I.

WHAT CAUSED THE PACIFIC HOMES DEBACLE?

THE TRUSTEE'S CONCLUSIONS

For more than 25 years, Pacific Homes perpetrated a fraud on unsuspecting elderly people in the name of the Methodist Church. That fraud, which consisted of taking money in exchange for the promise to provide lifetime care, but then diverting that money for the payment of current obligations instead of reserving those funds for the future costs of that care is best characterized as a modern day "Ponzi" scheme.[1]

Pacific Homes' management, directors and the Methodist Church, which controlled and directed Pacific Homes, were aware of the magnitude of the scheme and took active steps to encourage it and, simultaneously, to conceal it from the public. The essence of the scheme was the sale of prepaid lifetime leases and prepaid contracts for lifetime care to elderly persons who then became residents in one of the seven Pacific Homes retirement and convalescent communities. Residents were promised that by prepaying large sums of money they would have "permanent security, including complete medical and surgical care underwritten by Pacific Homes, a non-profit corporation of the Methodist Church". For the rest of their lives, residents were told, they could "forget inflation" by payment of fees "that can never be increased once you become a resident". Then, instead of reserving and investing these substantial cash pre-payments prudently, so they would be available in the future when needed to provide the services promised, the funds were diverted for expansion, speculative investments and payment of current operating losses. Since money was then needed to pay for the care of those residents whose funds had been squandered, more prepaid lifetime leases and care contracts were sold to raise cash. The scheme continued so long as enough new people could be induced to enter into the contracts.

Pacific Homes was in financial difficulty continuously for over 25 years before finally filing for protection under the Bankruptcy Act in 1977. The causes of that difficulty were multiple, interrelated and protracted:

problems

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1. Failing to establish adequate reserves to meet liabilities for future contracted care to residents;

2. Expanding facilities to meet Church missions without adequate financing;

[1] A "Ponzi" scheme is a fundamental type of fraud. It is based on taking money from investors on the promise of repaying huge returns and then paying off early investors with funds taken in from more recent investors. The scheme eventually collapses when not enough new investors are found to cover payments due. The scheme was played so sensationally by Charles Ponzi in 1919-1920, that it has been named for him ever since. A brief description of Ponzi's scheme is contained in Exhibit 1 of the Appendix.

3. Using prepaid life care funds to finance current operating deficits and expansion;

4. Encumbering assets for long-term borrowing without the ability to repay the loans, then using the borrowed funds to support operating deficits; and

5. Engaging in ill-conceived, speculative and ultimately disastrous investments, often to further Church missions, by the use of funds which should have been reserved to meet future life care liabilities.

The final collapse is directly traceable to gross mismanagement over an extended period of time. The continuous acts of mismanagement, negligence, waste and breach of fiduciary duties were known to, and officially sanctioned by, the Methodist Church which controlled Pacific Homes from its inception. Furthermore the management of Pacific Homes allowed outside pressures from the Methodist Church and its subordinate agencies to so dominate and control Pacific Homes' affairs that normal business judgment was replaced by philosophical and religious concerns that ignored the importance of fiscal responsibility. As the consequences of these acts became apparent to management and Church officials, causing increasing financial crisis for Pacific Homes, those responsible for the operation consciously and deliberately concealed the true state of affairs from the public in order to continue the "Ponzi" scheme of selling more prepaid life care contracts.

In the operation of its retirement communities, Pacific Homes was guilty of not maintaining adequate and commercially appropriate financial reserves since 1954. Since 1965, Pacific Homes was in violation of the State of California's mandated reserve requirements. By 1969, Pacific Homes had a deficit net worth of over $17 million and management was contemplating bankruptcy. However, these facts were concealed from new residents and the public and Pacific Homes operations continued. The deficit grew to over $27 million by 1976. deficit

How could the business have continued for so long a period of time under these conditions? Only because the Methodist Church directed the policies of Pacific Homes which included borrowing funds without the ability to repay, enticing elderly persons into residency by using the name of the Methodist Church, perpetuating the "Ponzi" scheme of selling prepaid life care contracts to fund current operations and expansion and concealing the true condition of the situation from residents, lenders and the general public. The more deeply Pacific Homes sank towards eventual bankruptcy, the more frantic were the efforts to borrow, to sell even more prepaid life care contracts in the name of the Methodist Church, and to conceal the losses and disastrous investments.

The State of California shares responsibility for the continuation of this fraud. By 1965, the State was aware that Pacific Homes was deficient in meeting its statutory reserve requirements and should have revoked Pacific Homes authority to sell life care contracts. Instead, the State ignored its mandatory duty, and allowed Pacific Homes to continue the "Ponzi" scheme right up to the day it filed for bankruptcy.[2]

Pacific Homes has always been a Methodist institution. It has always complied with the dictates of the Methodist Church and carried out Church missions without regard to economic consequences. The Methodist Church sanctioned the policies and actions of Pacific Homes, was fully informed of the financial problems for many years and encouraged Pacific Homes to present itself to the public as a Methodist agency. Instead of taking appropriate action to correct the problems at Pacific Homes, the Church allowed the same business practices to continue despite the knowledge that such continuance could only worsen the financial condition of Pacific Homes and add to the injuries and damages sustained.

The Methodist Church allowed Pacific Homes to fail. The Church should not be allowed to escape liability for the wrongs it has wrought. Legal actions have already been instituted against the Methodist Church by the Trustee and by the residents of the homes.[3]

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[2] The Pacific Homes debacle may well be the longest running, largest Ponzi scheme in history. The original scheme, run by Charles Ponzi in 1919-20, lasted eight months and resulted in losses to investors of approximately $4 million. Other schemes have been exposed in the years since, some resulting in investor losses in excess of $100 million. In 1973, when the Home-Stake Production Company went bankrupt it was revealed that nearly $100 million had been lost by investors over a 9 year period in an oil-drilling Ponzi scheme. The Pacific Homes fraud went on for over 25 years, involved several thousand resident-investors and has resulted in law suits claiming more than $200 million in damages.

[3] See Infra, Chapter VIII.

II.

DESCRIPTION OF PACIFIC HOMES

Pacific Homes is a California non-profit corporation, incorporated in 1929, which currently operates seven retirement homes and seven convalescent facilities for the elderly under various types of contracts under the terms of which all or a substantial portion of the payment for lifetime care and housing of such persons was made at the time they entered the respective facility. Ten of the facilities are located in California, two are located in Arizona and two in Hawaii. The residences are:

CASA DE MANANA, La Jolla, California, having a present capacity for 300 residents.

CLAREMONT MANOR, La Jolla, California, having a present capacity for 299 residents.

DESERT CREST, Phoenix, Arizona, having a present capacity for 183 residents.

FREDERICKA MANOR, Chula Vista, California, having a present capacity for 495 residents.

KINGSLEY MANOR, Los Angeles, California, having a present capacity for 299 residents.

POHAI NANI, Kaneohe, Hawaii, having a present capacity for 262 residents.

WESLEY PALMS, San Diego, California, having a present capacity for 378 residents.

The total capacity of the residential facilities is 2,216.

Since the initiation of the Chapter X case, the Desert Crest facility and some unused property adjacent to Kingsley Manor are in escrow, the sales thereof having been approved by the Bankruptcy Court.

The convalescent hospitals are:

CLAREMONT CONVALESCENT, Claremont, California, having a capacity for 53 patients.

CRESTVIEW LODGE, Phoenix, Arizona, having a capacity for 54 patients.

FREDERICKA CONVALESCENT, Chula Vista, California, having a capacity for 163 patients.

KAHANAOLA CONVALESCENT, Kaneohe, Hawaii, having a capacity for 40 patients.

KINGSLEY CONVALESCENT, Los Angeles, California, having a capacity for 51 patients.

LA JOLLA CONVALESCENT, La Jolla, California, a capacity for 41 patients.

SPARR CONVALESCENT, Los Angeles, California, having a capacity for 63 patients.

The total capacity of the convalescent facilities is 465.

Since the initiation of the Chapter X case, the Sparr Convalescent facility has been sold and the Crestview Lodge Convalescent Hospital facility is in escrow, the sale of these facilities having been approved by the Bankruptcy Court.

Copies of brochures describing the California facilities are enclosed in the pouch following the Appendix and located inside the back cover of this Report.

After a number of years of financial difficulties, the management of Pacific Homes initiated proceedings under Chapter XI of the Bankruptcy Act on February 18, 1977.

Efforts to reorganize the corporation under Chapter XI were not successful and on November 4, 1977, a motion to convert to a case under Chapter X of the Bankruptcy Act was filed. On December 9, 1977 that motion was granted and an order appointing the Trustee, who had served as Receiver during the final days of the Chapter XI proceeding, was entered.