Watch out: Ponzi scheme on steroids

Richard Sugar
Spoonful of Sugar

We've all heard and read extensively about the notorious Bernie Madoff Ponzi scheme. Thousands of personal investors and charitable organizations lost money. It is hard to imagine a more sinister misconduct. But there is one, one that ties both hands of its victim behind his or her back.

FirstPay was a well known payroll and tax service company that handled, on average, $100 million per year of customers' money. It prepared and processed payroll checks and reported and paid to the IRS associated payroll taxes and withholdings on behalf of its employer-customers. It had direct access to its customers' bank accounts. In performing its duties, it was supposed to transfer money from its customers' bank accounts to the IRS in satisfaction of its customers' payroll tax obligations and those of its customers' employees.

According to court filings, FirstPay got greedy and diverted its customers' cash, spending the money instead on a 42-foot sailboat, a personal home mortgage repayment, the purchase of personal real estate, and the funding of an unrelated pawn shop business. It was alleged that Mark Rothman, the owner of FirstPay, skimmed more than $11 million for his personal use.

He succeeded for so long by changing the IRS mailing addresses of his customers to his office. The scheme unwound Rothman was declared dead of Non-Hodgkin's lymphoma while traveling on his 42-foot boat in the British Virgin Islands. There are some who say his death was faked.

So why do I say this a worse case than the Madoff Ponzi scheme? Because in the Madoff scheme, investors lost the money in-hand only once. In the FirstPay situation, customers lost money that had been diverted from their accounts, on the one hand, and then lost out again, when the IRS came looking for payment of delinquent taxes from those same customers, and their employees, on the other hand.

Litigation, spawned from this situation, continued for a tedious 11 years. After FirstPay filed for bankruptcy, in an attempt to make some of FirstPay's customers whole, the bankruptcy trustee tried to recover $28 million deposited with the IRS in the 90 days preceding FirstPay's bankruptcy filing. Sadly, the Fourth Circuit US Court of Appeals ruled, this last December, that the money the bankruptcy trustee tried to recover did not belong to FirstPay in the first place, and therefore, could not be recovered and returned to FirstPay's customers.

The moral of the story? It's best to use both hands to hold onto your money. Your left hand should always watch what your right hand is doing — to avoid double-handed jeopardy. You are wise to separate the holder of your money from the party who accounts for your money, whether you are an individual or an enterprise.

Richard Sugar is a North Shore resident who practices law in Chicago and writes a monthly column for the Lake Forester.
RAS.Sugar1898@gmail.com