D.N.J. 2009). Chapter 7 trustee brought an adversary proceeding against leasing companies to which debtor sold its customer contracts and asserted claims for, among others, intentional fraudulent conveyances. The court's opinion was on motions to dismiss and for more definite statement.

The Court found that an intentional fraudulent conveyance requires the establishment of two elements: (1) a transfer of an interest of the debtor in property, or any obligation incurred by debtor; and (2) with actual intent to hinder, delay, or defraud creditors. Regarding intent, the absence of any of the enumerated badges of fraud will not preclude the finding of actual fraud. The Trustee urges that there are at least four badges present: the Debtor absconded, removal or concealment of assets, the value of the consideration received by Debtor was not reasonable equivalent to the value of the asset transferred or the amount of the obligation incurred, Debtor was insolvent or became insolvent shortly after the transfer was made or the obligation incurred.

In addition to pleading sufficient badges of fraud, the Trustee also urged that intent can be shown by establishing the existence of a Ponzi or Bust-Out scheme. "Proof of a Ponzi scheme will be sufficient to establish the Ponzi operator's actual intent to hinder, delay, or defraud creditors for purposes of actual fraudulent transfers." The Trustee contends that the NorVergence business model, also characterized here as the "Salzano Scheme" resembles that of a Ponzi Scheme or Bust-Out Scheme and therefore NorVergence's intent to defraud is shown. The Trustee argues that even if the Defendants possess a good faith defense, such a defense will not stand as an appropriate challenge to the adequacy of the Trustee's claims on a motion to dismiss the Complaint under Rule 12(b)(6). The availability of the defense must be left for discovery and/or trial. An analysis addressing actual intent to defraud a creditor is driven by 12 factors, also known as the "badges of fraud," set forth in N.J.S.A. 25:2–26. Generally, the existence of one badge can cast suspicion on the transferor's intent. A finding of several in one transaction generally provides conclusive evidence of an actual intent to defraud. The movant's

opposition to Count I and II pertains to the "actual intent to hinder or defraud" elements of § 548 and N.J.S.A. 25:2–25 et seq. The Trustee's task to establish intent focuses on proving Debtor's business scheme equates to a Ponzi Scheme. Upon demonstrating successfully the Salzano Scheme qualifies as a Ponzi Scheme, the actual intent to hinder, delay, or defraud creditors will be inferred. In re Bayou Group, LLC., et al., 362 B.R. 624, 633 (Bankr.S.D.N.Y.2007) (citing numerous cases in support); In re Slatkin, 310 B.R. 740, 748; In re Cohen, 199 B.R. 709, 717 (9th Cir. BAP 1996).

A resolution to the question whether the Trustee can employ the "Ponzi scheme route" to establish the intent prong for Count I and II of the Complaint based on the facts of this case requires a finding of facts exceeding the scope of this motion. The court found that more discovery was required on this issue. The Court was satisfied that Count I and Count II of the Trustee's Complaint stated claims for relief "plausible on its face" and dismissal of Count I and Count II was denied.

6. C.F. Foods, L.P., 280 B.r. 103 (Bankr.E.D.Pa. 2002). Plaintiff has the burden of proof on all elements. Intent can be inferred based on a Ponzi scheme. Good faith and fair value are *defenses*. Numerous courts have decided that a debtor's actual intent to hinder, delay or defraud creditors may be inferred from the Debtor's active participation in a Ponzi scheme. One can infer an intent to defraud future investors from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. Knowledge to a substantial certainty constitutes intent in the eyes of the law, and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them. The Transfers at issue were charitable contributions. Although Campus Crusade was not an investor in the Ponzi scheme, *neither § 5104(a)(1) nor § 548(a)(1)(A) requires that the transfers be made to defraud the transferee, but only that they are made with actual intent to hinder, delay or defraud any creditor of the debtor* (12 Pa.C.S.A. § 5104(a)(1)) or any entity to which the debtor was or became indebted (11 U.S.C. § 548(a)(1)(A)).

The court found that it was also reasonable, and, in this case, appropriate, to infer that, except for transfers to a person who took in good faith and for a reasonably equivalent value, as described in § 5108(a) of PUFTA or in § 548(c) of the Bankruptcy Code, all other transfers made by the debtor during an on-going Ponzi scheme are part of the overall fraud. The "good faith" exceptions found in § 5108(a) of PUFTA and § 548(c) of the Bankruptcy Code are not applicable to the transfers at issue here, because, in its answer to the trustee's interrogatories, Campus Crusade admitted that the Transfers were not in return for "the delivery of goods, services or loans of money or other reasonably equivalent value delivered by [Campus Crusade] to the Debtor." Based upon the foregoing, the Transfers to Campus Crusade were made by the Debtor with actual intent to defraud creditors. The Third Circuit Court of Appeals has held consistently that the plaintiff must prove each of the elements of a constructive fraud claim brought under Bankruptcy Code § 548.

III. LITIGATION ISSUES

A. Evidentiary Issues

1. Relevant Rules of Evidence

a. FRE 602 – Lack of Personal Knowledge

A witness may not testify to a matter unless evidence is introduced sufficient to support a finding that the witness has personal knowledge of the matter. Evidence to prove personal knowledge may, but need not, consist of the witness' own testimony. This rule is subject to the provisions of rule 703, relating to opinion testimony by expert witnesses.

b. FRE 703 – Bases of Opinion Testimony by Experts

The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.

c. FRE 705 – Disclosure of Facts or Data Underlying Expert Opinion

The expert may testify in terms of opinion or inference and give reasons therefor without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination.

d. FRE 901 – Authenticating Documents

(a) General provision.—The requirement of authentication or identification as a condition precedent to admissibility is satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims.

e. FRE 1002 - Requirement of Original

To prove the content of a writing, recording, or photograph, the original writing, recording, or photograph is required, except as otherwise provided in these rules or by Act of Congress.

f. FRE 1003 – Admissibility of Duplicates

A duplicate is admissible to the same extent as an original unless (1) a genuine question is raised as to the authenticity of the original or (2) in the circumstances it would be unfair to admit the duplicate in lieu of the original.

g. FRE 1004 – Admissibility of Other Evidence

The original is not required, and other evidence of the contents of a writing, recording, or photograph is admissible if—
(1) Originals lost or destroyed.—All originals are lost or have been destroyed, unless the proponent lost or destroyed them in bad faith; or
(2) Original not obtainable.—No original can be obtained by any available judicial process or procedure; or
(3) Original in possession of opponent.—At a time when an original was under the control of the party against whom offered, that party was put on notice, by the pleadings or otherwise, that the contents would be a subject of proof at the hearing, and that party does not produce the original at the hearing;
or
(4) Collateral matters.—The writing, recording, or photograph is not closely related to a controlling issue.

2. Evidentiary Issues That May Arise in a Ponzi Case

When a debtor that has been orchestrating a Ponzi scheme files bankruptcy, a host of evidentiary issues arise. The vast majority of these issues are related to foundation issues and the authenticity of certain of the debtor's documents, especially its books and records. Because the perpetrator of the Ponzi scheme is usually facing criminal charges (or is already in jail), the person with the best knowledge of the debtor's business is likely to be unavailable to testify as a witness. Even if the perpetrator is available to testify, he/she would likely refuse to do so, either by being generally uncooperative or by invoking the protections of the Fifth Amendment.

Assuming the Ponzi scheme had been uncovered prior to the bankruptcy, a chapter 11 trustee is likely to be appointed very early in the case. If the Ponzi scheme had not yet been discovered, the committee or other parties in interest will likely quickly discover that something is amiss and will seek the appointment of an examiner or a chapter 11 trustee. Under either scenario, the debtor will be under new management, and the trustee will likely come in and terminate any insiders who may have knowledge of the Ponzi scheme. Because the persons most knowledgeable about the debtor's financial situation will have been replaced, the trustee is likely to rely heavily on his professionals to manage the debtor's operations and maintain its books and records.

Of course, any successful Ponzi scheme relies on misinformation and deception. That deception most often arises in connection with the maintenance of the Debtor's books and records. Often, the perpetrator of the Ponzi scheme is the only person with knowledge of the debtor's true books and records, and other times the books and records are intentionally so misleading and complex that a snapshot of the debtor's books at any given time is impossible.

Typically, the trustee's professionals will need to recreate the debtor's records by using complex accounting principles that rely on scattered information within the debtor's records as well as certain information that can be obtained from third parties, such as bank account statements.

When the trustee needs to prove certain information about the debtor's books and records to satisfy its burden of proof—proving the debtor's insolvency for example—the trustee has several options. All of these options, however, are likely to face scrutiny under the Federal Rules of Evidence.

First, the trustee can offer information from the debtor's actual books and records. To do so, however, the trustee will need a witness with personal knowledge to testify as to the documents authenticity under FRE 602. Unless the trustee has been personally involved in the maintenance and creation of those records, however, the trustee will not possess the requisite personal knowledge to attest to their authenticity. Moreover, because the trustee has likely terminated any employees of the debtor who may be able to verify the authenticity of the documents, those employees likely will not agree to testify for the trustee willingly. Even if they were subpoenaed to testify, their knowledge of, and possible role in, the Ponzi scheme could cause them to, at a minimum, be subject to cross-examination by character evidence, or, even worse, to assert their Fifth Amendment rights. Similarly, the perpetrator of the Ponzi scheme, who would surely have the necessary personal knowledge will make for a very poor witness.

Second, assuming the trustee is unable to offer someone with personal knowledge to verify the debtor's documents, the trustee would likely try to have the documents admitted through the use of expert testimony. Although FRE 703 permits an expert to base his or her opinion on inadmissible evidence, if the trustee has no other evidence but the testimony of his hired expert, he will likely be unable to satisfy his burden of proof. See the discussions in Barber and Fisher below.

Third, if the trustee is unable to offer a witness with personal knowledge of the debtor's documents (or if no relevant documents exist), the trustee will be forced to offer recreated books and records as proof. FRE 1004 permits the use of other evidence of a writing in certain situations. If the records do not exist, or were destroyed prior to the trustee's appointment, the trustee may be able to offer third-party records and forensic accounting documents as evidence of the original books and records. Once again, this testimony will almost always require the use of expert testimony. Depending on the methods utilized by the expert in recreating the books and records, the expert's testimony could be subject to a Daubert challenge. Even if the testimony survives such a challenge (or is admitted without objection), the court will ultimately determine the weight to be afforded to the expert's testimony. If the expert did not take steps to independently verify or sample the evidence used in reaching the expert's conclusions, the court may assign little weight to the testimony and ultimately decide that the trustee failed to satisfy the requisite burden of proof.

3. Applicable Cases

a. Brinco v. Rio Props., Inc. (In re Nat'l Consumer Mortg., LLC), Case No. 10–cv–00930, 2011 WL 1300540 (D. Nev. 2011).

Plaintiff, chapter 11 trustee, filed adversary complaint against defendant casino as subsequent transferee of a fraudulent transfer allegedly made by debtor to a Ponzi scheme operator (a relative of the Debtor's owners), who used the proceeds to gamble at the casino. Casino filed a motion for sanctions for spoliation of evidence, alleging that the trustee allowed all of the Debtor's business records to be destroyed. Given the alleged importance of the lost evidence to Defendant's case, it also sought dismissal of the adversary or, in the alternative, an adverse instruction to the jury.

Plaintiff testified at his deposition that, upon the trustee's appointment, one of the Debtors' employees, Martinez, destroyed most of the Debtor's relevant records. The Trustee produced his "reconstructed financial records" based on incomplete third-party records in support of his case. Defendant alleges that the destroyed records were key to its defense against the Trustee's *prima facie* case on important issues such as the solvency of the Debtor, the initial transferee's role at the Debtor, and his intent (or lack thereof) to defraud creditors of the Debtor.

Trustee responded that the Debtor's records were scant when he took over and that Debtor's counsel had previously issues a litigation hold and seized the available records. While Martinez may have deleted some audio and surveillance files on his computer, the trustee was not sure when he did so and terminated Martinez within hours of learning that he may be an insider.

Ultimately, the Court found that Defendant did not provide sufficient evidence to warrant the imposition of sanctions against the Plaintiff trustee. Given the steps taken by Debtor's bankruptcy counsel to take control over the Debtor's financial records prior to the Petition Date, and the trustee's swift action in removing insiders and reinforcing the litigation hold, the Court determined that even if Martinez did destroy some of the Debtor's records, those records were unlikely to be relevant to the present dispute.

b. Fisher v. Sellas (In re Lake States Commodities, Inc.), 272 B.R. 233 (Bankr. N.D. Ill. 2002)

Plaintiff, chapter 7 trustee sued an investor in a Ponzi scheme to recover an alleged fraudulent conveyance. Trustee retained KPMG Peat Marwick, LLP to provide accounting services on behalf of the estates. At trial, the trustee offered three means of evidence: (i) his testimony, (ii) four documents, and (iii) expert testimony and the expert's report. The defendant challenged the admissibility of all three types of evidence.

First, the Court sustained the Defendant's challenge to the trustee's testimony regarding the debtors' business operations, finding that the trustee did not have personal knowledge. Second, the trustee tried to introduce a report prepared by KPMG and certain business records of the Debtors. The business records were sent directly to KPMG for analysis and the trustee was not involved in the preparation or maintenance of the business records, so the Court refused to admit the testimony under FRE 602 because the trustee lacked personal knowledge. Third, the trustee introduced an expert report and testimony in an effort to establish that the Debtors were insolvent and running a Ponzi scheme. The expert formed his opinion

based on a review of the KPMG Report and the business records, but he did not speak to any of the Debtors former employees. The Defendants did not challenge the admissibility of the report, but they did make a hearsay objection to the KPMG Report.

The trustee also initially planned to introduce the federal indictment of the orchestrator of the Ponzi scheme, Edward Collins, along with a copy of the criminal case docket. Presumably, he intended to use these documents to establish Collins's unavailability to lay the foundation for the business records. After the Defendants argued that the plaintiff should have supplemented his discovery responses with relevant documents used by the government in the criminal case, however, he withdrew his efforts to seek admission of these documents.

After the close of the trustee's case, Defendants moved for judgment on partial findings pursuant to Bankruptcy Rule 7052(c). Because the trustee had the burden of proof and all other evidence had been excluded, the Court turned to the issue of what weight to give the expert report and testimony. Because no other evidence had been admitted into the record, the Court ascribed no weight to the expert report. "If there are no facts in evidence, it is difficult to discern how an expert can assist the trier of fact." Id. at 244. Moreover, the Court also ascribed no weight to the expert report because (a) he did not perform a statistical sampling of the information on which he relied, (b) he did not interview anyone with personal knowledge of the business records on which he relied, and (c) he did not perform a forensic analysis with respect to the debtors' solvency. The Court acknowledged that had the Defendants raised a Daubert challenge, he might have excluded the expert testimony as well.

The bankruptcy court's decision was affirmed on appeal to the District Court in Fisher v. Page, 2002 WL 31749262 (N.D. Ill. 2002).

c. Barber v. Production Credit Servs. of W. Cent. Ill. (In re KZK Livestock, Inc.), 290 B.R. 622 (Bankr. C.D. Ill. 2002).

Mr. Knowles, Debtor's sole shareholder and director was operating a check kite. Prior to bankruptcy Debtor repaid a loan Knowles had with Defendant. Trustee sought to avoid the payment as a fraudulent transfer. After a series of prior rulings, the only remaining issue was whether the Debtor was insolvent at the time of the transfer. Both parties cross-moved for summary judgment.

The Trustee relied on affidavits of two experts, a retired FBI agent specializing in financial crimes and a CPA, as well as the deposition of one of Defendant's employees. The CPA, Neil Gerber, attempted to establish that the Debtor became insolvent prior to the transfer at issue and never became solvent again. This method of proving insolvency has been labeled "retrojection" by the courts.

The Defendant challenged the introduction of Gerber's testimony under Daubert, but the bankruptcy court permitted it, finding that the alleged shortcomings in the methodology may affect the weight attributed to it at trial. The Defendant also challenged Gerber's failure to meet with the Trustee or any of the Debtor's employees or examine certain corporate documents.

Ultimately, the Court found that the problem with Gerber's opinion was not the methods he used in arriving at his opinion but rather a lack of foundation for his analysis. This lack of foundation was largely attributable to the Debtor's failure to keep proper records. While the Court acknowledged that the Trustee did "the best he could with what he had," ultimately, the Trustee was unable to satisfy his burden of proof that the Debtor was insolvent at the time of the transfer.

B. **In Pari Delicto**

"It is well settled that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself." Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) (citing, inter alia, Caplan v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972)). However, a bankruptcy trustee also lacks standing to sue third parties where the debtor itself participated in the fraud.

In pari delicto comes from a longer Latin phrase: "In pari delicto potior est condition defendentis" In English: Where the wrong of both parties is equal, the defendant's position is stronger. This is an equitable defense, where plaintiff is prohibited from maintaining a claim where he bears fault for injury. In other words, a participant in the fraud cannot claim to be a victim of its own fraud. "A plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim." Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 354 (3d Cir. 2001).

This arises in tort claims, claims of violations of state partnership laws, claims of breach of fiduciary duty, and professional negligence claims.

- Lancelot Investors Fund (Petters Fraud)
  - Winston & Strawn: Peterson v. Winston & Strawn, LLP, 2012 U.S. Dist. LEXIS 147653 (N.D. Ill. Oct. 10, 2012) – bankruptcy of two hedge funds
  - auditors: Peterson v. McGladrey & Pullen, LLP, 676 F.3d 594 (2012) (Easterbrook, J.)
- Madoff
  - Judge McMahon: Picard v. JPMorgan Chase & Co., 460 B.R. 84, 92-83 (S.D.N.Y. 2011) ("Here, in pari delicto would preclude Madoff from recovering against Defendants, and, under general principles of agency law, his wrongdoing as BMIS's [the debtor] agent is imputed to BMIS itself. The acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their principals. The result is that (1) BMIS could not have sued Defendants for the alleged scheme, and (2) the Trustee—standing the shoes of BMIS—cannot do so either. Because management's misconduct is imputed to the corporation, and because a trustee stands in the shoes of the corporation, the Wagoner rule bars a trustee from suing to recover for a wrong that he himself essentially took part in."(citations, internal quotation marks, and alterations omitted)).

- Judge Rakoff: Picard v. HSBC Bank PLC, 454 B.R. 25, 37 (S.D.N.Y. 2011) ("Here, given that the Trustee's own complaint is replete with allegations of Madoff's role as the "mastermind[ ]" of the fraud, see, e.g., Am. Compl. ¶ 1, the Wagoner rule bars the Trustee as "successor in interest" to Madoff and Madoff Securities, from bringing common law fraud claims. Thus, the Trustee has no standing to pursue on behalf of the estate his common law claims against the HSBC Defendants and the UCG/PAI Defendants."

A dismissal of bankruptcy trustee's claims based on in pari delicto does not prevent investors from suing these third parties. See, e.g., MLSMK v. JP Morgan Chase & Co., 431 F. App'x 17 (2d Cir. 2011) (individual customers suing bank in connection with Madoff fraud). Avoidance actions not barred by in pari delicto. McNamara v. PFS (The Personal & Business Ins. Agency), 334 F.3d 239 (2003). In re The Pers. & Bus. Ins. Agency, 334 F.3d 239, 245-46 (3d Cir. 2003) (holding in pari delicto inapplicable to actions brought under § 548 of Bankruptcy Code because § 548 does not contain limiting language of § 541

C. **11 U.S.C. § 546(e)**

Section 546(e) of the Code is what has been called the "Stockbroker Safe Harbor". In enacting 546(e) Congress sought to reduce the ripple effect that a bankruptcy can cause in the securities market.

It provides, in pertinent part, that "the trustee may *not* avoid a transfer that is a . . . settlement payment . . . made by or to . . . a . . . stockbroker." In other words, the trustee may not be able to claw back a payment made by the debtor prior to bankruptcy if the payment was made to a stockbroker, or if the debtor itself *is* a stockbroker. "Stockbroker" and "settlement payment" are the operative terms of this provision. The Code's definition of "stockbroker" requires that one be "engaged in the business of effecting transactions in securities," and that one have a "customer" as defined by § 741(2). As for "settlement payment," the stockbroker safe harbor provision incorporates § 741(8)'s definition: "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

The stockbroker safe harbor provision, however, does not apply to *all* settlement payments made by or to a stockbroker. In fact, the provision explicitly excludes from its purview avoidance actions brought under § 548(a)(1)(A). That section allows the trustee to avoid transfers made "with actual intent to . . . defraud" in other words, fraudulent transfers.

But § 548(a)(1)(A)—the section to which the stockbroker safe harbor does not apply—is limited. Under that section the trustee may avoid only those fraudulent transfers made less than two years before the bankruptcy filing. This two-year "lookback period" is relatively short. To avoid earlier fraudulent transfers, trustees often bring § 544(b)(1) actions. Section 544(b)(1) allows the "trustee [to] . . . avoid any transfer . . . voidable under applicable [state] law." Generally, state fraudulent-transfer laws' lookback periods exceed § 548(a)(1)(A)'s two years. Although the stockbroker safe harbor explicitly excludes from its purview avoidance actions brought under § 548(a)(1)(A), the safe harbor does not comparably exclude actions

brought under § 544(b)(1). That is to say, while the trustee can use § 548(a)(1)(A) to avoid fraudulent transfers made less than two years before the bankruptcy filing, the stockbroker safe harbor prevents the trustee from using § 544(b)(1) to avoid fraudulent transfers made more than two years before the bankruptcy filing.

At first glance, it might appear that the stockbroker safe harbor would not shelter transfers from a brokerage firm that operated a Ponzi scheme before bankruptcy. After all, under the Ponzi scheme presumption, a court would presume that the firm made transfers "with actual intent to . . . defraud," which would enable the trustee to avoid them under § 548(a)(1)(A)81—the section to which the stockbroker safe harbor provision explicitly does not apply. Though Congress wanted to minimize systemic risk in the securities market, it recognized the competing need to remedy fraud. But Congress did not go far enough. The stockbroker safe harbor provision exempts from its purview only § 548(a)(1)(A) avoidance actions, which are limited to transfers made less than two years before the bankruptcy filing. As such, the stockbroker safe harbor prevents avoidance of—or, to state it positively, protects—fraudulent transfers that the trustee seeks to avoid under § 544(b)(1), which incorporates state laws' longer lookback periods. Specifically, the safe harbor can shelter false profits that a Ponzi scheme distributed more than two years before it filed for bankruptcy. This inevitably leads to inequity. The trustee's avoidance actions cannot reach those who invested early enough to be paid false profits more than two years before the scheme collapsed. These early investors retain their "profits" at the expense of the many net losers who—because they invested later—recover less than their principals from the Ponzi scheme's insufficient estate. Though enacted for the commendable purpose of reducing systemic risk in the securities market, the stockbroker safe harbor produces this unintended and undesirable result.

Recognizing the inequity that results from the protection of certain Ponzi scheme transfers, courts have attempted to exclude all Ponzi scheme transfers from the protection of the stockbroker safe harbor. However, each of the attempted methods proves inadequate.

1. Textualist Approaches To Narrow the Stockbroker Safe Harbor. — Since the stockbroker safe harbor provision shelters (i) "settlement payments" between a (ii) "stockbroker" and (iii) "customer," some courts have narrowly interpreted each of these three terms to exclude Ponzi scheme transfers from the safe harbor's protection.

a. A Narrow Reading of the Term "Settlement Payment." — In In re Grafton Partners, 321 B.R. 527 (9th Cir. BAP 2005) the Ninth Circuit Bankruptcy Appellate Panel excluded Ponzi scheme transfers from the protection of the stockbroker safe harbor by narrowly interpreting the term "settlement payment." In that case, the trustee assigned to liquidate the estate of a firm that had operated a Ponzi scheme brought an avoidance action to claw back some of the money that the firm had paid to an investor that ultimately withdrew almost all of its investment before the scheme collapsed. The investor, a trust company that provided fiduciary services to clients, argued that these payments were settlement payments, and that the stockbroker safe harbor protected them from avoidance. The court disagreed.

The stockbroker safe harbor provision incorporates § 741(8)'s definition of "settlement payment": "a preliminary settlement payment, a partial settlement payment, an

interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The Grafton court noted the circularity of this definition, which uses the term "settlement payment" five times. The court avoided this circularity by reading the phrase "commonly used in the securities trade" to modify *all* of the preceding terms and not just the immediate antecedent, "any other similar payment." In other words, the court read the definition such that common usage in the securities trade became a necessary condition of a "settlement payment." Recognizing that fraudulent transactions are not *commonly used* in the securities trade, the court held that Ponzi scheme transfers do not qualify as "settlement payments." In support of this reading of § 741(8), the Grafton court cited other cases. It stated that "[a]lthough the rhetoric of decisions describes the § 741(8) definition of 'settlement payment' as being 'broad' or 'extremely broad,' reality is different . . . [in that] decisions that actually have found protected settlement payments to exist have involved publicly traded securities in public markets in which an intermediary played a role." For the Grafton court, this apparent pattern in the case law confirmed that "settlement payment" should be interpreted to apply only to transactions common in the securities trade.

But the Grafton court's interpretation of "settlement payment" is not compelled. In fact, the Grafton court's textualist analysis is arguably flawed, as evidenced by the Second Circuit's reasoning in Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011) a more recent case that reached a different result. Indeed, a comparison of the courts' textualist analyses is revealing despite the cases' factual differences, the most notable of which is that the debtor in Enron did not operate a Ponzi scheme prior to bankruptcy. In Enron, the trustee brought an avoidance action not to claw back fraudulent profits, but to recover payments the debtor had made to redeem its commercial paper prior to maturity. The recipients of these payments were financial institutions that argued that the stock- broker safe harbor shielded the payments from avoidance. The Second Circuit agreed.

Like the Grafton court, the Second Circuit noted the circularity of § 741(8)'s definition of "settlement payment." Because establishing the limits of that definition presented an issue of first impression in the Second Circuit, the court looked to other circuits. It, like the Grafton court, noted that the rhetoric of the cases favored a broad interpretation of the definition. However, unlike the Grafton court, the Second Circuit determined that this rhetoric captured reality. In fact, without referencing Grafton or any Ninth Circuit decision, the Second Circuit stated that "[s]everal circuits . . . have *rejected* limitations on the definition that would exclude transactions in privately held securities or transactions that do not involve financial intermediaries"—the precise limitations the Grafton court *embraced.* Looking at the text of § 741(8), the Second Circuit held that the grammatical structure indicates that the phrase "commonly used in the securities trade" modifies only the immediately preceding term. The court relied on the "rule of the last antecedent," under which a phrase limits only its immediate antecedent. Since no comma separates the phrase "commonly used in the securities trade" from the antecedent terms, the court found that the "rule of the last antecedent" applied rather than a corollary rule under which a modifier separated from an antecedent series by a comma modifies each antecedent in the series. Based on this statutory construction and the apparent agreement among other circuits, the Second Circuit concluded that the modifier "commonly used in the securities trade" does not *limit* the definition of "settlement payment," but rather makes the final

term in the definition's series a residual one, underscoring the breadth of the stockbroker safe harbor.

Because the Enron court's textual analysis is based on a well-settled rule of statutory construction, it is more defensible than the Grafton court's competing textual analysis, which enjoys no such support. And although Enron did not involve a Ponzi scheme, the Second Circuit's interpretation of the Code's definition of "settlement payment" binds courts in the circuit, even in cases involving Ponzi schemes. Indeed, a New York district court presiding over the Madoff bankruptcy cited Enron in holding that the stockbroker safe harbor protected Ponzi scheme transfers. Thus, courts in the Second Circuit, and other courts that— defensibly— interpret the definition of "settlement payment" under the "rule of the last antecedent," need a different strategy to exclude Ponzi scheme transfers from the stockbroker safe harbor.

b. A Narrow Reading of the Term "Customer." — In Wider v. Wootton, 907 F.2d 570 (5th Cir. 1990), the Fifth Circuit excluded Ponzi scheme transfers from the stockbroker safe harbor's protection by narrowly interpreting the term "customer." In that case, an investment advisor operated an unusual Ponzi scheme. Typically, Ponzi scheme operators collect deposits from investors and purport to use this reservoir of deposits to purchase securities for these investors. But in Wider, the investors did not provide the operator a reservoir of cash from which to "purchase" securities; instead, an investor selected in advance the securities he wanted the operator to purchase and did not pay until the operator sent a (fabricated) slip confirming that the securities had been "purchased." After the scheme collapsed, the trustee assigned to liquidate the estate brought an avoidance action to claw back "proceeds" paid to an investor as the result of a fabricated securities transaction. The investor argued that, because he was the customer of a stockbroker, the stockbroker safe harbor sheltered these payments from avoidance. The court disagreed.

To be a "stockbroker" under the Code, one must, among other things, have a "customer" as defined by § 741(2). That section offers two alternative definitions of "customer." The first refers to an "entity . . . that has a claim against [a] person on account of a security received, acquired, or held by such person in the *ordinary course of such person's business*." The second refers to an "entity that has a claim against a person arising out of . . . a deposit . . . with [a] person *for the purpose of purchasing* . . . a security." The Wider court narrowly interpreted the first definition of "customer" to exclude Ponzi scheme investors. The court reasoned that Ponzi scheme operators do not receive, acquire, or hold securities in the *ordinary course* of business, as required by that definition, because the "business" of a Ponzi scheme is not to actually trade in securities but to fraudulently appear to do so. Additionally, the court held that the second definition of "customer" did not apply to the facts of Wider. That definition requires one to place with the stockbroker a deposit *for the purpose of purchasing* a security, which implies that the deposit must be placed *before* the security is purchased. In Wider, the Ponzi scheme's clients paid the operator *after* receiving (fabricated) confirmation of "transactions." If most Ponzi schemes operated like the one in Wider, the second definition of "customer" would be inapplicable and a narrow reading of the first definition would successfully exclude Ponzi scheme investors from "customer" status. But, as the Ninth Circuit noted in a later case, the facts of Wider are exceptional: In the case of *most* Ponzi schemes, investors deposit cash in advance for the purpose of purchasing a security. Thus, the second definition of "customer" will apply to

most Ponzi scheme investors, and the Wider court's narrow reading of the first definition will be of little use to courts seeking to exclude Ponzi scheme transfers from the stockbroker safe harbor. The Wider approach, in other words, is inadequate.

c. A Narrow Reading of the Term "Stockbroker." — In In re Slatkin, 525 F.3d 805 (9th Cir. 2008), the Ninth Circuit excluded Ponzi scheme transfers from the protection of the stockbroker safe harbor by narrowly interpreting the term "stockbroker." In that case, an investment advisor who was not a licensed broker-dealer purported to rely on licensed broker-dealers to execute transactions for his clients. In reality, he transferred hardly any investments to licensed broker-dealers and instead operated a Ponzi scheme. The bankruptcy trustee brought an avoidance action to claw back false profits that the operator had paid to net winners, who argued that the stockbroker safe harbor sheltered these transfers because the operator had been a stockbroker. The court disagreed.

The Code's definition of "stockbroker," in addition to requiring that one have a customer, requires that one be "engaged in the business of *effecting* transactions in securities." Citing Black's Law Dictionary's definition of "effecting," the Slatkin court interpreted the Code's definition of "stockbroker" to require that one be "in the business of making securities transactions happen." In Slatkin, most of the securities transactions that the investment advisor claimed to have effected were fictitious, but even the few transactions that actually occurred were not effected by the investment advisor. Since he was not a licensed broker-dealer, he transferred investments along to other people who made these securities transactions happen. The Slatkin court, however, limited the applicability of its holding. While ruling that this particular investment advisor was not in the business of making securities transactions happen, the court approvingly cited a case in which the Sixth Circuit held that a firm *was* "engaged in the business of effecting transactions in securities" *despite* the fact that the firm relied on other broker-dealers to conduct some of its transactions. In other words, as long as a firm conducts *some* of its own transactions, reliance on broker-dealers for other transactions will not preclude the firm from "stockbroker" status under Slatkin's reasoning. The investment advisor in Slatkin did not conduct any of his own transactions, but Slatkin was an unusual case. Many Ponzi scheme operators are licensed broker-dealers who actually do effect *some* securities transactions (even if the bulk of the transactions they claim to effect are fictitious). Under the Slatkin approach, those operators—such as Madoff—will generally qualify as "stockbrokers," making their transfers eligible for the stockbroker safe harbor's protection. This fact makes the Slatkin approach inadequate.

2. Intentionalist Approach To Narrow the Stockbroker Safe Harbor. — The textualist methods of narrowing the stockbroker safe harbor encounter a number of obstacles. But a statute's text does not always provide a complete answer. Parties sometimes argue that a particular application of a statute is contrary to Congress's intent in enacting the statute. This argument can prompt a court to attempt to discern that congressional intent. The statute's text is the best indicator of congressional intent, and if the text reveals such intent, the inquiry ends. But if a court cannot discern congressional intent from the text, the court may consider extra-textual materials, such as legislative history. Once the court discerns congressional intent, the court may apply the statute in a way that serves that intent, even if such an application strays from the statute's text.

Some bankruptcy courts have argued—though only in dicta—that sheltering Ponzi scheme transfers with the stockbroker safe harbor provision is contrary to Congress's intent in enacting the provision, even if allowed by its text. These courts have resorted to the legislative history, which explains that the stockbroker safe harbor was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." According to this intentionalist argument, the goal of minimizing displacement in the securities market has nothing to do with sheltering Ponzi scheme transfers, and so the stockbroker safe harbor should not be read to protect such transfers.

However, district courts reviewing the decisions of bankruptcy courts have rejected this intentionalist argument for two reasons. First, some higher courts argue that Congress's intent in enacting the stockbroker safe harbor can be discerned from the statutory text alone, making extratextual considerations unnecessary. In one of the Madoff cases (Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011), a New York district court (reviewing a bankruptcy court's decision) used this argument to reject the bankruptcy trustee's invocation of the legislative history. The district court disapproved of resorting to legislative history because the court found the statutory text to be clear and controlling. Recognizing that "to deviate from what Congress has clearly and constitutionally decreed is a power the judiciary does not possess," the court concluded that there was "neither a need nor a basis" to consider the legislative history of the stockbroker safe harbor.

A second objection to the intentionalist argument concedes that Congress intended the stockbroker safe harbor to minimize displacement in the securities market (as indicated by the legislative history), but concludes that this intent can be served by protecting certain Ponzi scheme transfers. Congress intended the stockbroker safe harbor to shelter transfers from Ponzi schemes—the argument goes—if doing so would minimize displacement in the securities market. In the Madoff case, the New York district court raised this objection in addition to the one discussed above. The bankruptcy trustee had argued that, because avoiding BLMIS's transfers would not cause displacement in the securities market, the stockbroker safe harbor should not protect those transfers. The district court conceded for the sake of argument that the stockbroker safe harbor was intended to minimize displacement in the securities market, but reasoned that avoidance of BLMIS's transfers *could* cause such displacement. Indeed, the trustee's own complaint alleged that Madoff's scheme involved approximately sixty-eight billion dollars and forty-nine hundred customers, so the court found "'*no* reason to think that undoing' such large transfers involving so many customers from so long ago as 2002 'would *not* . . . have a substantial . . . negative effect on the financial markets.'" To the contrary, the court supposed that avoidance actions of such magnitude would cause displacement in the market.

The Eighth Circuit has taken a similar position. See Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009). That court responded as follows to the contention that a particular application of the stockbroker safe harbor was contrary to congressional intent:

> [B]ecause so much money [$26.5 million] is at stake, we question [plaintiff's] assertion that the reversal of the payments—at least a portion of which were probably reinvested—would in no way impact the nation's financial markets. At

the very least, we can see how Congress might have believed undoing similar transactions *could* impact those markets, and why Congress might have thought it prudent to extend protection to payments such as these.

Thus, this intentionalist approach, like its textualist counterparts, is inadequate. In conclusion, while courts have attempted various strategies— both textualist and intentionalist— to exclude Ponzi scheme transfers from the protection of the stockbroker safe harbor, each strategy is inadequate.

D. 11 U.S.C. § 550 Issues

Topic: Initial Transferee Defenses

- Contractual obligation to pass along monies
    - Multiple tests employed by Ct. but problem arises with Ponzi Schemes
- Broker v. Financing Institution
    - Issue typically looks to relationship or past relationship
        - Dominion & Control or Mere Conduit
        - Following basic assumption as in schemes to reduce debt
    - Reconciliation difficulties
        - Just because a broker may not be a mere conduit doesn't mean that it would lack the dominion and control over funds
        - Mere conduit relies heavily on third parties but in broker cases money may not be passed along
        - Problems with what satisfies control
    - Cases
        - In re Derivium Capital, LLC, 437 B.R. 798 (2010)
        - In re Manhattan Inv. Fund Ltd., 397 B.R. 1 (2007)
        - Bonded Financial Services, Inc. v.European American Bank, 838 F.2d 890 (7th Cir. 1998)

        - In re Lancelot Investors Fund, L.P., 08 B 28225, 2012 WL 718631 (Bankr. N.D. Ill. Mar. 2, 2012)
        - Brian A. Abramson & Kyung S. Lee, Hurdles Trustees Face in Asserting Fraudulent-Transfer Claims Against Brokers in Short-Sales, Am. Bankr. Inst. J., February 2010, at 50

- Ethics topics Ponzi
    - Section 550 extended to trustees looking to recover from spouses
        - Good faith implicit in transfers?
        - Ruth Madoff or even Kimberly Rothstein two examples