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Our Mini-Theme: The Intersection Between Fraud, Crime, Bankruptcy and Asset Forfeiture

The Deranged Matchmaker: Fraud and the Intersection Between Crime, Bankruptcy and Asset Forfeiture

By Karen M. Gebbia

Fraud is a deranged matchmaker that brings bankruptcy law and criminal law together by blurring the line between two of humanity's oldest means of obtaining capital: borrowing and stealing.

When fraudulent financial schemes collapse, the same wrongdoer and the same assets may be treated under two parallel legal regimes. This is true because, regardless of the face financial fraud takes, from massive securities fraud, to breathtaking Ponzi schemes, to individual one-on-one capers, society must determine whether fraud creates a private debt best left to private resolution, or a crime upon society, or both.

Of late, the verdict has been "both." In the wake of the great recession, a substantial number of high profile parallel criminal prosecutions and individual and business bankruptcies arising from dramatically collapsing fraudulent schemes have hit the headlines, and the courts. Examples include the nationally infamous Madoff case (New York), Adelphia/Rigas securities fraud (Pennsylvania), Petters/Lancelot Ponzi schemes (Minnesota), fraud within the law firms operated by Marc Dreier (New York) and Scott Rothstein (Florida), the more locally shocking cases of Monroe Beachy (Ohio Amish Ponzi schemer), Lydia Cladek (Florida Ponzi schemer), Samantha Delay-Wison (Anchorage fraudster), Nick Cosmo/Agape (Long Island Ponzi schemer), and many others.

To criminal law, fraud is a crime—an act that harms society and calls for public vindication. To bankruptcy law, fraud is simply one in a humdrum and lengthy list of ways to create debt. Until fairly recently (the past half-dozen years, most notably), the intersection between criminal law and bankruptcy law in cases of fraud was relatively routine and noncontroversial. Both heard injured parties cry "Don't let them get away with it!"; and both happily obliged: criminal law by sentencing the fraudster to prison and likely to restitution; bankruptcy law by denying discharge to the debtor and/or the debt and excepting criminal prosecution from the "automatic stay."

Nevertheless, despite the possibility of a restitution order, criminal law had no direct impact on the fraudster's assets. Bankruptcy law gathered and distributed the assets to stakeholders under its own comprehensive scheme if the fraudster, or his business, filed bankruptcy.

Critical Developments in Criminal Law

What changed? Two significant developments brought criminal law into the realm of asset collection and distribution in new ways that put it on a collision course with bankruptcy law.

First, during the past several decades, criminal law has enthusiastically embraced the notion of victims' rights. In this regard, restitution orders have become standard in many federal sentences, including in fraud cases. Restitution does not, however, give the government power to seize a defendant's assets and restore or remit them to victims. This is where the second development, regarding forfeiture, comes into play.

Forfeiture allows the government to seize property that was involved in, facilitated, or is the proceeds of a wide array of crimes. In its earliest days, criminal forfeiture emphasized drug and money laundering crimes. In 2000, and again in 2006, Congress expanded criminal forfeiture to include a lengthy list of federal crimes, including a variety of frauds. Today, the government routinely seizes property as a mandatory component of many federal sentences. When coupled with restitution, remission, and restoration, forfeiture allows the government to take a defendant's assets and use them to compensate victims.

The expansion of forfeiture, combined with the growth of the victims' rights movement, has changed the practice of restorative justice from an arcane notion of discretionary compassion in favor of innocents, to a perceived entitlement that requires the government to fashion reasoned means of distributing literally billions of dollars of ill-gotten gains to fraud victims.

To understand how these changes altered the landscape, consider two simple examples of how forfeiture operates in the absence of fraud and bankruptcy: (1) a thief, and (2) a drug smuggler using a stolen boat.

Criminal forfeiture necessarily defines both the target property and any "victim" potentially entitled to compensation in reference only to the offense of conviction. The thief might be ordered to return the stolen goods, which property (or value) may be returned to the victim.

The smuggler's boat and contraband (drugs) may be seized under civil forfeiture, an *in rem* doctrine with ancient maritime roots. Under criminal forfeiture, an *in personam* action against the convicted smuggler, the government might also seize proceeds of the sale of the illegal drugs.

What of the smuggler's "victims"? If the smuggler had stolen the boat, the owner (if innocent) may petition for its return. It is unlikely that any claimant would be foolish enough to assert title to the illicit drugs. Unless the smuggler legitimately acquired other goods on credit, or employed honestly innocent sailors, it is difficult to identify other "victims" who might seek compensation. Moreover, neither the thief nor the smuggler is likely to file bankruptcy in an effort to discharge or restructure debts arising from the illegal activities. Thus, one might conclude that the gathering and distribution of assets through forfeiture is fairly straightforward.

This would be so until one considers fraud. Depending on the crimes charged (securities fraud, mail fraud, wire fraud, etc.), the forfeitable property identified as being involved in, facilitating, or constituting proceeds of the crime may include virtually all of the assets of the (possibly legitimate) business. The definition of victims, again in reference to the crimes of conviction, may include vast numbers of shareholders, investors, and others who claim to have been duped. The definition of victims might not, however, include many others who suffered harm from the business collapse, such as suppliers, utilities, trade creditors, employees, and lenders whose dealings with what they perceived to be a legitimate business unwittingly enabled the fraud to continue.

Fraud and Bankruptcy Law

How does bankruptcy law treat entities harmed by fraud? The answer lies in bankruptcy's fundamental objectives. Commonly synthesized as the "twin pillars" of modern bankruptcy law, these are: (1) the debtor's tenet of a "fresh start" for the "honest but unfortunate" debtor (the phrase typically employed with respect to individual debtors) or financial rehabilitation (of business debtors), and (2) creditors' rights tenets of restorative and distributive justice, expressed in terms of collective enforcement, maximization of value, and equitable distribution.

Our concern here is the second pillar. The Bankruptcy Code fosters collective enforcement by attempting to bring all assets and all claimants into a single forum to the greatest extent possible. This approach is perceived to maximize value for the entire body of interest holders by replacing the potential for multiple, costly, time consuming, parallel enforcement proceedings commenced by a variety of stakeholders racing to maximize their individual recoveries, with a single, efficient collection and distribution scheme. (Although, constitutional questions concerning the scope of bankruptcy jurisdiction have bedeviled the courts since the Bankruptcy Code was enacted and continue to do so to this day.)

In furtherance of collective enforcement, the Bankruptcy Code: (1) grants the bankruptcy courts broad jurisdiction over all of the debtor's property, wherever located and by whomever held, (2) requires entities holding property of the debtor to turn that property over to the bankruptcy trustee or estate, (3) gives the trustee in bankruptcy "strong arm powers" that permit the trustee to stand in the shoes of an entity that could have avoided a transfer of property under non-bankruptcy law, and (4) grants the trustee additional, bankruptcy specific powers to recover for the benefit of the bankruptcy estate prebankruptcy transfers that either preferred one creditor over others, or were made with a fraudulent intent or effect.

Through these powers, the Bankruptcy Code attempts to gather all of the debtor's property in one forum for equitable distribution. In this regard, bankruptcy law differs from forfeiture law, at least in theory, because forfeiture is limited to property tied to the particular crime(s) of conviction. Nevertheless, the enlarged definition of crimes for which forfeiture is authorized, combined with broad concepts such as substitute property, facilitating property, proceeds, and relation back (as outlined by Alice Dery in this issue), may result in broad forfeitures of virtually all of the assets that otherwise might be administered in a bankruptcy case. This is especially true in a Ponzi scheme where there arguably are few if any "clean" assets.

As with the debtor's property, the Bankruptcy Code seeks to gather all of the debtor's stakeholders in one forum. Claimants generally cannot opt out of the bankruptcy process, and typically will be bound by the discharge if they decline to participate.

In this regard, bankruptcy law again differs from forfeiture law because bankruptcy law is not limited to distributing property to "victims" whose injuries relate directly to the specific crime(s) of conviction. Rather, it proceeds under a broad construct that accounts for all of the fraudster's stakeholders without regard to whether their claims or interests arise directly from the fraud.

Finally, after all of the assets and stakeholders have been brought together in the bankruptcy forum, the Bankruptcy Code mandates distribution according to a carefully constructed and detailed distribution scheme. In so doing, it creates an "absolute priority" system under which debt must be paid in full before equity takes a share, analogous to the familiar notion that an insolvent entity may not distribute dividends to shareholders when it is unable to pay creditors. These distributive precepts may come into tension with forfeiture law, however, particularly if forfeited assets are distributed to "victims" under priorities (or exclusivities) that differ markedly from the distributions that would have been made under bankruptcy law. This is particularly galling to bankruptcy experts who argue that forfeiture may pay "equity" ahead of, or to the exclusion of, "debt."

An Underappreciated Tension

Here, the expansion of forfeiture powers brings into sharp focus an essential, and previously under-appreciated, tension between fundamental presumptions of criminal law, corporate law, securities law, and bankruptcy law. Bankruptcy law's absolute priority rule rests on the well-established notion that equity is paid after debt. This principle presumes that investors who did their diligence assumed both the upside potential of equity ownership and the downside risk of insolvency when they chose to invest rather than lend. But did they accept the risk that the information they considered when investing was fraudulent, or that the entity in which they were investing was a sham Ponzi scheme? If not, how does one reconcile the competing distribution schemes of bankruptcy (which may favor injured creditors) and criminal law (which may favor defrauded investors)?

Integrating Criminal and Bankruptcy Law

In this issue of *Business Law Today*, leading experts in criminal and bankruptcy law lay the groundwork for answering these questions. Alice Dery, Deputy Chief of the Department of Justice's Criminal Division, Asset Forfeiture and Money Laundering Section, Office of Policy and Training, provides an essential guide to the fundamentals of asset forfeiture and distribution. Henry Kevane, a partner in the San Francisco office of Pachulski Stang Ziehl & Jones, considers how asset forfeiture interacts with and upsets the expectations of bankruptcy law. Kathy Phelps, a partner in the Los Angeles firm Danning Gill Diamond and Kollitz, LLP, explores how third parties can assert rights with respect to assets the government has seized. She uses the complex issues that arose in the *Rothstein* case as a guide. Finally, the Honorable Steven Rhodes, bankruptcy judge in the Eastern District of Michigan, explains how cooperation agreements can reduce the tensions that arise between the government and the bankruptcy trustee. In so doing, he compares the cooperative approach achieved in the *Dreier* case, with the less than cooperative approach followed in the *Rothstein* case. Other cases in which the government and trustees were able to achieve cooperation on at least some aspects of the interplay between forfeiture and bankruptcy law include *Madoff* and *Petters*.

Although these experts bring different perspectives to the problem, their articles reveal a single theme, rooted in the value of communication and coordination. Coordination is possible because, although bankruptcy law and criminal law wield different tools, they hold firmly to the same fundamental principles regarding financial fraud: the honest but unfortunate debtor should not be shackled for life; the dishonest cheat should pay; the victims should be compensated.

It is not enough to agree upon these principles, however. The restorative and distributive rules of bankruptcy law and forfeiture law vest in highly developed statutes. Those statutes evolved from different sources, for different reasons, and are in many ways irreconcilable today. Consequently, it is incumbent upon those who practice and make policy in these areas to collaborate across disciplines to reconcile competing processes where possible, identify points of tension where necessary, and advocate for change where appropriate.

Moreover, although to date cooperative agreements have necessarily been ad hoc, given the rich variety of facts these cases present, the articles in this issue help us recognize emerging trends regarding when and how cooperation can be achieved.

The Business Law Section has been exploring these complex questions, and working to facilitate these objectives, since 2010 through its Working Group on White Collar Crime, Asset Forfeiture and Business Bankruptcy, an initiative of the Business Bankruptcy Committee and Committee on Bankruptcy Court Structure and Insolvency Process. Select materials from the Working Group's November 2011 Symposium are forthcoming in *The Golden Gate University Law Review*, Volume 42, Issue 4 (2012). The Working Group welcomes the voices of members of the Business Law Section.

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