By Bill Spitz, Principal

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Ponzi Schemes

The Finance shelves of the library are filled with adoring books on great investors, but I am actually drawn to biographies of financial scoundrels. Their schemes are fascinating, humorous in a perverse way, and most importantly, quite instructive. A good deal has been written about Alan Stanford, Bernie Madoff, and other recent practitioners of the most famous scam which is the Ponzi Scheme. However, Ponzi schemes have been around since at least the mid-1800s, and this form of fraud actually predates Mr. Ponzi by more than seventy years. Charles Dickens described a version of the scheme in his novel **Martin Chuzzlewit** in 1844, and the first well-documented examples were perpetrated by Adele Spitzeder in Germany (1869) and Sarah Howe in the U.S. (1880). Studying Ponzi schemes yield two inescapable conclusions: the lure of easy money will always attract criminals, and the search for high returns (aka greed) renders even intelligent and thoughtful people gullible and at least temporarily devoid of common sense. Wikipedia publishes a list of Ponzi schemes that includes more than one hundred examples. And, the failure of crypto exchange FTX, which appears to have many of the characteristics of a Ponzi scheme, is currently unfolding. So, in addition to historical interest, this is and will always be a timely topic.

After providing some basic information on the operation of Ponzi schemes, I describe a handful of examples and then finish with a list of the classic warning signs. As you will see, you never know where one of these will pop up, so caveat emptor!

THE BASICS

A Ponzi scheme is a scam in which the fraudster raises money from investors by promising a very high-interest rate or return that is in reality unachievable. Typically, potential investors receive a slick and convincing presentation that attributes the unusually high return to a secret, complex strategy or access to investments not available to others. In a few cases, the funds raised are actually used to purchase legitimate investments despite it being highly unlikely they will deliver a rate of return commensurate with the promised payout. Sadly, there have been cases of bona fide investment funds that turned to fraud when their strategy did not yield the expected results. More often, the perp either absconds with the funds entirely or uses them to support a lavish lifestyle. When interest or principal payments come due, the scoundrel is forced to raise money from new pigeons to be distributed to the original investors.

Ponzi schemes can actually persist for years because many of the investors opt to reinvest their interest payments given the high promised rate of return. Why would you choose to actually receive your interest payments or original capital when reinvested funds are seemingly percolating along at a 30% or 40% annual rate of return? Moreover, scam artists use charm and not-so-gentle persuasion to convince investors to keep their money in the program. The prime example of a durable fraud is Bernie Madoff's elaborate deception that lasted for at least fifteen years although Federal investigators suspect that parts of it may have been in place for thirty-five or more. Interestingly, Madoff's scheme was only discovered when he admitted the fraud to his sons who promptly notified Federal authorities. Had he not fessed up, who knows how long it might have continued!

"A Ponzi scheme is a scam in which the fraudster raises money from investors by promising a very high interest rate or return that is in reality unachievable."

Ponzi schemes falter when too many investors choose to redeem and/or new investors cannot be secured. What happens when a scheme ultimately collapses? If the original capital was actually used to purchase legitimate investments, victims may recover a portion of their funds as was the case with Madoff. More often, all of their capital is wiped out and there only rarely is a deep pocket to provide any relief. Unwinding failed schemes is usually a long, complicated process because the scammer typically goes to great lengths to conceal his activity including the location of misappropriated funds.

One key component of Ponzi schemes is falsified statements that are provided to investors to assure them that their funds are performing as promised. In most cases, the bogus reports are created by the schemer himself, but there are occasionally co-conspirators in the form of corrupt accounting firms.

This is only a brief primer; those interested in more detail might want to read one of the many books on Madoff such as **The Wizard of Lies** by Diana Henriques.

CHARLES PONZI

Charles Ponzi immigrated to the U.S. from Italy in 1903 at the age of 21 and almost immediately ran afoul of the law. After being fired from his job as a waiter for theft, he fled to Canada where he was imprisoned for three years for check fraud. Returning to the U.S., he became involved in a scheme to smuggle illegal Italian immigrants and spent two more years in prison. Upon his release, Ponzi floundered in a number of different jobs before developing an idea for the scheme that became so identified with him that it bears his name.

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International Reply Coupons (IRCs) allowed a person in one country to pay the postage for a reply from a correspondent in another. Due to differences in currency exchange rates, IRCs purchased in one country could theoretically be exchanged for postage at a higher rate in another; what we would call arbitrage today. Ponzi raised money from investors to purchase IRCs promising a return of 50% in forty-five days and 100% in ninety. The initial investors did receive prompt interest payments (paid with funds invested by others) lending credibility to his efforts, and Ponzi hired commissioned sales agents to solicit funds. In total, he apparently raised about $20 million in the first few months of 1920 from as many as 30,000 investors. His early supporters were working-class immigrants, some of whom mortgaged their homes to jump on the bandwagon. However, as the word spread, even wealthy Boston Brahmins invested in the program. As is generally the case with these schemes, Ponzi siphoned off funds to support a lavish lifestyle including the purchases of a mansion in Lexington, Massachusetts, a fancy car, and interests in several other companies.

While a fundraising success, the scheme was fundamentally unworkable. First, IRCs were only redeemable for postage stamps which could not easily be converted into cash. Second, the large sums raised by Ponzi would have required the purchase of some 160 million IRCs whereas only 27,000 were in circulation. With no actual investment return, Ponzi was forced to both raise money from new investors and borrow from a number of banks in order to keep the scheme afloat. Things began to unravel in August of 1920 when the Boston Post published a series of articles questioning the legitimacy of Ponzi's business. A "run on the bank" ensued, the Attorney General of Massachusetts shut down his firm, and Ponzi surrendered to Federal authorities knowing his arrest was imminent.

Ponzi's investors ultimately recovered only about 30 cents on the dollar and a total of six banks were rendered insolvent by their loans to him. While the overall dollars lost in this scheme are fairly minor as compared to many future scams, it was remarkable for the speed and breadth of his fundraising effort. What made his fundraising so impressive is the fact that it was heavily dependent on "word of mouth" given that he predated many modern forms of communication and media.

Ponzi was charged with 86 counts of mail fraud and ultimately received a sentence of fourteen years in Federal Prison. He was released after three and-one-half years and chose to move to Florida where he became involved in offering investors what turned out to be underwater tracts of land resulting in a one-year stint in prison there. He was then returned to Massachusetts where he served seven more years of his original sentence and was then deported to Italy. Ponzi eventually emigrated to Brazil where he spent his last years living in poverty. He died in 1949 at age 67.

Ponzi was charged with 86 counts *of mail fraud and ultimately received a sentence of fourteen years in Federal Prison.*

While somewhat dated, I feel it is important to include a description of Ponzi's scheme because it defined the genre. Hopefully, my four remaining examples are more poignant and relevant having occurred in the past twenty-five years. I deliberately chose case studies that may not be familiar. They are particularly interesting for two reasons. First, the perps came from many different walks of life. Second, the frauds occurred in very different venues and took on very different forms. However, the key point is that the underlying technique was largely the same in every instance.

Photo Credit: AP Photo/The Star Tribune, Jerry Holt, file

THE GOLDEN BOY

Tom Petters demonstrated an entrepreneurial bent while still in high school by starting a mail-order stereo company aimed at college students. Petters dropped out of college after one semester and began working as a regional manager for an electronics retailer. When that company folded, he purchased five of its locations. Based on this early retailing experience, he started The Petters Company, and later, Petters Warehouse Direct, in his home state of Minnesota. His companies were in the business of purchasing overstock, discontinued, and similar types of consumer goods from manufacturers and other vendors. These goods were to be resold to big box retailers at a profit. As the company became at least outwardly more successful, Petters purchased the Fingerhut Companies, the Polaroid brand, and Sun Country Airlines. At its peak, Petters Group Worldwide held ownership in some sixty companies of which it directly managed twenty employing 3,200 people and earning $2.3 billion in revenue. (2007)

Petters was a much-admired business leader and philanthropist in Minnesota serving as a Trustee of several colleges and universities. He made gifts and pledges to various charitable organizations totaling more than $35 million and formed the John T. Petters Foundation in memory of his son who was killed while on a college visit to Italy. Other than the tragedy of his son's death, Petters was The Golden Boy leading a charmed and exemplary life.

Then, on Sept. 8, 2008, Petters' close associate Deanna Coleman voluntarily confessed to Federal authorities that she had assisted him in a massive fraud. Promising returns of 15% to 20%, the firm had issued at least $3.7 billion in promissory notes over a ten-year period to a variety of lenders, hedge funds, and individual investors in order to finance the purchase of merchandise for resale. In reality, **no purchases or sales of merchandise were ever made!** With the help of Coleman and several others, Petters engaged in a large number of coverup tactics involving the issuance of false purchase orders, fake invoices and receipts, phony bank statements, and other manufactured documents. Some lenders gained confidence in Petters' business by wiring loan funds directly to vendors from whom they received appropriate confirmations. However, many vendors turned out to be either complicit or sham companies. After deducting a commission, most actually wired the funds back to the Petters Group Worldwide. As was the case with Madoff, it is interesting to ponder how long the fraud would have continued had Ms. Coleman not struggled with her conscience.

Most of the classic Ponzi scheme practices were present in this case. Early loans were repaid with the proceeds of new borrowings. Petters withdrew funds to support his lifestyle, pay bonuses to employees, invest in his other companies, purchase real estate for family members, fund businesses for family members, and pay co-conspirators. As it became more difficult to attract new lenders, he had difficulty meeting his loan obligations forcing him to use stalling tactics such as asking lenders for an extension until phony outstanding receivables were paid by supposed big box retailers.

Petters was found guilty of 20 counts of conspiracy, wire fraud, mail fraud, and money laundering and sentenced in 2010 to 50 years in prison. He is currently incarcerated at the U.S. Penitentiary at Leavenworth, Kansas, and will not be eligible for parole until 2052 at which time he will be 94 years old. Deanna Coleman received a one-year sentence, and various other conspirators received sentences of one to fifteen years. In November of 2022, a jury ordered BMO Harris Bank to pay almost $1 billion to victims of the fraud ruling that it had been negligent in not concluding that the billions of Petters Group dollars that flowed through accounts at the bank were associated with fraud. The suit alleged that the fraud could have easily been stopped had the bank filed a suspicious activity report with regulators as was its responsibility. That ruling is being appealed and a number of other lawsuits are pending.

Photo Credit: sandiegoville.com

THE GOLDEN GIRL

After earning an MBA degree, Gina Champion-Cain accepted a job in San Diego with real estate developer The Koll Company where she worked on several successful projects. Emboldened by her success there, she left in 1997 to start her own firm, American National Investments, and fairly quickly made a gutsy investment in an old Woolworth Building redeveloping it into a mixed-use property with dining, retail, residential lofts, and a House of Blues. With the help of a well-regarded public relations expert, she parlayed this successful project into a campaign to become a highly visible figure in San Diego. She gained media coverage, received civic awards, and was invited to join the boards of several downtown development coalitions. Apparently, the walls of her corporate headquarters were covered with plaques and other honoraria. By 2015, she had opened a number of restaurants and a retail boutique, and had developed several residential projects. Apparently, Ms. Champion-Cain was a very poor business manager who was not interested in operational details, but her visionary ideas, charisma, good looks, and apparent success carried the day. As was the case with Tom Petters, she was by all appearances The Golden Girl.

Along the way, she developed a side business in which she raised money from investors to provide financing to individuals and organizations applying for liquor licenses. Under California law, an applicant is required to immediately fund the entire cost of the license which can exceed $100,000. Given that the application process frequently takes more than one year, this requirement could be quite burdensome to small business applicants. Providing financing to them seemed to be a plausible strategy, which when combined with her sterling reputation and a promised return of up to 25%, allowed her to raise between $350 and $400 million from investors.

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In January of 2019, the scheme came crashing down when a hedge fund considering an investment did detailed due-diligence on Ms. Champion-Cain and her loan fund. The investigation discovered:

- Despite the letter of the law, California does not in practice require that the entire cost of the license be placed in escrow; a $5,000 to $10,000 payment is generally sufficient. In other words, the rationale for these loans did not exist.
- Her records indicated that several loans had been made to winemakers and breweries; their licenses do not require escrow deposits.
- The hedge fund checked with every liquor license attorney and consultant in California and found that none of their clients had used Ms. Champion-Cain's loan fund. In order to account for the $350-$400 million supposedly expended, she should have funded virtually every applicant in the entire state.
- The funds raised had been deposited in a Chicago Title escrow account that she alone controlled.

In fact, she had not made a single loan, and instead had used the funds to support her other failing businesses and opulent lifestyle. To deceive investors, she impersonated Chicago Title employees, created fake email addresses, and forged various documents and signatures. Ms. Champion-Cain pleaded guilty and was sentenced to 15 years in prison. She will be 68 when released.

There are two interesting postscripts to this story. First, Chicago Title and several other defendants agreed to settlements in which the investors will recoup 90% to 95% of their losses. Several Chicago Title employees were aware that Ms. Champion-Cain was impersonating them. There were other red flags. Escrow accounts generally exist for a limited time period and are created for a specific event or purpose. The fact that this account was evergreen should have raised concern. Additionally, sole access to an escrow account is highly unusual and suspicious. The second postscript is that Ms. Champion-Cain published a very successful book in 2022 titled **I Did it!**

THE CHURCH SCAM

The Greater Ministries International scheme is an example of an affinity fraud in which the victims are aligned with the perpetrator in some way. Examples include common membership in an organization, similar political, social, or religious views, family relationships, friendship, geography, and so on. These victims are particularly vulnerable because they often suffer from confirmation bias which is the tendency to accept information that supports a preconceived idea or belief while rejecting conflicting data or views.

While Greater Ministries International (GMI) was ostensibly a relatively straightforward Evangelical Christian denomination, its leaders were actually associated with a number of darker fringe organizations and points of view. Among them were White Supremacy, Neo-Nazism, Anti-Semitism, and a profound dislike of the U.S. Government as demonstrated by their participation in what was known as the Patriot Movement. Several, including the Church's leader Gerald Payne, had previously spent time in prison for various offenses.

GMI's flagship program, the "Double Your Money Gift Exchange", was marketed by citing Luke 6:38, "Give, and it shall be given unto you." Investors were promised that their money would double in seventeen months as a result of investments in "divinely inspired" (but non-existent) African gold and diamond mines. Investors were also promised that some of the profits would be used for "good works." GMI operated several additional scams including raising money for an herbal research center that allegedly had developed a cure for cancer, and a scheme that offered donors a square-foot parcel of land and citizenship in a to-be-determined sovereign country called "Greater Lands." It would be outside of the control of world governments and would abide solely by Biblical principles.

"...its leaders were actually associated with a number of darker fringe organizations and points of view."

GMI's elders focused their fundraising efforts on people with similar views, particularly the Amish and Mennonite Communities in Pennsylvania. These sects are deeply religious, suspicious of government, and isolated rendering them quite vulnerable to GMI's pitch. In total, approximately $500 million was raised between 1993 and 1997 from more than 18,000 people including 2,000 in Lancaster County, Pennsylvania. While all Ponzi scheme perps are quite callous regarding their impact on victims, the Greater Ministries Elders were particularly iniquitous in that they applied tremendous pressure on their flock to empty out their bank accounts, mortgage properties, max out credit cards, empty 401K accounts, and sell their businesses and equipment. Early investors received their interest and principal payments in envelopes stuffed with cash; a red flag that should have caused someone to notify the authorities. Instead, these payments motivated the flock to enthusiastically spread the good word among like-minded individuals, and it was reported that one fund raising meeting in Pennsylvania alone drew more than seven hundred attendees. To add insult to injury, the Elders took a 5% commission on all investments in the scam.

A number of states entered Cease and Desist Orders against GMI between 1995 and 1997, but the GMI Elders changed the name of their fund raising program to camouflage it and simply ignored the state orders in many cases. When actually dragged into court, they argued that as a religious institution, their activities were outside the authority of government. The collapse of the program occurred when Best Bank of Boulder, Colorado was seized by state regulators in August of 1999. GMI had large deposits there forcing it to suspend payments to investors instead substituting IOU certificates backed by the non-existent gold mines. At the same time, a four year federal investigation of GMI's activities concluded resulting in the arrest of seven people including both Payne and his wife Betty. Two defendants agreed to plea bargains while the remaining five were convicted on all counts receiving sentences ranging from thirteen to twenty-seven years.

Many turned over their entire savings *to him based on home town familiarity, his endearing personality, and frequently professed Christian values.*

Lest you think this an isolated occurrence, Business Week published an article on March 27, 2023 outlining a Ponzi scheme in which a Texas preacher turned financial planner named Doc Gallagher defrauded 200 people of more than $23 million. Gallagher was a regular on Christian Radio broadcasts giving him credibility with his victims who were for the most part elderly and quite religious. Many turned over their entire savings to him based on home town familiarity, his endearing personality, and frequently professed Christian values. Gallagher was given a twenty-five year sentence in 2019, and his investors have to date recovered only about one-third of their capital.

Photo Credit: inf.news/en/news/af8da0ba5655984d83b84414b8906bb3.html

THE CHINESE APHRODISIAC SCAM

The details of this fraud are somewhat sketchy, but I had to include it in order to inject a little levity into what is otherwise a somber paper.

Ants hold a special place in Chinese culture as many believe that consuming them increases longevity, provides immunity to disease, increases the stamina of athletes, and most important, increases male sexual potency. Wang Fengyou created the Yilishen Tianxi Group in 1999 to make health care products based on ground-up ant carcasses. (Don't gag!) The company produced a Viagra substitute pill and sold an ant-based wine. Wang became wealthy and a media darling who was frequently photographed with important government officials and endorsed by famous people.

The actual scam involved the sourcing of ants for the company's products. Company representatives approached Illiterate peasants who had received payment for land that was appropriated for urban development offering them a 30%+ annual return on an investment of $1,600. Investors purchased three boxes of special "medicinal ants" which they were required to feed and water until the ants died of natural causes some months later. At that point, the boxes would be repurchased by a Yilishen Tianxi employee at a premium generating the promised return. The carcasses would be sent to the Company's factory where they would be ground into powder to produce the company's medicinal products. One reason the scam lasted for eight years was that rather than cash out, many of the investors rolled over their profits into purchases of even more boxes. Purchasers were instructed never to open the boxes lest they contaminate the ants, so it is not clear what, if anything, they contained. One wonders what actually went into the pills and wine that were marketed! (Ugh!) In total, roughly $1.2 billion was raised from more than one million individuals!!

"The actual scam involved the sourcing of ants for the company's products."

The U.S. banned imports of Yilishen's products in 2004 reducing revenues and forcing the cancellation of a proposed public stock offering in Hong Kong. Business slowly declined until 2007 when the company entered bankruptcy after failing to repay ant box purchasers. Several large demonstrations followed around the country including a protest by more than 10,000 individuals in Shenyang that required intervention by riot police. Wang Fengyou was arrested in December of 2007 and confessed to his entire scheme as well as to staging counter demonstrations that were "injurious to public safety." He was sentenced to death. Whether or not the sentence was ever carried out is unclear, but the perpetrator of a similar ant fraud was executed in 2008.

This scam highlights some of the complexities and peculiarities of business and culture in China. Wang Fengyou was quite cozy with government officials, and some of the funds raised in the scam were probably used to bribe them. In all likelihood, their willingness to "look the other way" contributed to the longevity of the scheme. The government promised to reimburse the large number of illiterate peasants who lost their life savings to this scam although there have apparently been no such payments made to date. In order to avoid further embarrassment, the Chinese government clamped down on reporting on the scheme by journalists and ordered lawyers not to represent plaintiffs.

An interesting cultural aspect of this fraud is a pervasive "get rich quick" mentality in China that enables lots of Ponzi scammers. Another societal quirk seems to be an obsession with aphrodisiacs which apparently take up a good deal of shelf space in many pharmacies. You couldn't make all of this up!

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DANGER SIGNS

I had two primary goals in writing this paper. The first was to demonstrate that these scams are often propagated by seemingly prominent individuals. Second, I wanted to make it clear that Ponzi schemes can occur anywhere. We examined frauds rooted in a wholesale consumer goods company, a real estate developer, a religious institution, and a health care products company. Add to them the scam perpetrated by a highly respected investment manager (Madoff) and phony certificates of deposit issued by a fraudulent bank. (Stanford)

The best safeguard against scams is good old common sense that casts doubt on easy money. A second admonition is to deal with people you know and trust. However, as further protection, here are some specific indicators of suspicious circumstances:

- Unusually high or consistent returns.
- Opaque, complex, or secret investment strategies.
- Investment programs involving a lock-up unless there is a good reason for illiquidity such as is the case with real estate and private equity.
- Unfamiliar service providers including accountants and law firms.
- Aggressive advertising.
- Unregistered investments and/or unlicensed sellers.
- Difficulties in receiving prompt payment.
- Missing or incomplete paper work, particularly if accompanied by excuses.
- Accounting errors or inaccurate reporting.
- “Guaranteed” investment returns.
- An investment manager who serves as his own custodian.
- Pressure to reinvest.

As the old saying goes, “if it seems too good to be true, then it is!!”

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866.619.1003

GREENSBORO
855.821.4999

MEMPHIS
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