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# Overcoming Administrative, Procedural and Evidentiary Hurdles in Ponzi Scheme Litigation

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## ARTICLE

# OVERCOMING ADMINISTRATIVE, PROCEDURAL AND EVIDENTIARY HURDLES IN PONZI SCHEME LITIGATION

*SHARON Z. WEISS & NATALIE B. DAGHBANDAN\**

### INTRODUCTION

The unfortunate reality that comes with a Ponzi scheme case in bankruptcy is a mass of deceived unsecured creditors clamoring for their money back, and few, if any, present assets within the bankruptcy estate with which to pay them. The sheer size of most Ponzi schemes cases necessarily presents unique evidentiary, procedural and administrative challenges to professionals seeking to sort out the failed Ponzi enterprise. Ponzi scheme cases are riddled with litigation, which generally falls into four categories: (1) litigation against the Ponzi scheme operator(s), (2) litigation against parties who enabled the scheme to continue (such as professionals), (3) litigation to recover assets (such as legitimate accounts receivable or proceeds from the sale of property), and (4) avoidance actions against those who received property from the Ponzi scheme. This fourth category (and sometimes the third) may involve hundreds of defendants, who may be located throughout the country (or even the world).

This Article provides strategic suggestions and practical applications for Ponzi scheme litigation, including filing a procedures motion, seeking substantive or administrative consolidation, and utilizing and overcoming evidentiary hurdles.

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## I. AVAILABILITY OF PROCEDURE ORDERS

When confronting a Ponzi scheme case in bankruptcy, counsel may petition the court for an order modifying the time otherwise applicable to various procedural requirements. This petition will likely appeal to the reason of those professionals involved, due to the immense volume of adversary proceedings likely to arise in a Ponzi environment. Ponzi schemes typically give rise to extensive avoiding power actions.<sup>1</sup> The premise underlying all avoiding power litigation, namely advancing the Bankruptcy Code's goal of equality of distribution among those who lose money when debtors fail, has a particularly pronounced meaning when the debtor is (or operates) a Ponzi scheme.

Although all investors and creditors may be victims, the havoc wrought by a Ponzi scheme often falls disproportionately on some. The trustee thus has, and is obliged to pursue, significant recovery claims (e.g., avoidance claims) that if taken to judgment and recovery, could greatly "balance" the ultimate recoveries out of the Ponzi scheme among investors (including investor-transferees), *inter se*. This litigation would, however, also be expensive, time-consuming and likely frustrating for investors, other creditors and perhaps even the court.

## A. MODIFYING TIME FOR PROCEDURAL REQUIREMENTS

A motion seeking to modify procedures in bankruptcy ("Procedures Motion") is designed to ameliorate the problems identified above, to the extent possible. The Procedures Motion seeks to streamline the litigation process by modifying, and in some respects eliminating, the need for individualized review of every case management issue that arises, such as extending pleading deadlines, effectuating continuances and making discovery more efficient.

Section 105(a) of Title 11 of the United States Code ("Bankruptcy Code") provides authority for the Procedures Motion.<sup>2</sup> It provides in pertinent part: "The court may issue any order, process . . . that is necessary or appropriate to carry out the provisions of this title."<sup>3</sup>

Accordingly, a party requests—through a Procedures Motion—entry of an order modifying certain procedures governing adversary proceedings, including, *inter alia*, summons issuance, response dates, calendaring, status conference hearings, discovery, certain motion

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<sup>1</sup> See *Janvey v. Alguire*, 647 F.3d 585, 598-99 (5th Cir. 2011); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589 (9th Cir. 1991).

<sup>2</sup> 11 U.S.C.A. § 105 (Westlaw 2012).

<sup>3</sup> *Id.*

practices and settlement or abandonment of avoidance claims. Due to the large number of adversary proceedings commenced against multitudes of defendants in a typical Ponzi scheme in bankruptcy, the movant will argue that some of the informal and formal local practices should be modified to ease the paper and logistical burdens on the court and all parties in interest. The proposed modified procedures suggested below provide a more systematic and efficient manner of managing the case load and ensuring that no party in interest will be excluded, inadvertently or otherwise, from receiving notice of any potentially dispositive action in the adversary proceedings.

### 1. *Summons Issuance*

In the author's experience, the Clerk of the Court normally issues a summons within two days from the filing of a complaint. Once the summons is issued, the Plaintiff is required to serve it, which places statutory and local rule time pressures on the Plaintiff.<sup>4</sup> Rule 4(m) of the Federal Rules of Civil Procedure,<sup>5</sup> made applicable by Federal Rules of Bankruptcy Procedure ("Bankruptcy Rule") 7004,<sup>6</sup> allows a plaintiff 120 days from the filing of a complaint to serve a summons (which time may be expanded for good cause).<sup>7</sup> The movant may request that his or her counsel be permitted to insert in the summonses submitted to the court an issuance date up to sixty days in the future so the complaints can be grouped and served in sub-groups. Extending the issuance dates of the summonses will not only allow the movant's counsel sufficient time to prepare for service of the complaints on all the defendants, but it will also obviate the potential for having the court's staff issue dozens of alias summonses.

### 2. *Early Meeting of Counsel*

Federal Rules of Civil Procedure 26(a)(1) and (f),<sup>8</sup> made applicable by Bankruptcy Rule 7026,<sup>9</sup> govern initial disclosures and meeting requirements. Through a Procedures Motion, the movant may request to be excused from these requirements. In light of the large number of defendants in the looming adversary proceedings, which may be located

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<sup>4</sup> See, e.g., Bankr. C.D. Cal. R. 7004-1.

<sup>5</sup> FED. R. CIV. P. 4(m).

<sup>6</sup> FED. R. BANKR. P. 7004.

<sup>7</sup> FED. R. BANKR. P. 7004.

<sup>8</sup> FED. R. CIV. P. 26(a)(1); FED. R. CIV. P. 26(f).

<sup>9</sup> FED. R. BANKR. P. 7026.

nationwide, it would be extraordinarily burdensome for the movant's counsel to contact by telephone, or discuss in person, with each and every defendant, such matters as exchanging documents, preliminary discovery schedules, witness lists, and other evidence reasonably available to each party. At the same time, the actual value of such burdensome conferences most likely would be nominal at best. Instead, the movant could suggest that his or her counsel mail a letter to all defendants (which letter could be included with the summons and complaint). In the letter, the movant's counsel could provide a partially completed draft of the joint status report setting forth the movant's responses so that each defendant could have all of the information required of the movant without unnecessary logistical burdens. The defendants could be asked to complete their respective portion of the joint status report without the attendant requirement to communicate by person or by phone. In addition, the letter could provide each defendant with a telephone number that defendants (or their counsel) may use to leave messages to which the movant's counsel will timely respond. The movant's counsel also could invite settlement discussions in the letter and inform each defendant of the modifications to procedures contemplated by the Procedures Motion.

### *3. Initial and Continued Status Conferences*

The Procedures Motion could request that the initial status conference for each group of defendants be held on the same date, which would be reflected in the summons, and scheduled at least sixty-five days after issuance of the summons. Furthermore, the movant could request that the court permit subsequent status conference dates to be utilized as a trailing date for continued matters. This continuation would enable the movant to agree to continuances without imposing on the court in each case. Stipulations with opposing counsel would also be simplified. Some adversary proceedings against investor defendants will necessarily be resolved short of trial; perhaps some will be in a default or settlement status, and the balance will either be continued or have discovery cut-off dates set. A trailing continuance date of forty-five days would decrease the burden of scheduling and of reported calls to the courtroom deputy clerk for continuance requests.

### *4. Responses to Adversary Complaints*

The movant may request that the court extend the common thirty-day response time to forty-five days. Pursuant to Bankruptcy Rule

9006,<sup>10</sup> the court may enlarge the time for a response. The extended response date should accommodate the needs of most defendants, including out-of-state defendants that need to engage local counsel. The enlargement of time would obviate the need of the movant to enter into multiple stipulations extending the time with many defendants. In individual cases where the movant is informed of a reasonable hardship, he or she may separately agree to additional, reasonable time to respond.

#### 5. *Extensions of Time to Respond to Complaints*

Although enlarging the time for responding to the complaints should minimize the number of defendants requesting extensions of time, the movant may request that the court grant the parties authority to enter into informal, written extension agreements to extend time to respond, provided that no extension of time runs beyond the date one week before the initial status conference date absent a specific order of the court. Because reasonable extension requests are commonly granted, the proposed modification is intended to reduce the number of ministerial pleadings flowing through the clerk's office.

#### 6. *Defaults*

If a defendant fails to interpose a timely response to the adversary complaint (and thus has defaulted), the movant may file his or her Request for Entry of a Default Judgment and request, at the first status conference, for a prove-up hearing. This way, the Plaintiff can separate the default actions from the balance of the actions to permit final judgments to be entered pursuant to Bankruptcy Rule 7054.<sup>11</sup> Such proposed modifications will reduce the court's calendaring time in processing default cases. Additionally, they would provide the defendants a second, formal notice of the adversary proceeding, with an opportunity to avoid default and file a responsive pleading.

#### 7. *Discovery*

Federal Rule of Civil Procedure 7026(d),<sup>12</sup> as made applicable by Bankruptcy Rule 7026,<sup>13</sup> provides in pertinent part: "Except . . . when authorized under these rules by order or agreement of the parties, a party

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<sup>10</sup> FED. R. BANKR. P. 9006.

<sup>11</sup> FED. R. BANKR. P. 7054; FED. R. CIV. P. 54.

<sup>12</sup> FED. R. CIV. P. 26(d).

<sup>13</sup> FED. R. BANKR. P. 7026.

may not seek discovery from any source before the parties have conferred as required by Rule 26(f).”<sup>14</sup> Note that, in the Procedures Motion, the movant may seek a modification of the meet and confer deadlines as described above in Part I.A.2.

The movant’s likely intention is to obtain some very basic information from the defendants through written discovery to establish his or her prima facie case and to learn, as soon as practical, whether a defendant has any meaningful defenses or would be unable to pay a judgment even if one were obtained. In order to save mailing costs and to expedite the discovery process, the movant may request that he or she be permitted to serve limited formal written discovery concurrently with the summonses and adversary complaints, provided, for example, that the response date will be no earlier than thirty days after the response to the complaint is due. Because the time to answer will be enlarged, defendants actually will have more than seventy-five days to respond to this basic, written discovery. In scheduling deadlines, however, the court should keep in mind that the defendants are being asked to evaluate the complaint, obtain counsel, respond to the complaint, prepare a meet and confer report and respond to discovery, all in a relatively short time line.

#### B. MODIFYING PROCEDURAL REQUIREMENTS FOR ABANDONMENT AND SETTLEMENT

Avoidance claims against hundreds of defendants can easily arise in a Ponzi scheme bankruptcy. The claims against each defendant transferee may range from hundreds of dollars to several hundred thousands or millions of dollars. In addition to the procedural modifications discussed above, a movant may also request modifications to certain settlement and/or abandonment procedures ordinarily provided by applicable rules of practice. The modified procedures may be used to administer claims and adversary actions and reduce litigation expenses that are disproportionate to the ultimate possible recovery. They might, for example, establish guidelines whereby avoidance claims can be abandoned or compromised through a more efficient process than ordinarily attends case-by-case settlements.

Authority for such a request lies in Bankruptcy Rule 9019(b)<sup>15</sup> and Bankruptcy Code section 105<sup>16</sup> on the grounds that (1) applying the ordinary rules to this portfolio of litigation, and (2) requiring the movant to file a motion and hold a hearing on the settlement of every avoidance

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<sup>14</sup> FED. R. CIV. P. 26(d).

<sup>15</sup> FED. R. BANKR. P. 9019(b).

<sup>16</sup> 11 U.S.C.A. § 105 (Westlaw 2012).

claim would be unduly expensive for the bankruptcy estate and for the transferees while unnecessarily burdening the court's calendar. Accordingly, using a proposed settlement formula and procedure would protect the interests of the bankruptcy estate, the defendant transferees and other general unsecured creditors. The formula for a proposed settlement of avoidance claims should take into account: (1) the estimated cost incurred by the bankruptcy estate if litigation were pursued, (2) an estimate of the ultimate proposed distribution to all creditors, including the defendant transferee, and (3) the status of the defendant transferee's claim in the bankruptcy case.

First, the Procedures Motion can estimate net recovery to investors based on (i) the amounts the estate would expect to recover (after discounting for the costs, uncertainties and other vagaries of litigation) if the estate pursued all avoidance actions to judgment, and (ii) the distribution to each investor if all legitimate claims were recognized and allowed. Then, the Procedures Motion can seek authority to effectuate "net deals" built roughly on the premise that investor-defendants are entitled to keep the target return calculated under this formula but no more, and treating as conceptually irrelevant for these purposes whether the target return is achieved by pre-petition transfers or post-petition dividends.

The movant may request an order authorizing, but not requiring, the movant to abandon or settle fraudulent transfer or preference claims without further order of the court, so long as the abandonment is warranted under sound business judgment or if the settlement fits within certain parameters based on an approximation of the outcome extensive litigation would have had for the defendants, creditors and other investors. Furthermore, the Procedures Motion may seek authorization for the movant to exchange a settlement agreement and mutual releases with such a defendant transferee, where the settlement meets specified court-approved criteria. Likewise, the Procedures Motion may seek authority for the movant to abandon any claim or dismiss any adversary proceeding upon implementation of the settlement, without further order of the court, including where the defendant has provided evidence that the movant believes, with sound business judgment, that costs of collection of any judgment weighed against the likelihood of recovery from the defendant will not be cost-effective.

## II. SUBSTANTIVE AND ADMINISTRATIVE CONSOLIDATION

Similar to requests for procedural modifications, a Ponzi scheme in bankruptcy also provides a unique opportunity for substantive consolidation of multiple debtors. As noted below, substantive



consolidation is when all of the assets and liabilities of two or more entities become one entity. It typically occurs when the financial affairs of the entities are hopelessly entangled or when separate corporate entities have otherwise been disregarded by those in control of the debtors. There are many competing interests a court may evaluate in ordering substantive consolidation, that typically involve an intensive factual analysis. Should the court conclude that substantive consolidation is inappropriate with respect to a certain set of debtors and/or nondebtors, then a movant may suggest administrative consolidation in the alternative as a procedural matter to assist in streamlining litigation, pleadings, hearings, rulings, etc.

#### A. SUBSTANTIVE CONSOLIDATION

Although not expressly provided for in the Bankruptcy Code, a Bankruptcy Court's power to substantively consolidate estates has been part of the Court's general equitable powers since passage of the Bankruptcy Act of 1898.<sup>17</sup> Under the Bankruptcy Code, the power derives from the equitable powers embodied in section 105.<sup>18</sup> The primary purpose of substantive consolidation "is to ensure the equitable treatment of all creditors."<sup>19</sup> This equitable remedy pierces the corporate veil, eliminates inter-company claims, and pools the assets and liabilities of once separate entities.<sup>20</sup>

The U.S. Supreme Court has yet to adopt a uniform standard for substantive consolidation. However, the circuit courts of appeals have articulated three somewhat divergent standards for its application.<sup>21</sup> The first test is a three-part burden-shifting test announced by the District of Columbia Circuit in *In re Auto-Train*.<sup>22</sup> Under this test, a prima facie case for substantive consolidation is proven where a movant establishes

<sup>17</sup> Bankruptcy Act of 1898, 55th Cong., 2nd Sess., 30 Stat. 544.

<sup>18</sup> 11 U.S.C.A. § 105 (Westlaw 2012); see *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 763-64 (9th Cir. 2000) (citing *Reider v. F.D.I.C. (In re Reider)*, 31 F.3d 1102, 1105 (11th Cir. 1994)); *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 n.1 (2d Cir. 1988).

<sup>19</sup> *In re Bonham*, 229 F.3d at 764 (quoting *In re Augie/Restivo*, 860 F.2d at 518).

<sup>20</sup> *Id.* (citations omitted).

<sup>21</sup> *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005); *In re Augie/Restivo Baking Co.* 860 F.2d 515; *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270 (D.C. Cir. 1987). Five of the nine circuit courts of appeals that have adopted standards for substantive consolidation have applied restrictive tests. *In re Owens Corning*, 419 F.3d 195; *In re Bonham*, 229 F.3d 750; *Fishell v. U.S. Tr. (In re Fishell)*, 111 F.3d 131, \*2-3 (6th Cir. 1997) (unpublished per curiam opinion); *Woburn Assocs. v. Kahn (In re Hemingway Transp.)*, 954 F.2d 1, 32 n.15 (1st Cir. 1992); *In re Augie/Restivo Baking Co.*, 860 F.2d 515. Presumably the remaining circuits apply less restrictive standards.

<sup>22</sup> *In re Auto-Train Corp.*, 810 F.2d at 276.

by a preponderance of the evidence that (1) there is substantial identity between the entities to be consolidated, and (2) consolidation is necessary to avoid some harm or to realize some benefit.<sup>23</sup> Creditors are then given the opportunity to object to consolidation if they can demonstrate that they (1) relied on the separate credit of one of the entities, and (2) will be prejudiced by the consolidation.<sup>24</sup> Nevertheless, the court may overrule an objection and grant substantive consolidation if the court determines that the benefits of substantive consolidation “heavily” outweigh the harm.<sup>25</sup>

Additional tests were outlined in *Augie/Restivo*<sup>26</sup> and *Owens Corning*.<sup>27</sup> The Second Circuit in *Augie/Restivo* created a two-prong test where substantive consolidation is granted when (1) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (2) the affairs of the debtors are so entangled that consolidation will benefit all creditors.<sup>28</sup> In 2005, the Third Circuit in *Owens Corning* relied on the *Augie/Restivo* test in creating its own restrictive standard. The court determined that substantive consolidation is applicable only where (1) pre-petition creditors disregarded debtors’ corporate separateness so significantly that they relied on a breakdown of entity borders and treated them as one entity, or (2) the debtors’ post-petition assets and liabilities are so scrambled that separating them is prohibitive and will hurt all creditors.<sup>29</sup>

Regardless of which standard is applied, the realities of a Ponzi scheme often will satisfy all three tests. A trustee’s investigation into the structure and business affairs of a Ponzi scheme will likely uncover evidence that affairs of debtor and nondebtor entities used to further the Ponzi scheme are so intertwined that consolidation will benefit all creditors. Even the disjunctive restrictive test is satisfied where “the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors or where no accurate identification and allocation of assets is possible.”<sup>30</sup>

The trustee’s investigation may reveal that the Ponzi scheme entities have commingled their funds so that it would be essentially

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<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 (2d Cir. 1988).

<sup>27</sup> *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

<sup>28</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 518.

<sup>29</sup> *In re Owens Corning*, 419 F.3d at 211.

<sup>30</sup> *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 766 (9th Cir. 2000).

impracticable, if not impossible, to retrace and break out the assets, activities and liabilities of the different entities as part of the overall Ponzi scheme as a matter of practice, thus, leaving it highly doubtful that professionals could unscramble the debtors' books and records. Even the possibility that the affairs might be unscrambled may not provide a net benefit to the estate if (1) the associated expense will more than likely exceed the assets presently on hand in the estate, or (2) if funds become available to undertake the task, unscrambling would have little meaning for creditors in any event. Thus, substantive consolidation may be proper in a Ponzi scheme in bankruptcy where multiple entities were used to support the Ponzi enterprise.

Recent examples of substantive consolidation in Ponzi scheme bankruptcies include *West End Financial Advisors LLC*<sup>31</sup> and Bernard L. Madoff ("Madoff").<sup>32</sup> In the substantive consolidation involving the Madoff Ponzi scheme, the trustee for Bernard L. Madoff Investment Securities LLC (BLMIS) and the trustee of Madoff's individual chapter 7 bankruptcy, among others, reviewed the BLMIS and Madoff financial affairs and found "a history of payments and transfers from BLMIS to Madoff, Madoff's misuse of BLMIS funds, the intertwining of, and lack of a practical manner in which to separate, the financial affairs of Madoff and BLMIS."<sup>33</sup> Similar reasoning (i.e., a hopeless commingling of assets among multiple entities in a Ponzi scheme) justified substantive consolidation in *West End Financial Advisors LLC*.<sup>34</sup>

Nonetheless, prior to requesting substantive consolidation, the following practical considerations should be considered: (1) the effect of substantive consolidation on creditors, (2) the value of preserving transfers between bankruptcy estates for avoidance purposes, and (3) possible tax ramifications.

## B. ADMINISTRATIVE CONSOLIDATION

If the bankruptcy court denies a request to order substantive consolidation, a party in interest may alternatively petition for administrative consolidation. Bankruptcy Rule 1015(b)<sup>35</sup> specifically allows a court to enter an order to jointly administer related bankruptcy

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<sup>31</sup> *In re West End Fin. Advisors LLC*, No. 11-11152 (Bankr. S.D.N.Y. July 25, 2011), ECF No. 194 (order directing partial substantive consolidation).

<sup>32</sup> *Sec. Investor Prot. Corp. v. Bernard Madoff Inv. Sec. LLC (In re Bernard L. Madoff)*, No. 08-01789 (Bankr. S.D.N.Y. June 10, 2009), ECF No. 252 (order granting substantive consolidation).

<sup>33</sup> *Id.* at ¶ I.

<sup>34</sup> *In re West End Fin. Advisors LLC*, No. 11-11152 (Bankr. S.D.N.Y. July 6, 2011), ECF No. 179 (supplemental application for order directing substantive consolidation ¶¶ 17 and 18).

<sup>35</sup> FED. R. BANKR. P. 1015(b).

cases.<sup>36</sup> In a Ponzi scheme, multiple debtors may be related either by way of common ownership and control or by the fact that the entities were created in one way or another to fund the Ponzi scheme and were operated in a way that disguised the fraud.

If multiple debtors' business operations and organizations are closely related parts of a complex and integrated business structure, joint administration of the cases could simplify and substantially reduce the costs of separate administration. For example, joint administration would obviate the need for multiple notices, applications and orders being served on the same parties. Additionally, if each creditor has already filed claims against the particular debtor that allegedly owes it money, then the rights of the debtors' respective creditors would not be adversely affected by joint administration of these cases. Accordingly, administrative consolidation may be in the best interests of the debtors, their creditors, equity security holders, limited and general partners, the bankruptcy court and the United States Trustee if the court deems substantive consolidation improper.

### III. EVIDENTIARY CONCERNS

This section briefly surveys various evidentiary considerations regarding the use of evidence from one Ponzi litigation forum to other related proceedings.

#### A. ADMISSIONS IN PLEA AGREEMENTS TO PROVE INTENT

The Ninth Circuit has repeatedly held that the existence of a Ponzi scheme may be established by the Ponzi operator's admissions in a plea agreement made in connection with criminal prosecution.<sup>37</sup>

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<sup>36</sup> Bankruptcy Rule 1015(b) provides, in relevant part:

If a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and an affiliate, the court may order a joint administration of the estates. Prior to entering an order the court shall give consideration to protecting creditors of different estates against potential conflicts of interest. An order directing joint administration of individual cases of a husband and wife shall, if one spouse has elected the exemptions under §522(b)(2) of the Code and the other has elected the exemptions under §522(b)(3), fix a reasonable time within which either may amend the election so that both shall have elected the same exemptions. The order shall notify the debtors that unless they elect the same exemptions within the time fixed by the court, they will be deemed to have elected the exemptions provided by §522(b)(2).

FED. R. BANKR. P. 1015(b).

<sup>37</sup> *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008); *Santa Barbara Capital Mgmt. v. Neilson (In re Slatkin)*, 525 F.3d 805, 814 (9th Cir. 2008).

Furthermore, other courts have held that the existence of a Ponzi scheme is sufficient to establish actual intent to hinder, delay or defraud creditors for purposes of proving fraudulent transfer.<sup>38</sup> The Bankruptcy Court for the Southern District of Florida relied on this same reasoning in an adversary proceeding related to the *Rothstein Rosenfeldt Adler, PA* bankruptcy where the trustee used Ponzi operator Scott Rothstein's plea agreement to establish intent.<sup>39</sup> This holding was also recently applied in an adversary proceeding related to the Ponzi scheme orchestrated by Bernie Madoff.<sup>40</sup> Thus, courts nationwide have adopted the general principle that admissions made in a Ponzi operator's plea agreement are sufficient to establish actual intent to defraud.

#### B. HEARSAY PROBLEMS WITH WITNESS UNAVAILABILITY

Nevertheless, any practitioner seeking to use the Ponzi operator's admissions in his or her plea agreement to establish intent must be prepared to address evidentiary issues arising from the nature of the plea agreement. Technically, the plea agreement and resulting judgment order are hearsay because they are being used for the truth of the matters asserted, namely that the Ponzi operator ran the debtor as a Ponzi scheme and had the actual intent to defraud creditors.<sup>41</sup> Yet, the plea agreement and judgment order are admissible under Federal Rule of Evidence 803(22),<sup>42</sup> which allows hearsay evidence of a "final judgment, entered after a trial or upon a plea of guilty (but not upon a plea of nolo contendere), adjudging a person guilty of a crime punishable by death or imprisonment in excess of one year, to prove any fact essential to sustain the judgment . . . ."<sup>43</sup>

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<sup>38</sup> *In re AFI Holding, Inc.*, 525 F.3d at 704; Sec. and Exch. Comm'n v. Res. Dev. Int'l, LLC, 487 F.3d 295, 301 (5th Cir. 2007); Picard v. Estate of Chais (*In re Bernard L. Madoff Inv. Sec. LLC*), 445 B.R. 206, 220 (Bankr. S.D.N.Y. 2011) ("It is now well recognized that the existence of a Ponzi scheme establishes that transfers were made with the intent to hinder, delay and defraud creditors.") (citations omitted).

<sup>39</sup> Stettin v. Adler (*In re Rothstein Rosenfeldt Adler, P.A.*), No. 09-34791-BKC-RBR, 2010 WL 5173796, \*5 (Bankr. S.D. Fla. Dec. 14, 2010) (citing *In re Slatkin*, 525 F.3d at 811-12) ("Criminal plea agreements are admissible to establish the existence of a Ponzi scheme and a wrongdoer's fraudulent intent.")

<sup>40</sup> *In re Bernard L. Madoff Inv. Sec. LLC*, 445 B.R. at 220-21 (citing Bear, Stearns Sec. Corp. v. Gredd (*In re Manhattan Inv. Fund Ltd.*), 397 B.R. 1, 8-14 (Bankr. S.D.N.Y. 2007)).

<sup>41</sup> See FED. R. EVID. 801(c).

<sup>42</sup> FED. R. EVID. 803(22).

<sup>43</sup> *Rosen v. Neilson (In re Slatkin)*, 310 B.R. 740, 745 (C.D. Cal. 2004); *Scholes v. Lehmann*, 56 F.3d 750, 762 (7th Cir. 1995) (finding plea agreement admissible under Rule 803(22) in a fraudulent transfer suit brought by receiver against various third parties).

Alternatively, a plea agreement may be admissible under Federal Rule of Evidence 807,<sup>44</sup> the “residual” or “catch-all” exception to the hearsay rule. This rule provides:

A statement not specifically covered by Rule 803 or 804 but having equivalent circumstantial guarantees of trustworthiness, is not excluded by the hearsay rule, if the court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interests of justice will best be served by admission of the statement into evidence.

The Ninth Circuit applied this rule in deeming the Ponzi operator’s plea agreement admissible in *In re Slatkin*.<sup>45</sup> Likewise, in 2011, the Bankruptcy Court for the Southern District of New York applied this reasoning to admit admissions made in Madoff’s plea agreement.<sup>46</sup>

### C. COORDINATION WITH GOVERNMENTAL AGENCIES

In a Ponzi scheme context, the bankruptcy trustee, court-appointed receiver and a government entity may enter into coordination agreements to facilitate cooperation among multiple entities where each has a role related to judicial resolution of the Ponzi scheme. Coordination among these parties is necessary in the Ponzi context because violations of both criminal and civil laws have occurred with the additional overlay of bankruptcy laws. Such agreements generally aim to facilitate collection and distribution of fraudulently obtained funds to Ponzi scheme victims. The ultimate goal of coordination is to minimize the potential for expensive litigation. “In every possible instance, the absence of coordination among the various parties in these cases will diminish the recovery of the victims and creditors of this fraud.”<sup>47</sup> Coordination agreements allow multiple parties to collaborate to resolve creditors’ and investors’ claims against already limited resources, and reduce the extent

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<sup>44</sup> FED. R. EVID. 807.

<sup>45</sup> *Santa Barbara Capital Mgmt. v. Neilson (In re Slatkin)*, 525 F.3d 805, 812 (9th Cir. 2008).

<sup>46</sup> *Picard v. Estate of Chais (In re Bernard L. Madoff Inv. Sec. LLC)*, 445 B.R. 206, 221 (Bankr. S.D.N.Y. 2011).

<sup>47</sup> *In re Petters Co.*, No. 08-45257 (Bankr. D. Minn. Aug. 18, 2010), ECF No. 407 (motion seeking approval of Petters Coordination Agreement ¶ 37); *In re Petters Co.*, No. 08-45257 (Bankr. D. Minn. Sept. 14, 2010), ECF No. 453 (order approving Petters Coordination Agreement). Tom Petters was found guilty in December 2009 of twenty felony counts relating to fraud, money laundering and conspiracy in connection with originating a \$3.65 billion Ponzi scheme.

to which the parties to the agreement must compete against each other to obtain and distribute the same assets.

A coordination agreement was particularly useful in the *Dreier LLP* bankruptcy, which resulted from a Ponzi scheme originated by the law firm's sole equity partner, Marc Dreier.<sup>48</sup> In *Dreier LLP*, chapter 11 trustee Sheila M. Gowan ("Trustee Gowan") and the United States Attorney's Office for the Southern District of New York ("USAO-SDNY") successfully negotiated a coordination agreement whereby the USAO-SDNY and Trustee Gowan agreed to divide the debtor law firm's assets between the forfeiture and bankruptcy proceedings.<sup>49</sup> The thrust of the agreement was to prevent the USAO-SDNY from seeking forfeiture of funds obtained by Trustee Gowan through avoidance actions in bankruptcy. Because the USAO-SDNY agreed to forbear from forfeiting the proceeds of certain avoidance actions, Trustee Gowan was able to distribute the proceeds of these actions to creditors.<sup>50</sup>

#### CONCLUSION

Ponzi schemes provide unique evidentiary, procedural and administrative challenges in the bankruptcy context. As more of these schemes inevitably find their way into bankruptcy, the strategies discussed in this Article can aid practitioners and courts in navigating through the minefield of Ponzi schemes in bankruptcy.

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<sup>48</sup> *In re Dreier LLP*, No. 08-15051 (Bankr. S.D.N.Y. Jan. 28, 2010), ECF No. 337 (trustee's motion for approval of agreements, Exh. B. Coordination Agreement). Court approval of a revised coordination agreement was entered on June 9, 2010. *In re Dreier LLP*, No. 08-15051 (Bankr. S.D.N.Y. June 9, 2010), ECF No. 610.

<sup>49</sup> Coordination Agreement ¶¶ 2-6, *In re Dreier LLP*, No. 08-15051 (Bankr. S.D.N.Y. Jan. 28, 2010), ECF No. 337. Specifically, the agreement provided that the USAO-SDNY "shall not seek to forfeit or assert a right with respect to the proceeds of any actions seeking to avoid fraudulent transfers or preferences brought by the Chapter 11 Trustee against the persons and entities identified in the attached Schedule 2." *Id.* at ¶ 4.

<sup>50</sup> *In re Dreier LLP*, No. 08-15051 (Bankr. S.D.N.Y. Jan. 28, 2010), ECF No. No. 337 (trustee's motion for approval of agreements, Exh. B. Coordination Agreement).