News from Moss & Barnett
A Professional Association

Spring 2009

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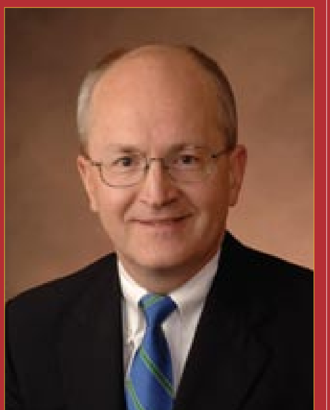

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Charles Ponzi is Not Your Friend

The past year has brought news of Ponzi schemes of stunning proportions. Schemes measured in billions of dollars have pushed schemes measured in mere millions of dollars off the front page. Thousands of investors, including individuals who invested their life savings and charities, have been hurt upon the inevitable collapse of these schemes.

Victims invariably react to news of the collapse by saying, "I can't believe I did not see this coming." In truth, though, Ponzi schemes can be extraordinarily difficult to detect. This article will explore some ways an investor can avoid being the next Ponzi victim.

Charles Ponzi did not invent the pyramid fraud scheme that now bears his name. His story, however, does demonstrate well the nature of a pyramid scheme and provides avoidance lessons that can still be applied today.

Mr. Ponzi was a charming and ambitious person who in the early 1900's induced investors to invest with him by offering very high returns on a dubious scheme involving, of all things, international postage charges. Many of the investors were Mr. Ponzi's friends (or friends of friends) and relatives. Mr. Ponzi kept the scheme afloat by using money from later investors to pay the earlier investors. After a few months, the supply of new investors ran out and the scheme collapsed leaving many investors with nothing.

Here are a few lessons from Mr. Ponzi's story:

- A high rate of return is suspect. First ask why this promoter *can* pay more than what is paid on comparable investments. Then ask why this promoter *would* pay more than a market rate. A legitimate promoter with a strong and stable history should be able to borrow from institutional lenders at very favorable rates. The very fact that the promoter is offering higher rates should be an indication either that the investment is untried and too risky for the ordinary investor or that the investment is fraudulent.

- The fact that a promoter is a friend (or at least acts friendly) or a relative or is active in a particular club, charity, or religious organization, does not endow the promoter with special business skills and may not make the promoter any more trustworthy. For example, dramatic charitable contributions by a promoter may have been funded with investor money.

- Vanity can cloud good judgment. The clever promoter lets investors think that they are especially smart and discerning. Each investor believes that he or she is among the select few allowed to invest, when in reality anyone with a checkbook can invest.

- Beware of secrecy and urgency. A promoter who cannot (or will not) explain his or her business plan in a few short paragraphs, support the plan with audited financial statements, and then provide a reasonable time to digest that information does not deserve to receive any investor money.

- Early performance may not be repeated. Any Ponzi scheme can pay investors consistently for months, or even years, without the benefit of any legitimate business. New investor cash can support the appearance of success. Investors must look at operating results, not just at cashflow.

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- Do not assume that other investors have already investigated the investment. Each investor must be prepared to ask the necessary questions as if he or she were the first to invest with this particular promoter.

- Beware of unusual documents. Legitimate investments have a common look and feel that sophisticated investors expect to see. Quirky documents from unusual sources are a red flag for extra caution.

A clever promoter can manipulate his or her investment scheme so that many of the factors described above are not present, but a careful consideration of all these factors should help an investor see through most Ponzi schemes that might be presented. An investor with questions regarding an investment should seek out advice from a trusted lawyer, accountant, or investment advisor.