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<u>MCMULLEN</u> REJECTS <u>MOONEY</u>: Rollover IRAs Are Exempt - Maybe

Many Californians fail to realize that individual retirement accounts are not necessarily exempt from the claims of creditors under California law.[1] In contrast to funds held in 401(k)[2] and 403(b)[3] plans (or other qualifying “private retirement plans” [4]), which are exempt (subject to certain limited exceptions) *without limitation* as to amount and remain exempt after withdrawal[5], IRAs are only exempt to “the extent necessary” for the beneficiary’s support upon retirement.[6] This unfortunate limitation places IRAs in the cross hairs of creditors and the protection offered by the “to the extent necessary” qualification is frequently illusory. When the IRA is placed in contest by a creditor, the beneficiary typically has fallen on hard times and cannot afford effective legal counsel. Moreover, the published decisions in this area offer little comfort for the prospective retiree.[7]

continued on page 2

In This Edition

SOUTHERN CALIFORNIA’S MOST EXPENSIVE RIDE: The Ponzi

In the past fifteen years, I have represented over thirty clients who were taken on one of Southern California’s most expensive rides – the Ponzi scheme.[1] The victims included counties, cities, towns, doctors, lawyers, accountants, preachers, teachers and firemen (among others).[2] Although many of the defrauded, by their own admission, were unsophisticated, others were the “best and the brightest.” It seems no one is immune and the ticket to the next ride is just a phone call away. Here are a few observations that may help you avoid the expense.

Mr. Ponzi ►

<u>Investigate The Promoter</u>

In four of the five ponzi schemes that victimized my clients, the purveyor/promoter of the scheme was neither a securities broker, nor a registered investment advisor, yet the underlying investment was a “security.”[3] If the clients had checked on the schemer’s status with either the California Department of Corporations, or with the Securities & Exchange Commission, they would have discovered this illegality before the checks were written.

The following website, which is maintained by the SEC, allows investors to check an advisors registration status: <u>www.adviserinfo.sec.gov</u>. The NASD maintains a similar site for securities brokers: <u>www.nasd.com /InvestorInformation/InvestorProtection</u>/. Before you invest, check these websites. If the advisor seeking your money is unregistered, or the broker is unlicensed (or has a history of problems), invest your money elsewhere.

Continued on page 2.

Although contributory IRAs are at risk under California law, does this infirmity extend to IRAs funded solely with funds from a 401k plan? Since distributions from a 401k or other ERISA qualified plan remain exempt even after distribution, presumably this status should follow these funds into the IRA account. Unfortunately, a case decided seven years ago decided otherwise.

In *In re Mooney*[8], a bankruptcy case, the court ruled that once 401k funds were placed in an IRA, they were subject to the IRA exemption limitation, to wit, the nebulous "to the extent necessary" test.

The *Mooney* decision, which was rendered in 2000, was wrongly decided. As indicated above, the statutory language governing private retirement funds plainly states that the distributed funds remain exempt, whether in the plan or outside the plan (or under your bed, in your closet, or any place else as long as they are traceable).[9] Under the *Mooney* analysis, an IRA operates as a "negative" exemption, stripping these funds of their otherwise ironclad protection. This is inconsistent with the statutory language and counterintuitive in the extreme.

Fortunately, a California Court of Appeal recently weighed in on this issue and rejected *Mooney*. In *McCullen v. Haycock*[10], which was decided in February of 2007, a creditor tried to gain access to the funds in an IRA, notwithstanding the fact that every penny in the account was admittedly derived from a 401k distribution. Relying on *Mooney,* the creditor argued that the otherwise exempt funds became subject to the "extent necessary" standard, once they were deposited into the IRA. *McCullen* rejected this analysis.

The *McCullen* court correctly pointed out that the applicable California statute stated that 401k funds were exempt, whether in the plan, or outside the plan, as long as they were traceable. *Mooney* failed to honor this dictate. The court also noted that under the *Mooney* ruling, the 401k funds would retain their statutory protection in all instances, except when they were deposited into an IRA account. Nothing in the IRA exemption, the *McCullen* court noted, indicated that the legislature intended this result and it would be contrary to the basic concept underlying the exemption for private retirement plans, to wit, *the protection of these funds*.

The California IRA problem used to apply in bankruptcy as well, at least for California residents. However, the enactment of BAPCPA[11] in 2005 substantially mitigated the problem. Now, IRAs are exempt up to a total of one million dollars in bankruptcy cases, exclusive of rollover contributions (which means 401k or 403B rollovers would be exempt, in addition to the funds in any contributory IRA).[11] *However, this rule only applies to debtors in the bankruptcy system*.

The *McCullen* decision is not a California Supreme Court decision. Other courts in California are free to follow the reasoning of the *Mooney* court, until the California Supreme Court or the California legislature lays this issue to rest. Accordingly, California investors should recognize that IRAs remain a somewhat risky destination for 401k funds and IRAs funded with non-rollover contributions are unquestionably subject to the "extent necessary" test. Whenever possible, 401k funds should be rolled back into another 401k plan to avoid the risk posed by California's defective statutory system. ♣

PONZI – Continued from page 1

If the promoter tells you the investment is a "security," and consequently the licensing requirements do not apply, take a second look. If you lack control over the investment (the difference between a partnership interest and a limited partnership interest) and do not own a direct interest in the underlying asset, it's probably a security.

Place Restrictions On Your Funds

To run a ponzi scheme, the promoter needs control over your money and the ability to hide the use of these funds. Whenever possible, impose restrictions on the promoter's access to your investment dollars and demand accounting data from third party account holders. The promoter should be able to (and want to) detail where your funds will be deposited, how they will be expended, and who will have control over these funds. As a general rule, your check/wire should be made out to the entity that controls the investment asset, which should be separate from the promoter, or your funds should be deposited into an escrow, with strict distribution controls.

ECON 101

The following significant headlines appeared in May of 2007:

- **Walmart suffers largest single month sales decline in almost thirty years**
- **Foreclosure rate in April of 2007 is double2006 rate**
- **Gas prices reach record high**
- **Dow reaches record high**

In the past two years, the Fed has raised interest rates over 400% on a consumer base with nominal savings and historic levels of debt (savings rates have been consistently poor for decades and have been negative since 2005). I suspect that consumers are starting to realize they lack the cash and credit to sustain their spending habits.

My amateur prognosis: The Fed's Sisyphean obsession with inflation and the consequent increase in rates *may* have pushed the rock over the hill and down the other side. However, the professionals (Wall Street and the Fed) have a different view.

Sean A OKeefe

PONZI - continued from page 2

Particularly in smaller investment deals, with non-institutional investment outfits, there is no reason for the promoter to have unfettered control over your money. Whenever a contrary structure is in place, more investigation is necessary.[4]

Ask For The Principal's CV

Low risk/high yield investments, the standard fare offered in ponzi schemes, reflect a market inefficiency. Although such opportunities exist, they are difficult to find and have a short life expectancy. Generally, two kinds of people find these opportunities – the brilliant[1] and/or the lucky. The ponzi promoter will invariably represent that he or she is in the former category. My experience suggests the reality is otherwise. The schemer's gift is a facile tongue, not an exceptional intellect.[5]

Before investing, obtain the promoter's resume. If the promoter wants your money, particularly a lot of it, he/she should be willing to give you a CV that describes the promoter's experiential and educational pedigree. Mr. Ponzi's modern brethren will resist this demand or fabricate the data. If they refuse to provide the information, invest elsewhere. If they give you this information, check a few references. You worked hard for your money, don't waste it. ♣

Article One Notes

1.IRAs are more often than not the retirement vehicle of the least financially well off. Denying these accounts protection is an irrational policy position.

2. IRC § 401(k).

3. IRC § 403(B).

4. C.C.P. § 704.114.

5. C.C.P. § 704.115(b) & (d).

6.C.C.P. § 704.115 (e).

7. Some of the decisions only make sense if a) a third world retirement venue is assumed, or b) the IRA owner will have the capacity to save vast sums in the future and earn exceptional returns. This arbitrary case by case system is unnecessary and wasteful. Since the legislature does not seem inclined fix the State's dysfunctional exemption system remains, the courts should at least provide linear guidance on the "reasonably necessary" standard by adopting a simple and rational methodology. For example, the existing IRA deposit could be increased through the projected date of retirement using U.S. Treasury yields as the yield indicator (based on commensurate term U.S. Treasuries instruments). Then, the resulting balance could be converted into an income stream using annuity calculators readily available on insurance websites. This methodology would at least give the courts a rational picture of what the prospective retiree is looking at in the future.

8. In re Mooney, 248 B.R. 391 (Bankr. C.D. Cal. 2000).

9. C.C.P. § 704.115(b) & (d).

10. McCullen v. Haycock, 147 Cal. App. 4th 753 (2007).

11. Bankruptcy Abuse Prevention And Consumer Protection Act of 2005.

12. 11 U.S.C. § 522(n)

Article Two Notes

1. The ponzi scheme is the brain child of Charles Ponzi, one of the world's great swindlers. The ponzi concept is simple. Offer investors a high yield based upon an allegedly legitimate, but in fact non-existent, investment opportunity. As investment dollars flow in, use a part of this principal inflow to pay bogus dividends or interest to the investors. These cash payments validate the merits of the underlying investment opportunity. As the word of this great opportunity spreads, more investment dollars follow and the game continues until the schemer decides to flee the jurisdiction or until the fraud is uncovered. In many ponzi disasters, the original business concept was real. The ponzi develops later when losses are suffered and the promoter is not inclined to tell the truth to the investors.

2. These clients contacted me for representation after they received a complaint in the mail from the receiver appointed by the Securities & Exchange Commission to take over the failed investment scheme (or from a Chapter 7 trustee) demanding repayment of the fictitious profits distributed to them by the promoter during the term of the investment.

3. See, Section 2(a)(1) Securities Act of 1933; Rule 3a11-1, Securities & Exchange Act of 1934; SEC v. W.J. Howey Co., 328 U.S. 293 (1946); Marine v. Weaver, 455 U.S. 551, 555 (1982). The definition of a "security" is derived from the economic realities test first explained by the U.S. Supreme Court in the Howey case. Under the Howey Test, an interest will be classified as a security only if the following three elements are present:

- an investment of money has been made,
- in a common enterprise and
- the investor has the expectation of profits, which profits are expected to arise solely, or substantially, from the efforts of the promoter or third party.

See also, Silver Hills Country Club vs. Sobieski, 55 Cal. 2d 811 (Cal. 1961); People v. Park, 87 Cal.App.3d 550, 563 (1978)("Under widely accepted judicial interpretation and definition, an investment contract for the purposes of securities laws means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.").

4. Nascent investment outfits should bend over backward to convince the investor that they can't get its hands on the money under the cash control system in place. This should be an upfront sales point.

5. Ask any top fund manager - consistently beating the market is very difficult (even with the benefit of an incredible resume). It generally requires exhaustive analysis, experience, a strong financial education and more than a little luck. Although someone without these qualifications could stumble upon an exceptional profit opportunity, your next problem is their capacity to exploit it.