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Broke & abandoned

A state agency ignored investors while a company took millions

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By DEVONA WELLS / The Press-Enterprise

What is a Ponzi scheme?

It's a fraud disguised as a legitimate business that pays earlier investors with money from later ones. Large returns early on convince people the investment is safe. As the scam progresses, they often put in more. But the momentum of raising cash from new investors and paying it out can't be sustained.

Mary Anne Hughes thought she had a sure bet.

Looking to recoup stock-market losses, the Canyon Lake woman dropped by several investment seminars a month. Then she found D.W. Heath & Associates.

She liked the pitch, and she liked the promised return.

Hughes began pouring money into the firm in 1999, unaware that the state Department of Corporations the previous year had ordered Heath & Associates' president, Daniel Heath, to stop selling investments.

She became one of hundreds of Heath clients who signed over retirement accounts and drained their savings while complaints about Heath piled up at the department responsible for protecting investors.

For six years, Heath defied the state's order. He ultimately raised an estimated $192 million from more than 1,600 investors. The department had the authority to ask a court to freeze the firm's assets. Instead, it was busy laying off investigators to save money.

William Wilson Lewis III / The Press-Enterprise

Mary Anne Hughes of Canyon Lake waited weeks to tell her ailing husband, Charles William (Bill) Hughes, that the $249,190 in retirement savings they had invested with Heath & Associates was mostly gone.

The Department of Corporations handed off its Heath files last year to the Securities and Exchange Commission, which in less than two months got the company closed.

Hughes, by then, had given $249,190 to Heath & Associates. Most of the money she counted on for a comfortable retirement is gone.

"No one can really understand what it feels like to work all your life and have it all taken away. And knowing you can't go back and start over," said Hughes, 62.

The principals of Heath & Associates, now the focus of Riverside County's largest-ever fraud prosecution, remain in jail. Authorities say money raised by the firm was part of a typical Ponzi scheme that funneled funds to earlier investors to cover promised interest payments.

Daniel Heath's attorney, Barry O. Bernstein, said his client declined to talk about the case, and Heath did not respond to letters requesting an interview. A previous attorney for Heath, David Bortman, said the business would not have collapsed if the government had not interfered.

California's Department of Corporations is in charge of enforcing state investment laws. Once known for aggressively pursuing suspected fraud, the department's policy shifted away from investigation after Gov. Gray Davis took office in 1999, according to interviews with veteran investigators and lawyers no longer at the department. The enforcement division ended up losing nearly half of its workers, and investigations and court actions fell off, according to interviews and statistics.

"The effect of that has been to decrease public protection. There isn't any doubt about that," said Bill McDonald, the department's enforcement director for 21 years until he retired rather than take a demotion in 2001.

Theories about the department's shift vary from a desire to micromanage investigators to not wanting to share credit for investigations, according to former department workers. Some say there was a philosophical change in focus from pursuing unlicensed con artists to devoting more attention to unscrupulous brokers. But the men who were in charge won't talk.

William Kenefick, an acting commissioner for two years starting in 1999, did not respond to phone messages and a letter requesting an interview. Contacted at his home, Kenefick declined to comment**.** Demetrios A. Boutris, who ran the department from early 2001 through 2003, also would not comment.

Complaints and Cutbacks

Questions and warnings about Heath came from not only investors, but from a financial firm handling Heath accounts and from the Department of Corporations' own employees.

Former investigator Carol Fong saw Heath in action, giving 60 or so seniors investment advice at least three years after the state told him to stop acting as a broker because he was not licensed. Also, he was not offering state-approved investments, authorities say.

"I told the (department's) attorney that was handling the case, 'He's doing the same exact thing.' The attorney never did anything," said Fong, who identified the attorney as Mark Harman. He has since left the department and declined to comment.

By 2001, the Heath case and others languished as investigators were told to stop assisting district attorneys with criminal cases, according to former Department of Corporations employees. The rationale: State employees shouldn't supplement the work of county prosecutors.

In 2003, as part of budget-cut layoffs, the Department of Corporations gutted its investigation unit, losing all 14 investigator positions. California's savings: About $900,000 a year.

At least 50 complaints and inquiries made by Heath investors sat stacked at the Department of Corporations as layoffs were in the works, said former investigator John Noonan. "When I found out these people were calling, I said, 'We've got to do something.' I was angry. They wanted us to finish our old cases, didn't want to stick us on anything big."

Cases the department referred for criminal prosecution declined from 27 in 2002 to none in 2004. Department officials said they could not provide criminal-referral statistics for 1991 through 2001.

In recent years, the Department of Corporations continued issuing desist-and-refrain orders -- a first step toward prosecution -- but rarely followed through with civil action to shut down a company.

Today, the Department of Corporations says it's trying to do more with less but still has no investigators. Going without such expertise makes prosecuting white-collar crime difficult, said Michael Silverman, a Riverside County deputy district attorney.

"We don't have the manpower in our office to do what needs to be done in these cases," he said, referring to the investigation of investment fraud. "Our office isn't designed just to handle securities cases."

Nonetheless, Riverside County mounted its criminal case in July against Heath, 48, along with Heath's father, John Heath, 78, Larre Schlarmann, 49, and Denis O'Brien, 50. In jail interviews or through their attorneys, John Heath and O'Brien said they knew nothing of suspected illegal activity at Heath & Associates. A previous attorney for Daniel Heath said he denied the charges. Schlarmann did not respond to a letter requesting an interview and his attorney did not return phone calls.

All four men have pleaded not guilty to securities fraud and grand theft.

Daniel Heath and O'Brien reached settlements earlier this year in a civil case brought by the Securities and Exchange Commission, which has powers similar to the Department of Corporations for shutting down suspected frauds. In total, Heath and O'Brien agreed to pay $111.5 million in damages, although the SEC has said it's expected that most of it never will be paid.

'Stung'

Kathryn Holguin, an investigator at the Department of Corporations for 25 years, said that shortly before she retired in December 2001, her supervisors told her not to work criminal cases.

"I would have them laughing at me when I'd ask who's going to care about these little old ladies getting ripped off. They'd say, 'Kathy, that's not our problem.' "

Complaints once were followed up by investigators who phoned or visited investors. Investigators might have searched a company's office, posed as an investor or collected evidence recommending prosecution. Sometimes they assisted local district attorneys as a case was tried.

Heath & Associates telemarketers in Hemet called seniors, sometimes several times, to get them to seminars and then one-on-one meetings. The firm also operated in Pasadena and Brea.

Paul Hering, who invested about $240,000, blames the Department of Corporations for letting Heath collect his savings after the 1998 desist order.

Like others, he started out small but eventually gave Heath nearly all his savings. The company charged with getting money back to investors has forecast a return of just 14 cents for every missing investor dollar.

"Our state, unfortunately, doesn't care about the people who get stung," said Hering, 75, who lives in a Lake Forest mobile-home park.

Department of Corporations officials say they referred the Heath case to the Riverside County district attorney's office for criminal action in 2000 but could not provide evidence of a referral.

Last year, the district attorney's office said it never received the referral. It started investigating the case by April 2004.

Acting Commissioner Wayne Strumpfer said he's conducting an informal review of how the Department of Corporations handled the Heath case. The results likely will be shared with the governor's office, he said.

This is not the only case being reviewed by Strumpfer but is of particular concern because of the number of seniors involved and the amount invested, a spokeswoman said.

'Deteriorating' Department

Retired Department of Corporations attorney Dorene Wolf said that before she left in 1997, the department regularly took companies to court.

"We were so aggressive and so good. I can't figure out what happened," she said.

Attorney General Bill Lockyer grew so dissatisfied with the Department of Corporations that he put together a corporate-crime unit that launched last year. From 1999 through 2002, Lockyer said his office received no criminal referrals from the Department of Corporations. Previously, the attorney general would get a couple of referrals a year, a spokesman said.

Lockyer, in a hand-written letter to investor Elinor Morris, called the department's response to the Heath case "inadequate, if not negligent."

The department's drive to reduce criminal work emerged from the new leadership's desire to tightly control investigators, interfering with their work, said former enforcement head McDonald.

"That misses the point, which is protecting the public," McDonald said. "These are state citizens protected by a state agency."

In 2001, the same year McDonald left, former supervising investigator Al Lomas retired after what he said were years of frustration.

Acting Commissioner Kenefick told him twice to not take suspected frauds, including the Heath case, to a district attorney, he said. Lomas said Kenefick told him the department didn't have the resources to do criminal work.

"I left because the department was deteriorating," said Lomas, who worked 22 years for the agency. "I thought they wanted to get rid of investigators. And I guess they did."

Warning Signs

Defendant O'Brien, a Heath & Associates salesman for nine years, said he didn't know about the state's 1998 order against Heath until an investor asked him about it a few years ago. In an interview at the county jail in Banning, O'Brien said that Heath told him the order was a nonissue and that the firm's investments were exempt from securities laws.

Never did anyone from the state visit or call Heath & Associates to see if Heath was violating the order, he said. The firm used free lunches to recruit investors, offering what salesmen called safe and guaranteed investments returning as much as 9.5 percent yearly.

"They look at me and say I should have known, but maybe you guys dropped the ball," O'Brien said of the Department of Corporations.

By early 2003, a year before Heath & Associates was closed, the Colorado company administering the firm's Individual Retirement Accounts told California officials by letter that Heath might not be obeying the desist-and-refrain order.

Heath often didn't return phone calls and gave poor excuses when the company, First Trust, tried verifying that he had complied with the order, said James R. Hoy, the company's assistant general counsel.

That spring, the Department of Corporations subpoenaed Heath records from First Trust.

Hoy said he sent information about Heath to the department through September 2003. Two months later, all of the investigators were gone.

"The best we can do is tell all our account holders what we learn and present the findings to the state, which is in a position to do something about it," Hoy said. The company also sent a letter to investors warning them about Heath.

First Trust is being sued by investors who claim the company covered up for Heath.

"Our company policy is to not comment on pending lawsuits," Hoy said Friday.

Former investigator Noonan said then-chief of enforcement Jo Dunlap rejected his request in the summer of 2003 to execute a search warrant at Heath & Associates because the follow-up work couldn't be completed after Noonan was laid off.

Through a spokeswoman, Dunlap declined to discuss the Heath case. Dunlap was replaced as enforcement chief in December and now is the department's acting general counsel.

In Feburary 2004, Hughes began drawing interest from her Heath accounts to cover day-to-day expenses.

The monthly checks halted about a year ago after the firm was closed. Cut off from her nest egg, Hughes relied on credit cards to pay for groceries, gas, car insurance and property taxes.

Hughes racked up $24,000 in debt that she is paying off with money from the April sale of a manufactured home in Wildomar, where she had planned to retire.

She waited three months to tell her husband, who had endured several strokes, that their money was likely gone. Hughes was afraid the news would cause another stroke.

"He didn't understand it. I still don't think he really understands," she said.

Still No Investigators

Strumpfer, the department's new acting commissioner, said he's making the best of an understaffed situation. The enforcement head now personally reviews complaints, and the agency works closely with other departments to target investment fraud.

"We're just trying to stay above water," he said. "It's tough to be proactive, but I'm at least looking into finding a way to do that."

Regardless of the past, Strumpfer said he wants to share the department's expertise, whether it's for a state or district attorney's case.

"I want to get the job done," he said.

So far this year, Strumpfer said the department has made 11 criminal referrals -- up from zero last year. But today's referrals don't include search warrants and other work the department used to do when it had investigators.

The department has issued desist-and-refrain orders at a steady pace in recent years. But such civil actions as injunctions, a next step, have dropped off.

Without the muscle of investigators, some say the state desist orders mean little.

"They can't enforce them. That's the dirty little secret," said Barry Minkow, who was convicted in 1987 of securities fraud for a Ponzi scam involving his ZZZZ Best company. He is now a pastor and fraud investigator. "They've got nobody to enforce them."

Strumpfer said that even with a reduced staff, the department penalizes violators. Through April, two injunctions have been filed to halt investment offers previously slapped with a desist order. That compares to just two securities-related injunctions obtained by the department all of last year.

Richard A. Lowenstein, deputy district attorney in Los Angeles County's major fraud division, sees new vigor at the Department of Corporations.

"As much as they can help, they're helping. Hopefully they will get more investigators and be back in business as a very good agency," he said.

When asked if he'd like to see investigators return, Strumpfer said the positions no longer exist in the department's budget: "It's a moot point."

It would take a year to budget such positions and get them filled, though legislation or emergency funding could speed things up, said Department of Corporations spokeswoman Susie Wong.

Strumpfer said the department is training accountants to investigate.

But accountants can't do some of what investigators did, such as access confidential criminal records and testify on behalf of investment victims.

Lack of Attention

Ronald Marron has seen the department from two sides, inside as a legal intern in the early 1990s and now as a private attorney who pursues fraud cases for jilted investors.

The department doesn't get the money it needs to stop investment fraud, he said. "It's not their fault. The state and the governor don't make it a priority, and the state's broke."

Margo Hamilton, regional manager for Riverside County's C.A.R.E. -- Curtailing Abuse Related to the Elderly -- worries that attention paid to identity theft distracts legislators from the devastation of Ponzi schemes. The Riverside-San Bernardino metro area ranked No. 2 this year for the number of people, per capita, reporting they were victims of identity theft, according to the Federal Trade Commission.

But Hamilton notes that more money is typically lost through Ponzi schemes than ID theft.

"In investment fraud, you may have 20 victims. But you may also have $3 million in losses," she said.

Hughes' expected loss of around $214,000 means no retirement travel and no college fund for the grandson she raised. Hughes has taken out a reverse mortgage and will get by on Social Security checks that started arriving last month.

Soon after Hughes found out Heath & Associates had closed, she said she filled her days with rum and Coke and told friends she would kill herself. Hughes was hospitalized and is still taking antidepressants.

She tries now to focus on what can be done rather than what can't. Still, she sometimes finds herself thinking: "This doesn't happen to people. People don't do this to you.

"I've come a long way," she said, "but I still can't believe it."

Staff writer Paul Herrera contributed to this story.

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