

Anatomy of a Fraud

Alleged scam targets asset-based lending firms

BY PAULA SCHAAP | It's an old story.

Local boy makes good. Local boy builds his own multi-million dollar business from the ground up. Local boy spreads his wealth around, doing good with large charitable gifts.

Local boy is hauled off to jail on allegations that his business was a total fraud from start to finish. The sums involved in the fraud may total more than \$3 billion, according to FBI documents.

That's the story of Thomas Petters, Minneapolis businessman and philanthropist, and now a man accused of masterminding an extensive fraud. Petters' criminal defense attorney did not return calls seeking comment.

There are some unusual aspects to the old story in this case, however. For one, Petters' alleged scheme had backing from a particular hedge fund strategy, asset-based lending. That strategy is better known for its consistent returns and low volatility, than for investors being taken in by a con artist.

At a time when the asset class as a whole was down 8.36% year-to-date, according to the HFN Hedge Fund Aggregate Average, asset-based lending was up 6.02%.

The reason asset-based lending is considered a safe, if pedestrian, strategy is because the investor is supposed to get evidence that the collateral – tractors, engine parts, appliances – is, in fact, backing up the investment. Invoices, security interest filings and insurance are all provided to the investor so that he can ascertain that his money is safe.

For asset-based lending firms, Petters Co. (PCI) was so well known that it was referred to as the “Petters trade,” according to Douglas Hirsch, a partner with law firm Sadis & Goldberg, who represents a number of hedge fund firms that invested with Petters.

When PCI and its parent company Petters Group Worldwide filed for bankruptcy after their founders' arrest, hedge fund firm Ritchie topped the list of creditors with a claim for more than \$208 million, according to court documents. Interlachen Capital Group came in second with a claim for more than \$68 million.

What allegedly happened in the Petters case seems so breathtakingly simple that it's hard to imagine how investors were taken in, let alone how it could keep going for so long. One of Petters' companies, PCI, was supposed to buy high-end merchandise, such as wide-screen TVs, from vendors and resell them to big box discount chains like Sam's Club. But PCI had employees and other co-conspirators who phoned up the paperwork for merchandise that were never bought and sold, according to the FBI.

Promised investment returns and loans were paid off in traditional Ponzi-scheme fashion. Some of investors' money may have gone to Petters stakes in other companies, like Polaroid, Fingerhut and Sun Country Airlines. Petters also lived high on the hog. His gambling losses at Las Vegas' Bellagio Casino were more than \$10 million, the FBI said.

One of Petters' co-defendants, Larry Reynolds, even went so far as to show insurance companies a warehouse full of electronic goods; goods that belonged to other companies, the government charged.

Samuel Buell, a professor at Washington University's law school and a

former U.S. Attorney, says that while he didn't know the exact circumstances of the Petters case, he was struck by the way Petters was caught. PCI's Vice President Deanna Coleman, who had worked with Petters for years, walked into the FBI's office, Sept. 8 and dumped the whole scheme into the agency's lap. Before that, the government had no idea what was going on, according to court documents.

“That's pretty unusual in a case of this size,” Buell says. “Generally what happens is that some little piece of the picture will be exposed because there will be some third party complaint about something not squaring up properly and the Bureau will start to look.

“[Coleman] may have realized that there was some shoe that was about to drop that was going to put her in a bad spot, so she wanted to get out ahead of it,” Buell says.

Coleman and two co-conspirators have already pleaded guilty

and have agreed to cooperate with the government. Coleman's criminal defense attorney did not return calls seeking comment.

There is at least one indication that the scheme was about to unravel. In August, hedge fund Acorn Capital Management sued Petters personally on his guarantee of \$50 million for \$273 million worth of loans, according to court documents.

The alleged fraud's unveiling has been a big shock to the Twin Cities' business community, as well as charitable organizations that were either the beneficiaries of Petters' consider-

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Hedge Fund Performance by Strategy

Last 12 Months Through September 2008, by Percent Return

This chart displays the last 12 months of the aggregate performance of hedge funds through September 2008, according to HedgeFund.net-PerTrac Universes, a feature of PerTrac Online. The data below presents select strategies. HedgeFund.net-PerTrac Universes charts the aggregate performance of a total of 33 different hedge fund strategies.

	Mar 2003	Feb 2003	Jan 2003	Dec 2002	Nov 2002	Oct 2002	Sept 2002	Aug 2002	Jul 2002	Jun 2002	May 2002	Apr 2002
All Funds	-4.90%	-1.23%	-2.28%	-0.96%	1.74%	1.41%	-2.20%	1.74%	-2.55%	0.68%	-1.40%	2.89%
Convert. Arbitrage	-8.84%	-0.43%	-1.82%	-0.59%	1.14%	0.62%	-1.83%	-0.58%	-0.09%	-0.71%	-1.03%	1.86%
CTAs	0.39%	-0.40%	-3.45%	2.77%	1.92%	0.06%	-0.85%	6.94%	1.75%	1.86%	0.67%	3.33%
Distressed	-6.02%	-1.10%	-1.94%	-0.91%	1.25%	0.89%	-1.44%	-0.52%	-2.48%	0.03%	-1.57%	1.99%
Emerging Markets	-10.48%	-4.49%	-3.79%	-3.68%	2.06%	2.62%	-3.78%	3.26%	-5.39%	2.03%	-2.04%	5.24%
Event Driven	-7.01%	-0.15%	-2.02%	-2.55%	1.83%	1.54%	-1.60%	0.89%	-2.76%	-0.02%	-2.24%	2.54%
Fixed Income	-3.03%	0.13%	-0.56%	-1.04%	0.62%	0.88%	-1.50%	-0.42%	-1.45%	0.01%	-0.66%	1.34%
Fixed Income Arb.	-2.77%	0.04%	0.22%	-0.49%	0.98%	1.52%	-2.92%	-0.52%	0.57%	0.72%	-0.36%	0.76%
Fund of Funds	-5.41%	-1.64%	-2.64%	-0.66%	1.66%	0.88%	-2.63%	1.39%	-2.69%	0.45%	-1.42%	3.01%
Long/Short Hedged	-6.54%	-1.26%	-2.57%	-2.20%	2.34%	2.42%	-2.57%	1.50%	-4.30%	0.64%	0.64%	3.40%
Macro	-1.66%	-1.99%	-1.36%	0.18%	0.86%	0.48%	-1.44%	2.55%	-0.39%	1.01%	-0.36%	3.00%
Mark. Neutral Equity	-2.63%	-1.43%	-0.92%	1.13%	1.28%	0.98%	-0.47%	1.30%	-1.01%	0.67%	-0.17%	1.24%
Risk Arbitrage	-2.60%	1.04%	-0.04%	-1.21%	1.29%	1.61%	-0.81%	0.52%	-1.58%	-0.02%	-1.42%	1.42%
Short Bias	5.92%	-2.18%	-0.61%	7.91%	-1.85%	-3.80%	1.20%	3.81%	4.66%	0.55%	6.09%	0.87%
Technology Sector	-5.28%	-0.01%	-1.88%	-4.18%	1.32%	3.43%	1.27%	-0.06%	-6.72%	-1.02%	-3.21%	6.40%
Value	-6.77%	0.35%	-1.99%	-5.26%	2.38%	3.15%	-2.56%	-0.56%	-3.64%	0.45%	-3.00%	2.11%

About HedgeFund.net-PerTrac Universes and PerTrac Online

HedgeFund.net-PerTrac Universes are available through PerTrac Online, an advanced tool for hedge fund analytics available exclusively to registered users of HedgeFund.net. The Universes provide a three-dimensional view of HedgeFund.net's hedge fund performance indices. Detailed percentile rankings are calculated each day for each of 33 investment strategies. The results are presented in easy-to-use tables and graphs. Alternative Universe provides monthly, yearly, and sector-focused views of PerTrac Online aggregate data on a rotating basis.

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able largesse or trusted his company with their investments.

Brian Gudmundson, whose law firm Zimmerman Reed, has brought a RICO action against PCI on behalf of a number of ministers and non-profit organizations who may have lost everything says he isn't surprised that unsophisticated investors were taken in.

Even for the sophisticated, however, Gudmundson says he could see how a scheme as simple as fabricating documents could work.

"I talked to some sophisticated investors and they said they checked the papers again and there's everything they would need: insurance, securitization. They said I would invest in it again," he says.

One person who is not surprised to hear that Petters landed behind bars is Randy Shain, vice president of First

Advantage Investigative Services, a firm that does background checks for hedge funds and other investors.

Shain's firm looked into Petters in 2002 at the behest of several hedge fund firms who did not go on to invest in the deal. One of the first red flags was that Petters said he graduated from St. Cloud University. It turned out that he went to the school for only one semester.

Richard Bookbinder, whose fund-of-funds firm Bookbinder Capital Management was one of the firms that retained Shain to investigate Petters' company said the inconsistency about his college degree was enough to get Petters struck from his potential manager list.

"I don't care if someone went to City University, Harvard, or Rutgers, it doesn't matter," Bookbinder says. "But if we're told, I graduated from

college X and it turns out you attended for only one semester, that's a non-starter for us."

Shain also says, "I've seldom seen so much litigation for someone."

Included among the cases from the late 1990s and early 2000s was one divorce, one bankruptcy and at least one criminal case for a financial crime.

In hindsight, many of the civil cases look eerily similar to the scheme that Petters is now charged with perpetrating; someone was inveigled to invest in a buying and selling transaction that never quite paid off. But that's probably of cold comfort to investors waiting to see what will happen now.

"As we're finding out, watching what's happening in the markets these last few months, a lot more than we'd like to admit in our economy is based on trust and faith," Buell says.