

Receivership Law Revealed

Peter A. Davidson Explains it All

By Lisa Miller

Peter A. Davidson, a partner at Beverly Hills' Ervin, Cohen & Jessup, is considered one of the premier legal specialists in the field of receivership law. And he enjoys recognition as a bankruptcy attorney and a receiver and court appointed monitor as well.

Mr. Davidson represents bankruptcy trustees, receivers, secured creditors, debtors and creditors' committees. He practices in state court, federal court and bankruptcy court. Many of the receivership cases he handles involve enforcement actions by government agencies such as the Federal Trade Commission, the Securities and Exchange Commission, the California Department of Corporations and the office of the California Attorney General. Mr. Davidson is admitted to practice in all United States District Courts in California, the United States District Court, Northern District of Texas, the United States Court of Appeals, Ninth Circuit and the United States Supreme Court.

"I practice in a little-understood area of the law," Mr. Davidson says. "But this area is important for plaintiffs and defendants alike."

As a receiver, conservator and monitor, many of Mr. Davidson's assignments have touched on real estate, escrow, mortgage, limited partnerships, finance, mining, numismatics, cellular telephone licenses, health maintenance organizations, money order entities and telephone companies.

"I love the fact that I get to work with different and widely diverse subjects every day," he says. "This is one of the more creative sides of the practice and I really relish it."

As an acknowledged expert in the field, it is not unusual for Mr. Davidson to become embroiled in high-profile cases as well as those less notable. One such memorable matter concerned bankruptcy cases in the 1990s filed by Michael Jackson's parents, Katherine and Joe, and two of Jackson's brothers, Tito and Jermaine.

"What may seem like cut and dried legal minutia or a tedious practice area of law by some is a source of intrigue for me," Mr. Davidson, who earned his Juris Doctorate from UCLA's School of Law in 1977, says. "Searching for hidden assets, finding creative solutions to paying creditors, and unveiling fraudulent activities such as Ponzi schemes and white collar crime in the process can make for an interesting day on the job."

Mr. Davidson says his work requires painstaking investigations. Sometimes he must spend a decade delving into and resolving a bankruptcy or receivership case. Two recent cases involving Ponzi schemes have garnered the public's attention. The first is the *Wallenbrock* matter, filed

by the Securities and Exchange Commission. In that case, Mr. Davidson filed 245 lawsuits against participants in the scheme. In that case, hundreds of investors were bilked out of more than \$200 million investing in non-existent latex glove receivables. The other case was *Unicyber*, filed by the Federal Trade Commission, where Spanish-speaking consumers were sold inoperable rebuilt computers.

"It all started in the late 1970s, when I was assigned a receivership case," he says. "It lasted five years."

Mr. Davidson's interest in receivership law, and his substantial results in the field, caught the attention of government agencies. Many of them asked the courts to appoint him to act as a receiver or for Mr. Davidson to act as counsel for the receiver.

As a result of his extensive practice in the area, Mr. Davidson became active in many bankruptcy/receivership associations and organizations. He has served as the president of the Los Angeles Bankruptcy Forum, been a member of the Board of Directors of the California Bankruptcy Forum, co-chair of the Los Angeles/Orange County Receiver's Forum (and served as an editor-in-chief of that association's regular publication, *Receivership News*), writes a column: "Ask the Receiver," and currently acts as an editor for the *California Bankruptcy Journal*.

His work has been featured in many legal trade publications including an appearance on the cover of *Los Angeles Lawyer* magazine and *The Journal of the National Association of Bankruptcy Trustees*. He has been quoted in *REIP the Rewards*, where he provided input for the article "Real Estate Fraud, Schemes and Scams." He has been quoted on *ATMmarketplace.com* and in *Bankruptcy Court Decisions Weekly News & Comment*. Mr. Davidson appeared on Court TV's broadcast program "Open Court" as a commentator during the first Phil Spector murder trial.

Mr. Davidson is a member of the executive committee and is the past chair of the Remedies Section of the Los Angeles County Bar Association and a member of both the Financial Lawyers Conference and the National Association of Bankruptcy Trustees.



DAVIDSON AT A GLANCE

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Giant Ponzi Scheme Unmasked

Appellate Court Clarifies Fraudulent Transfer Parameters Under Receivership Law

By Lisa Miller

Significant new appellate decisions dealing with receiverships are rare. But *Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008) is such a rarity. *Donell* establishes, for the first time in the Ninth Circuit, the right of a receiver to recover from investors in a Ponzi scheme, those payments made to the investors over and above the principal amount of their investment, by using California's Uniform Fraudulent Transfer Act, Civil Code § 3439 et seq.

While authority in bankruptcy cases existed that allowed trustees to recover "false profits" from investors in Ponzi schemes using either the bankruptcy code's fraudulent transfer provision or equivalent state law fraudulent transfer statutes, no reported case applied California law and the use of California's fraudulent transfer statute by a receiver. And *Donell* resolves a number of undecided issues in the Ninth Circuit concerning a receiver's standing and an investor's right to offset income tax paid on gains and other expenses the investor incurred in making the investment. In *Donell*, the Court held that the receiver does have standing to pursue these claims against investors, rejecting offset claims.

"I hoped that we could get the court to decide these issues not only for this case, but for future cases." Peter A. Davidson, a partner at Ervin, Cohen & Jessup and lead counsel on *Donell*, says.

Defendant Kowell invested in a Ponzi scheme that promised investors a 20 percent return in 90 days by using their money to provide working capital to Malaysian latex glove manufacturers. The scheme defrauded approximately 6,000 people, mostly elderly investors, of over \$200 million. Mr. Kowell not only got back his investment, but he received a "profit" on his investment as well. But the money raised from investors was not used as promised. Instead, it was used to pay off early investors, pay personal expenses of the principal, and to invest in risky start-up companies.

"This was a typical Ponzi scheme," he says.

The Securities and Exchange Commission learned of the scheme and filed a civil enforcement proceeding against the companies and the principal. The principal was later indicted for securities fraud and money laundering and was ultimately sentenced to 20 years in prison.

"My client was appointed by the district court as receiver for the entities," Mr. Davidson says. "I welcomed the assignment—I love these types of cases."

Plaintiff Donell filed suit against Mr. Kowell and other investors who received profits on their investment. He claimed that the profit payments were fraudulent transfers under California's Uniform Fraudulent Transfer Act. Mr. Davidson, filed a motion for summary judgment. Mr. Kowell defended by asserting that because the investments took the form of promissory notes and the Ninth Circuit, in a previous decision, had found that promissory notes were securities, the receiver could not bring the fraudulent transfer action against him but could only sue him for securities fraud, despite the fact that he was an innocent investor in the scheme and had not committed securities fraud.

"The other side came up with some pretty creative defenses in this case," Mr. Davidson says. "Some of them were new and had not been tested in the courts."

Mr. Kowell argued that the statute of limitations for securities fraud should apply, not the four year statute of limitations applicable to a fraudulent transfer action. And Mr. Kowell claimed that the fraudulent transfer statute was not meant for cases like this, so the receiver had no standing to bring a fraudulent transfer action against him. He finally argued that he should be entitled to an offset against whatever liability he might have, for income taxes he paid on the gains that were paid to him, and other expenses he incurred in making the investment.

"These arguments aren't easy to make with a straight face," Mr. Davidson says.

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The Ninth Circuit affirmed the district court's grant of Mr. Davidson's Motion for Summary Judgment. The court first noted that the district court had ancillary jurisdiction to hear the case even though the case only involved the California's Fraudulent Transfer Act, because the receiver's action was ancillary to the SEC enforcement case where the receiver was appointed.

"Once I read this, I knew we were off to a good start," he says.

The court next affirmed the receiver's theory of the case that in a Ponzi scheme the perpetrator of the scheme has the "actual intent" to defraud creditors and, therefore, as a matter of law, investors who received payments from the operator of a Ponzi scheme have received fraudulent transfers. Under this "actual fraud" theory, the receiver may recover the entire amount paid to the investor, including the investor's original investment, unless the investor can establish what the Ninth Circuit called the "good faith" defense, which permits an innocent investor to retain funds up to the amount of the investment.

"This was one of the most important points that the court made," Mr. Davidson says. "It enables receivers to pursue the false profits paid in these schemes."

In order to determine an investor's liability, the Ninth Circuit indicated the court should follow a two-step process"

- First, the court should determine whether the investor is liable pursuant to the so called "netting rule," pursuant to which amounts transferred by the operator of the scheme to the investor are netted against the amounts invested. If the investor received back more than the investment, the receiver has established liability.
- Second, the court must determine the actual amount of liability.

"The Court's analysis provides terrific guidance for practitioners," he says. "This is what makes the decision so useful on a practical level for the entire industry."

The court stated that a good-faith investor can retain payments up to the amount invested, but is liable for the "profit" paid to the investor. Investors are permitted to keep their initial investment because they have claims for restitution or rescission against the operator of the scheme, up to the amount of their investment. Payments in excess of the investment must be returned as fraudulent transfers because they do not represent a return but are, in reality, other investors' money.

The only restriction on the investor's liability is that the payments of fictitious profits that are avoidable must have been paid within the applicable statute of limitation. The receiver is not required to trace the funds or match each investment with each payment made by the investor.

The court may presume that the payments received by an investor are initially payments against the investors' claim for restitution. Transfers in excess of that amount, made within the statute of limitations, are avoidable as fraudulent transfers.

"This holding is grounded in practicality and common-sense analysis," he says. "This decision provides a lot of clarity."

The court rejected Kowell's claim that because the statute deals with debtors and creditors the Fraudulent Transfer Act was not intended to apply to investors in a Ponzi scheme. The court indicated that the terms of the statute are abstract in order to protect defrauded creditors, no matter what the form of scheme or financial fraud.

"The court was absolutely correct when it rejected Kowell's claim that the federal securities laws preempted California's Fraudulent Transfer Act," Mr. Davidson says. "The court was right to find no basis for preemption."

Regarding Kowell's claim that he should be entitled to an offset for taxes paid on the transfers to him and other costs, the Ninth Circuit held that there were three reasons for not allowing these offsets:

- First, if offsets were permitted for taxes, there would be no reason not to permit other offsets for countless other types of expenses, which would defeat the purpose of the Fraudulent Transfer Act.
- Second, even if offsets were permitted for taxes paid, it would introduce complex problems of proof and tracing in each case and the result might be that investors who received identical payments would be treated differently because of their tax situation.
- Third, the court could not discern the equity of permitting an offset that would really come at the expense of the other innocent investors.

"This is a fair and well-reasoned decision that will have a significant impact, given the Madoff scandal and other Ponzi schemes that are coming to light," Mr. Davidson says.