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ALISON FRANKEL'S ON THE CASE

Time for the president to lawyer up, say legal experts

(Reuters) – If President Donald Trump wants to protect his own interests as the FBI and Congress move forward with investigations of possible ties between the Trump campaign and Russian officials, he should hire a private lawyer to advise him, according to six lawyers with experience in the sort of mushrooming Washington probes that have enveloped Trump.

The president might suffer political fallout from bringing in his own lawyer, these experts said, but Trump should be receiving advice from a lawyer who represents him, not the White House. White House counsel represent the institution of the presidency, not Trump himself, much as corporate general counsel represent their company and not CEOs.

Moreover, under legal precedent from the investigation of President Bill Clinton, Trump's communications with White House

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REUTERS/Jonathan Ernst

President Donald Trump should get advice from a lawyer who represents him, not the White House, legal experts say, because White House counsel represent the institution of the presidency, not the president himself.

EXPERT ANALYSIS

Chinese companies with U.S. ambitions give rise to new enforcement priorities

William F. McGovern, Shaun Z. Wu and Nan Wang analyze recent U.S. enforcement actions alleging bribery and corruption in China and what the extraterritorial reach means for cross-territorial actions against U.S. companies by the Chinese government.

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EXPERT ANALYSIS

When it's too good to be true: A Ponzi primer

Michael Braverman and Christopher Ekimoff of consulting firm Resolution Economics LLC analyze the characteristics of a Ponzi scheme and discuss how investors can prevent falling prey to the fraud.

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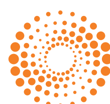

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When it's too good to be true: A Ponzi primer

By Michael Braverman and Christopher Ekimoff
Resolution Economics LLC

The Ponzi scheme, a well-known, well-practiced and well-documented fraud phenomenon, is named for Charles Ponzi, a con-man who operated during the 1920s and 1930s. The story of Mr. Ponzi, however, was not the first account of a person to abscond with investors' money in such a manner — depictions of investment schemes similar to a Ponzi scheme were elements of some of Charles Dickens' works — like "Little Dorritt" — as early as 1857.

That said, one can imagine that individuals have attempted to lure potential investors with promises of large returns since the rise of commerce in major European cities. This investment scheme has persisted throughout history, most recently in the Tom Petters, Allen Stanford and Bernard Madoff cases of the past decade.

ELEMENTS OF A PONZI SCHEME

Fraud schemes come in many shapes and sizes, but the Ponzi scheme has two basic elements — it is operated in a deceptive manner and is sustained by a constant flow of additional and/or new client money.

Deceptive operations

A Ponzi scheme is based on an investment promise that is not fulfilled, either by design or by misfortune. The unfulfilled promise is always hidden from the investor.

To better understand this concept, consider a hypothetical example of a successful technology stock trader-turned-fund manager.

The manager solicits investments in his fund based on his deep knowledge of the technology industry, earned over years following the market. He purports to be able to deliver higher returns than the S&P 500 Index, and promises to use a proprietary strategy he developed to achieve those returns.

> This element of deception differentiates a Ponzi scheme from a legitimate investment.

As individuals and firms begin investing in the manager's fund, he purchases stocks based on his strategy. During the first few years of operation, the manager delivers returns that are in fact better than the S&P 500 Index, and new clients line up to invest in his fund.

As new money comes in, the manager continues purchasing stocks according to his strategy. In subsequent years, however, the technology industry takes an unforeseen turn and the manager's strategy is no longer profitable. The fund begins losing money, and clients pull out of the fund.

At this point, there is nothing unique (or fraudulent) about this manager and his sales pitch or the results of his strategy. The fund manager promised to use a strategy, based on his experience, to try and beat the S&P 500 Index but failed to do so.

He used his clients' funds in the manner in which he described, but did not achieve the returns he had hoped for, and lost some of their money. It is an unfortunate outcome, to be sure, but not necessarily fraudulent at this point.

A Ponzi scheme would be rooted in deception, such as in the following examples:

- The investment manager accepts client money, but never actually invests the funds and does not purchase stocks according to his strategy. Rather, he uses the money for personal purposes and creates a picture of excess and wealth to fool investors into believing his success.
- The investment manager accepts client money and purchases stocks according to his strategy, but lies to his investors about the fund's performance. He continues to solicit money from new investors in order to keep his "business" in operation, but consistently misreports results due to the bogus nature and unsuccessful outcome of his strategy.

In each scenario outlined above, the investment manager's strategy and business model are the same as in our original example. The difference is that the manager chooses to deceive his investors and create a façade of success, whether through personal displays of wealth and/or deceitful investor communications to keep his fund afloat.

This element of deception differentiates a Ponzi scheme from a legitimate investment. An investment manager can lose his investors' money due to unforeseen or uncontrollable circumstances that are

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inherent in investing, but lying to clients about how and why the money was lost is fraudulent.

Some early investors in a Ponzi scheme may redeem their original investment and some profit, which helps obfuscate the schemer's true intentions, but fund assets will eventually dwindle due to the fraud and the inevitable lack of available new money.

As time passes, the fund manager may be forced to suspend client redemption requests in an attempt to prevent the fund from toppling and the scheme from being exposed.

Exclusively sustained by new investment

The second element of a Ponzi scheme is that it only continues as long as new money is provided by clients. The phrase "robbing Peter to pay Paul" is often used to describe the "transfer" of funds from new investors to fulfill the promises to earlier investors.

Longer-running Ponzi schemes are typically created by individuals with a strong public image of success, a seemingly-unfailing self-confidence and an executive presence that exudes charisma — all characteristics of great sales people. They rely on their successful sales pitches to keep the scheme afloat.

Ponzi schemes are never solvent relative to their investors' principal and purported earnings. The table below outlines a simple example of year-over-year investment and performance of a Ponzi scheme in which the investment strategy does not provide the promised returns.

The investment manager started with $100,000 in initial client assets, promised 20 percent returns per year and reported that performance to his clients at each year's end. His "strategy", however, only provided 4 percent in annual returns.

If a client wished to withdraw his invested assets at any time during the investment timeline ("Reported Principal" in the table above), the investment manager might not have sufficient funds to cover the investor's redemption request (as shown as "In the Red" in the table above).

Therefore, a Ponzi schemer must continually bring in additional client assets to cover his lifestyle and cover any client redemption requests that might otherwise expose the shortfall in the investment fund.

Year	Reported Principal	Promised Returns	Total Funds Reported	Actual Returns	Actual Total Funds	Amount "In The Red"
1	$100,000	20%	$120,000	4%	$104,000	$(16,000)
2	$120,000	20%	$144,000	4%	$108,160	$(35,840)
3	$144,000	20%	$172,800	4%	$112,486	$(60,314)
4	$172,800	20%	$207,360	4%	$116,986	$(90,374)
5	$207,360	20%	$248,832	4%	$121,665	$(127,167)

Again, what differentiates a Ponzi scheme from a failed investment strategy is that the results are communicated deceptively to the investor. Without new investment, the lie is eventually unveiled and the Ponzi scheme crumbles.

PONZI SCHEMES IN TODAY'S INVESTMENT INDUSTRY

To further understand the pervasiveness of Ponzi schemes, some investment industry resources attempt to measure the value and impact of Ponzi schemes on the investment community.

Ponzitracker.com, a legal blog focused on news, proceedings and other Ponzi scheme information, compiled a database of Ponzi schemes reported from 2008-2013 that had alleged losses over $1 million. In total, the 557 cases listed in the PonziTracker database allege aggregate losses over $65 billion.

In 2015, the 8th U.S. Circuit Court of Appeals found that the general partner of an investment fund was willfully blind in monitoring his fund managers. The case focused on the general partner's apparent lack of oversight, showing he did not follow up on key red flags and inflated results that were reported to clients.

The willful blindness count was affirmed on appeal and the general partner was ordered to pay $17 million in restitution. *United States v. Hansen*, 791 F.3d 863 (8th Cir. 2015).

A Ponzi schemer can be subject to both criminal and civil penalties. The average sentence for Ponzi perpetrators in the PonziTracker.com study is approximately 12 years.

In some cases, perpetrators have received jail sentences akin to life sentences, probably to dissuade other would-be white collar criminals.

The phrase "robbing Peter to pay Paul" is often used to describe the "transfer" of funds from new investors to fulfill the promises to earlier investors.

Sadly, Ponzi schemes have ripple effects that do not necessarily end when an investor cashes out. As recent cases have shown, even investors who exit Ponzi schemes before they fold can be liable for "false profits" they received at the detriment to other investors.

Such "clawback" suits look to recover monies taken out of the Ponzi scheme before its collapse and redistribute those funds to investors who were left holding the bag at the scheme's demise.

In certain states, such as New York, the clawback period can reach up to six years after the fact. Further, if an individual involved with the fund is found to be "willfully blind," they may be liable for clients' losses as well.

Civil cases can also lead to years of lawsuits by investors and regulators, debarment from practicing in the financial industry, seizure of assets and disgorgement of ill-gotten gains and significant financial penalties.

WHY DO PONZI SCHEMES CONTINUE TO OCCUR?

It may appear strange to an average investor that Ponzi schemes continue to occur when they are so well documented, publicized and significant in today's investing industry. Their continued occurrence can be attributed to at least two factors: the optimism of individual investors and the cunning and greed of fraudsters.

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- The promise of consistent, market-beating returns will always be enticing to investors.
- The techniques of deceit and promotion of the investment by the Ponzi schemer will continue to fool investors.

For investors, the allure of an investment that guarantees a certain return, promises to beat the market or does both is tied to one of the primary reasons why individuals invest their money: increasing one's wealth.

That reason, coupled with an investment manager touting his success and respect in the industry and who continuously requires new investment in his fund, leads to Ponzi schemes duping investors into parting with their hard earned money.

In some cases, Ponzi schemers do not initially set out to create a fabricated investment fund, until greed leads them awry. In our example, the investment manager may beat the market, as promised, in the first few years of executing his strategy.

However, during the first downturn in his performance, he may feel that even though the strategy no longer generates the returns promised, that the past reporting period was "just one down quarter" and his lies about actual returns will not matter when the market turns around.

Such rationalization is a classic element of financial fraud, as documented by the Association of Certified Fraud Examiners. After the initial deceit at the first down quarter, it can be hard for a fraudster to admit his lies and the underlying failure.

This difficulty, coupled with the trust investors place in him, makes it easy to see how such Ponzi schemes can endure into the future.

In a classic example of such rationalization, convicted Ponzi schemer R. Allen Stanford continues to defend his investment business as legitimate, despite being convicted of fraud and sentenced to 110 years in prison.

Stanford operated the Stanford International Bank in the Caribbean island of Antigua, luring investors by selling certificates of deposit with exceedingly high rates of return. Eventually his sales pitch grew to a Ponzi scheme that held a supposed $8 billion in client monies and owned various speculative and unprofitable real estate, airline and media assets.

Periodically, Stanford and James Davis, SIB's chief financial officer, decided on a predetermined investment return and had their employees reverse-engineer SIB's financial statements to report investment income the bank never earned.

Stanford blames the SEC for his downfall, stating his investment strategies were legitimate, and but for the negative press and loss of investor confidence due to the SEC's investigation, he'd still be in business today.

However, Stanford's subordinates at the bank tipped off authorities to the misappropriation of investor funds to support his lavish lifestyle, and a judge sentenced Stanford to 110 years in prison for his fraud.

> If an individual involved with the fund is found to be "willfully blind," they may be liable for clients' losses as well.

The case included testimony from Clayton Gerber, a U.S. postal inspector, on the forensic accounting analysis he performed to estimate the cash flows of SIB through its accounts across the globe, including the Isle of Man and Switzerland.

Gerber spent three years reviewing information related to SIB accounts and transaction activity, and concluded that SIB should be required to forfeit its assets to the U.S. government.

Stanford is currently appealing the rulings against him and is also fighting cases from duped investors; he even stated his hope that a new Supreme Court justice appointed by President Trump would increase his chances of freedom. Some fraudsters' rationalizations are undefeatable in their own minds.

RED FLAGS AND CONSIDERATIONS FOR INVESTORS

Ponzi schemes may differ widely in their packaging and take the form of real estate investments, derivatives hedging, precious metal sales or other types of investments. Nonetheless, there are several red flags or indicia that may belie an underlying Ponzi scheme.

- Key man/black box strategy: An investment manager touts his personal knowledge and strategy without providing any further details, such as using only the phrase "timing the market" to explain his success. If a strategy cannot be replicated (or at least generally understood), it may indicate the potential for issues in generating returns in the future.
- Operational irregularities: Does the investment firm claim to have billions of assets under management but hires a sole practitioner to be its auditor, as in the Bernard Madoff Ponzi scheme? Does the investment manager provide web-based access to investor account balances, or only provide an annual statement mailed to investors? Does the investment manager regularly communicate with clients, or only communicate when seeking more cash to prop the fund up? Are clients requested to direct the transfer of their assets to the investment manager's personal bank account rather than an account in the name of the fund? Stark differences in the sophistication of a firm's operations and how successful the firm describes itself may encourage further investigation.
- Market corroboration of strategy: If an investment manager describes a trading strategy to satisfy a skeptical investor, does the strategy perform as reported for the given period? In our example above, the investment manager purports to beat the market with key investments in technology stocks. Does he report returns in the last quarter of 20 percent, while the technology sector has actually decreased in value? Without more information on the investment manager's strategy, it can be difficult to believe how such returns could be possible.
- Unclear redemption policy: The downfall of any Ponzi scheme is insolvency. If a fund manager has broad discretion in satisfying client redemption requests (i.e., can delay or freeze requests at any time) one should be wary of the fund.

Tom Petters, convicted in December 2009, ran a $3.65 billion Ponzi scheme for 10 years in which he solicited investments to allegedly

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purchase electronics for resale to "big box" retailers. In hindsight his enterprise, Petters Co. Inc., demonstrated many characteristics of an unsophisticated business and had several indicia of fraud in its operations.

From day one, Petters fabricated purchase and sale documents, falsified bank records and sent out false financial statements showing billions in receivables from retailers.

In true Ponzi scheme fashion, Petters used investor money to repay some investors, pay his co-conspirators and support his lavish lifestyle.

To further maintain his façade of success and project an air of legitimacy to investors, Petters acquired companies such as Fingerhut, Polaroid and Sun Country Airlines.

When pressured by investors for redemptions, Petters would blame slow payments from retailers and even write bad checks.

Petters' purported scheme to profit by selling electronics to established retailers should have prompted investors to question his methods: wouldn't such prestigious companies already maintain a steady and reliable supply of products? How could Petters offer a better deal than the manufacturers by playing middle man?

One of Petters' co-conspirators ultimately tipped off authorities, bringing his Ponzi scheme to an end, and putting Petters behind bars for 50 years.

KEY TAKEAWAYS FROM PONZI SCHEMES

In short, Ponzi schemes are most damaging to investors that do not perform appropriate due diligence. They rely too greatly on the fund manager's purported reputation, whether by his standing in the market or the recommendation of close friends.

According to a 2011 Marquet International report, a study of Ponzi schemes published in 2011, "affinity fraud" accounted for 85 percent of all Ponzi schemes reviewed. Affinity fraud occurs when a specific group of individuals with a shared characteristic — religion, geography, age — are targeted by a fraudster for their scheme.

As was widely reported, the Jewish communities in New York City and Palm Beach, Florida were significantly impacted by the Madoff Ponzi scheme. Many Madoff investors relied on recommendations from their communities, and those recommendations were deemed fit in lieu of investigative due diligence on Madoff, his funds and their alleged returns.

Investors should protect their wealth before selecting an investment and throughout the duration of their investment. Investors can better protect their money against misuse by continuously monitoring their investments and liaising with a fund's investment manager regarding fund/asset performance, the fund's operations and other details regarding an investment,.

The greed and ego of a Ponzi schemer, as well as returns that are significantly less than promised, can lead a legitimate investment fund down a fraudulent path. Investors must push back and investigate irregularities when their money is on the line, regardless of past success or promised returns.

Ponzi schemes may continue into the future, but a skeptical, informed investor can mitigate significant losses before it's too late. WJ

WESTLAW JOURNAL **CORPORATE OFFICERS & DIRECTORS LIABILITY**

This publication provides coverage of both federal and state litigation and legislation involving the individual liability of corporate officers and directors and corporate governance issues. It summarizes and provides access to the latest pleadings and opinions in this area of the law. Commentary by key litigators provides perspective and insight. It also discusses director and officer liability insurance, fiduciary duty, corporate governance, shareholder suits, and insider trading

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