Committees: Commercial Fraud

Tracing Commingled Funds in Fraud Cases

Date Created: Wed, 06/21/2017 - 16:42

Melissa Davis
KapilaMukamal, LLP;
Fort Lauderdale, Fla.

Commingling of funds frequently occurs in fraud cases and is notably common in Ponzi scheme cases. It occurs when funds belonging to one party are deposited into the same bank account as funds that belong to a different party. Because money is fungible, it is not possible to trace exactly which dollars belong to which party if they reside in the same bank account.

Consider an instance where funds that are derived from a fraud scheme are commingled with other nonfraud funds in the same bank account, and part of the commingled funds are subsequently used to purchase assets while the balance of funds remains in the bank account when the fraud is uncovered. If a trustee or receiver is appointed, they are charged with taking possession of or recovering assets for the benefit of the fraud victims. If such funds are commingled in bank accounts with nonfraud funds or assets were purchased with commingled funds, the trustee or receiver may need to prove what amount is associated with funds derived from the fraud to be successful in a recovery. There are several accepted methodologies that trustees and receivers can use to demonstrate tracing of commingled funds to quantify the specific amounts associated with the fraud.

Tracing

Tracing is a forensic accounting technique utilized to determine what happened to specific funds, whether they were utilized to purchase a specific asset or for some other purpose, or whether they reside in a specific account. It may be possible to trace a specific sum of money from one bank account to another if there is no commingling. But when it is not possible to specifically identify funds in a bank account, applying tracing methodologies is an equitable substitute. [1]

Lowest Intermediate Balance Method

The "lowest intermediate balance rule" (LIBR) is the governing standard and has its roots in trust law. In *In re Thomas H. Dameron*, the court found that LIBR is an accepted methodology for tracing commingled funds. [2] In a trust matter, LIBR assumes that the trustee spends his own money from the commingled account before spending the trust's proceeds, which only remain in the account to the extent that the account balance remains at or above the amount of the trust proceeds. The same may be applicable in a fraud case.

In a fraud case, application of LIBR essentially presumes that the owner of the commingled account will preserve the fraudulently obtained money for the benefit of the defrauded victims. Even if the account-holder has wrongly commingled someone else's money with his own, LIBR presumes that the account-holder spends his own money first and maintains the defrauded party's money in the account until there is no "clean" money left to spend, and only then will the victim's money be utilized. Figure 1 is an example of LIBR-tracing methodology applied to illustrate the balance available of fraud funds after commingling occurs.

Figure 1: LIBR Tracing

Date	Description	Deposit	Withdrawal	Fraud Funds Balance	Nonfraud Funds Balance	Total Balance

Date	Description	Deposit	Withdrawal	Fraud Funds Balance	Nonfraud Funds Balance	Total Balance
5/1	Beginning balance (non-fraud funds)				$1,000	$1,000
5/2	Deposit (fraud funds)	$5,000		$5,000	$1,000	$6,000
5/3	Withdrawal		($500)	$5,000	$500	$5,500
5/4	Withdrawal		($2,000)	$3,500	$0	$3,500

On May 1, the balance in the bank account is $1,000 of nonfraud funds. On May 2, $5,000 of funds obtained from a fraud scheme are deposited into the account and commingled with the beginning balance. The balance at the end of May 2 is $6,000, comprised of $5,000 of fraud funds and $1,000 nonfraud funds. On May 3, there is a withdrawal of $500. Since LIBR assumes that the account owner will spend his own money first, the $500 withdrawal is assumed to be derived from nonfraud funds, leaving a balance of $5,000 in fraud funds and reducing the balance of nonfraud funds to $500. On May 4, there is another withdrawal of $2,000, which will first be applied to the nonfraud funds balance of $500, and only when that balance is reduced to zero is it assumed that the fraud funds are utilized, leaving a balance of $3,500.

Replenishment

As noted *in re Thomas H. Dameron,* once the trust funds are depleted, or in our example the fraud funds are depleted, they cannot be replenished by subsequent deposits. There appear to be two schools of thought when it comes to replenishment. On the one hand, courts have found that subsequent funds deposited into an account containing commingled funds do not replenish any of the trust funds previously utilized (unless there was intent to do so). [3] Figure 2 contains the same transactions as Figure 1, with one subsequent $2,000 deposit being made after some of the fraud funds were depleted.

Figure 2: LIBR with Subsequent Deposit (No Replenishment)

Date	Description	Deposit	Withdrawal	Fraud Funds Balance	Nonfraud Funds Balance	Total Ba
5/1	Beginning balance (nonfraud funds)				$1,000	$1,000
5/2	Deposit fraud funds	$5,000		$5,000	$1,000	$6,000
5/3	Withdrawal		($500)	$5,000	$500	$5,500
5/4	Withdrawal		($2,000)	$3,500	$0	$3,500
5/5	Deposit (nonfraud funds)	$2,000			$2,000	$5,500

On May 5, there is a deposit of nonfraud funds for $2,000. Under this theory of replenishment, although $1,500 of the fraud funds were previously depleted, the subsequent deposit does not replenish the balance but instead is credited to the account-holder.

On the other hand, courts have found that when an account-holder deposits subsequent additional funds into the account with commingled funds, one presumes that the new money is first used to replenish any funds that belonged to the defrauded victims but were wrongly spent by the account-holder. [4] In *In re Mahan Rowsey Inc.,* the court found that "when a trustee replenishes a commingled account which has fallen below the amount held in trust due to the trustee's invasion, the trustee is presumed to return the beneficiary's money first." [5]

After the fraud funds are fully replenished, the remaining money is credited to the account-holder. *In re Bernard C. Mazon,* the court found that this replenishment methodology was a commonly recognized forensic accounting principle. [6]

Figure 3 illustrates the alternative replenishment rule. On May 5, when the deposit of $2,000 is made, the first $1,500 is credited to the fraud funds balance, bringing the balance back up to the original amount deposited into the account. Only when the fraud funds are completely replenished will funds be credited back to the account-holder.

Figure 3: LIBR with Replenishment

Date	Description	Deposit	Withdrawal	Fraud Funds Balance	Nonfraud Funds Balance	Total Balance
5/1	Beginning balance				$1,000	$1,000

Date	Description						
5/2	Deposit fraud funds	$5,000		$5,000	$1,000	$6,000
5/3	Withdrawal		($500)	$5,000	$500	$5,500
5/4	Withdrawal		($2,000)	$3,500	$0	$3,500
5/5	Deposit	$2,000		$5,000	$500	$5,500

Other Tracing Methods

Courts have also applied the *pro rata* method, whereby withdrawals from an account containing commingled funds are attributed to the source in proportion to their respective balances at the time of the withdrawals. [7] In our fraud-tracing example, the first withdrawal of $500 that was made after the deposit of the $5,000 in fraud funds would be allocated based on the balance of both fraud and nonfraud funds. On May 3, when the balance in the account is $6,000, comprised of $5,000 in fraud funds (83.33 percent) and $1,000 in nonfraud funds (16.66 percent), the $500 withdrawal will be allocated in proportion, or $416.65 to fraud funds (83.33 percent) and $83.35 to nonfraud funds (16.66 percent).

In the "first in, first out" method (FIFO), it is presumed that moneys are paid out in the order in which they were paid in. [8] In the "last in, first out" method (LIFO), it is presumed that the last moneys deposited into an account are the first ones withdrawn, which results in an entirely different outcome. [9]

Conclusion

Application of different tracing methodologies to the same set of transactions will bring about varying results. In our example, if the trustee or receiver attempted to either recover the asset purchased with fraud funds or to recover the balance remaining in the bank account that was associated with the fraud, the results would vary. Under LIBR, the recovery could total $5,000, of which $1,500 would be associated w withdrawal (assuming the funds were used to purchase some asset to recover) and $3,500 would be associated with the balance rema the account.

Figure 4: Tracing Methodology Results Summary

Tracing Methodology	Total Withdrawal Amount	Withdrawal Allocated to Fraud	Withdrawal Allocated to Nonfraud	Fraud Funds Remaining	Nonfraud Funds Remaining	Total Funds Remaining
LIBR	$2,500	$1,500	$1,000	$3,500	$0	$3,500
Pro Rata	$2,500	$2,083	$417	$2,917	$583	$3,500
LIFO	$2,500	$1,500	$1,000	$3,500	$0	$3,500
FIFO	$2,500	$2,500	$0	$2,500	$1,000	$3,500

Different courts have demonstrated the applications of each methodology under varying circumstances. Applying the correct methodology will require a study of applicable case law and facts surrounding the particular case. Knowledge of each available tracing methodology is important so that the cor

---

[1] *In re U.S. v. Henshaw*, 388 F.3d 738 (10th Cir. 2004) (citing William Stoddard, *Tracing Principles in Revised Article 9 § 9-315(B)(2): A Matter of Careless Drafting, or an Invitation to Creative Lawyering*, 3 Nev. L.J. 135, 135 (Fall 2002)).

[2] *In re Thomas H. Dameron, et al. v. Robert O. Tyler, et al.* 155 F.3d 718 (33 Bankr. Ct. Dec. 279, Bankr L. Rep P 77,804).

[3] *Id.*

[4] *In re Bethlehem Steel Corp. v. Tidwell*, 66 B.R. 932 (M.D. Ga. 1986)

[5] *In re Mahan Rowse, Inc.*, 35 B.R. 898 (Bankr.W.D. Okla. 1983)

[6] *In re Bernard C. Mazon and Jane I Mazon, Debtors, et al. v. Robert E. Tardiff Jr., et al.*387 B.R. 641; 2008 U.S. Dist. LEXIS 34618.

[7] *In re Christensen*, 122 Nev. 1309, 149 P. 3d40 (2006) citing *United States Fidelity & G. Co. v. Union Bank & T. Co.*, 228 F. 448 (6th Cir. 1915); *Gwynn v. Spurway*, 28 F.2d37 (S.D. Iowa 1928).

[8] *Id.* (citing Harris J. Diamond, Note, *Tracing Cash Proceeds in Insolvency Proceedings Under Revised Article 9*, 9 Am. Bankr.Inst. L. Rev. 385, 413 (2001).

[9] *Id.*

Help
Center