

Expert Analysis

Commingled Funds in Corporate Debtor's Account Not Subject to Forfeiture

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The 11th U.S. Circuit Court of Appeals ruled June 12 that when a criminal defendant has commingled criminal proceeds with non-criminal operating revenues in his company's bank accounts, none of those funds are subject to forfeiture by the government in the face of a competing claim by the company's bankruptcy trustee and they must be turned over to the trustee. *United States v. Rothstein*, No. 11-10676, 2013 WL 2494980 (11th Cir. June 12, 2013).

In the process, the court adopted an "indivisible without difficulty" standard for determining when a bank account becomes commingled such that criminal proceeds are no longer traceable for the purposes of forfeiture statutes.

FAKE SETTLEMENTS

By 2009, Scott Rothstein had built a 70-attorney law firm, Rothstein Rosenfeldt Adler PA, based in Fort Lauderdale, Fla. The firm closed that November after the discovery that Rothstein had been using the firm for years as a tool for a Ponzi scheme in which investors lost hundreds of millions of dollars.

Rothstein had deposited the money into the firm's client trust accounts, which helped perpetuate the scheme. He told investors that they were purchasing interests in structured settlements the firm had negotiated confidentially for other clients in employment litigation and that the investors would receive periodic payments being deposited by the settling defendants into the firm's trust account.

The structured settlements were fake, and the investors' money was used instead to pay prior investors, to enrich Rothstein's personal lifestyle and acquire lavish property and businesses interests, and to subsidize the law firm's shortfall in operating revenue to pay its operating expenses.

The same trust accounts where the investors' money was being deposited also held legitimate client funds and fee retainers.

CRIMINAL CHARGES

Within a month after the Rothstein Rosenfeldt firm's collapse, it became the subject of an involuntary Chapter 11 case, and a trustee was appointed.

A few days later, Rothstein was charged in the U.S. District Court for the Southern District of Florida with conspiracy to engage in wire fraud, money laundering and racketeering activity.

The U.S. government has a civil forfeiture right as to “any property ... which constitutes or is derived from proceeds traceable to [the offense constituting “specified unlawful activity”] ... or a conspiracy to commit such offense.” 18 U.S.C. § 981(a)(1)(C). The crimes Rothstein was charged with qualify as specified unlawful activity.

The word “proceeds” expands the reach of forfeiture, since it covers property of any kind obtained directly or indirectly as the result of the commission of the offense giving rise to forfeiture, and any property traceable thereto, and is not limited to the net gain or profit realized from the offense. 18 U.S.C. § 981(a)(2).

The civil forfeiture statute requires a warrant upon probable cause but does not require a criminal arrest. In the Rothstein case, the government asserted its civil forfeiture rights in the criminal information it filed, adding a lengthy list of bank accounts, real estate, motor vehicles, jewelry, cash, and personal and business investments.

More than \$2 million in firm trust accounts drew the bankruptcy trustee’s special attention because they were titled in the name of the Chapter 11 debtor corporation.

CRIMINAL FORFEITURE

The United States also alleged that Rothstein’s conduct constituted a basis for forfeiture under the federal “criminal forfeiture” statute, 18 U.S.C. § 982(a), and under the criminal forfeiture provisions of the Racketeer Influenced and Corrupt Organizations Act, as to all the same assets.

Section 982 is less specific than the civil forfeiture statute on the required nexus to the crime, covering property “involved in” the offense or property traceable to such property.

Criminal forfeiture is based on *in personam* jurisdiction, so its adjudication depends upon an arrest and conviction. Such a forfeiture is mandatory in a judgment of conviction under RICO, 18 U.S.C. § 1963(a), and in money laundering cases under 18 U.S.C. § 982(a)(1).

Rothstein pleaded guilty to the charged crimes and admitted all the forfeiture allegations.

The United States did not proceed with the civil forfeiture, which offers extensive protection for third-party claimants under 18 U.S.C. § 983. Rather, it obtained a preliminary order of criminal forfeiture upon Rothstein’s plea and published notice of the opportunity for third parties to assert claims of interests in the forfeitable property.

Pursuant to 21 U.S.C. § 853(n), the bankruptcy trustee of the law firm timely asserted his claim that the money in most of the bank accounts, and all properties that may have been purchased using funds in those accounts, were property of the law firm’s bankruptcy estate, and asked that they be released from the forfeiture.

The District Court entered a judgment convicting Rothstein of his crimes and forfeiting all the property listed in the information to the United States.

The court found that four bank accounts holding more than \$2 million were traceable to Rothstein’s crimes under the “lowest intermediate balance” rule favored by both parties, leaving the bankruptcy estate with no interest in the funds.

The lowest intermediate balance rule is a legal fiction used to establish identifiable proceeds. It states that a particular deposit of the funds of another remains identifiable as proceeds so long as the account balance has never dropped below the amount of that deposit.

The court did order smaller law firm operating accounts turned over to the trustee. As to the other real and personal property, the court struck the trustee's claims on equitable grounds. The United States had promised that the entire proceeds, after administrative costs, would be paid to the crime victims, so justice would be better served by having the government administer the properties for restitution purposes, the court said.

The 11th Circuit reversed. The panel had questioned at the oral argument whether the government's and District Court's action may have violated the automatic stay of Section 362(a) of the Bankruptcy Code, but the appeals court did not mention the issue in its decision.

It also let pass the District Court's suggestion that the Justice Department's administration of the property as restitution for crime victims was more equitable than a bankruptcy trustee's administering the property for the benefit of all creditors of the law firm, as well as the crime victims, whose claims represented most of the claims by amount in the firm's bankruptcy case.

The court held that the government could not have established that *any* of the funds in the commingled trust accounts were traceable to Rothstein's crimes.

It recognized that the 3rd Circuit has held that a particularly large deposit of criminal proceeds into a bank account containing non-criminal funds did not become commingled so as to prevent tracing for forfeiture purposes. But it also noted that the 3rd Circuit has held that jewelry purchased from a bank account that contained, at the time, numerous criminal and non-criminal deposits is necessarily untraceable to the crime.

SUBSTITUTE ASSET FORFEITURE

The 11th Circuit posited that commingled funds that could not be divided into criminal and non-criminal "without difficulty" would be free from forfeiture. A remedy is available under 21 U.S.C. § 853(p)(1)(E) to allow use of "substitute asset" forfeiture where commingled proceeds in a bank account cannot be divided without difficulty.

The court consoled the government with the suggestion that Rothstein's stock interest in his law firm may be ripe for such "substitute asset" forfeiture, presumably in the event that the bankruptcy case produces a surplus above creditor claims.

Finally, the 11th Circuit remanded the case to the District Court for further proceedings as to the other properties the trustee claimed — few or none of them titled in the name of the law firm. To the extent the properties are found to have been acquired with monies from commingled criminal and non-criminal proceeds in the law firm's accounts, they will be property of the bankruptcy estate free from forfeiture, the appeals court said.

The ruling could lead to a major effort to retrace the source of all funds used to purchase tens of millions of dollars in luxury goods, real property and investments. A Chapter 11 plan, which would establish a liquidating trust to complete the trustee's efforts, is presently being circulated for voting in the case.

The 11th Circuit adopted an "indivisible without difficulty" standard for determining when a bank account becomes commingled such that criminal proceeds are no longer traceable for the purposes of forfeiture statutes.

SUMMARY

Several things should be noted about what the court did *not* hold. First, in many Ponzi scheme cases, there are no legitimate revenues, only proceeds of the crime. In those cases, the bankruptcy trustee for the corporation used by the criminal as the engine of the fraud would not be able to offer any evidence to rebut the statutory presumption that the bank account funds derived from the crime.

Second, nothing in the *Rothstein* decision prevents a victim of the criminal's fraudulent solicitation of funds from seeking a judicial recognition of a constructive trust or equitable lien over funds specifically traceable to the victim's monies.

Third, the government still may be able to stand in line ahead of creditors where the commingled account was that of the criminal himself. The proceeds of a crime constitute the criminal defendant's interest in property. *Rothstein* at 13, citing *United States v. Conner*, 752 F.2d 566, 575-76 (11th Cir. 1985). So in a case where the criminal commingled money earned honestly and dishonestly in the same personal bank account, the government could still obtain a forfeiture of the account as the criminal's "substitute asset" where by the commingling the criminal had rendered the account "indivisible without difficulty."

Nonetheless, the Court of Appeals has broken new ground in the long-simmering conflict between bankruptcy and government forfeiture. At least in the 11th Circuit, where a criminal commingles criminal proceeds with non-criminal revenues in a company account in such a way that the funds cannot be separated without difficulty, the funds will first be available to pay the company's debts, including the victims of the crime, through its bankruptcy proceeding.



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