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Article 5

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### Expanding the Ponzi Scheme Presumption

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## EXPANDING THE PONZI SCHEME PRESUMPTION

David R. Hague\*

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### INTRODUCTION

*The man who is admired for the ingenuity of his larceny is almost always rediscovering some earlier form of fraud.*

—John Kenneth Galbraith<sup>1</sup>

These days, especially with the Bernie Madoff scandal and similar cases plastered all over the media, most people are familiar with the phrase “Ponzi scheme.” The majority of people know someone who has been directly or indirectly affected by such fraudulent schemes. Although these scams can be complex and multifaceted, they are generally nothing more than a typical “borrowing from Peter to pay Paul” scheme. In the broadest sense, Ponzi schemes are investment frauds that include the payment of returns to earlier investors from funds contributed by later investors.

Victims of Ponzi schemes usually make the same mistake: they place their trust in a friend or close confidant who promises them un-

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1. JOHN KENNETH GALBRAITH, *THE AGE OF UNCERTAINTY* 75 (1975).

usually high investment returns if they will “just trust her” with their money. At the inception of these schemes, investors actually receive these promised returns on their investments. Because these investments are so effortlessly rewarding, investors tell their friends about the “great opportunity” to invest, and new investors come into the picture, funneling more money into the enterprise. Unbeknownst to them, these new investors begin funding “returns” to existing investors; the enterprise that once appeared so solid, dependable, and trustworthy turns out to be nothing more than a house of cards that inevitably crumbles.

When the dust clears and the Ponzi scheme unravels, the schemers and their entities frequently end up in bankruptcy or an equity receivership. In bankruptcy, the court appoints a trustee. In an equity receivership, the court appoints a receiver. Although separate laws govern bankruptcy proceedings and receiverships, the goals and directives of trustees and receivers are alike: they must take immediate control of the entities, cease ongoing fraudulent activity, collect assets for the bankruptcy or receivership estate, and achieve a final, equitable distribution of the assets of the estate.<sup>2</sup> One of the primary tools for achieving these objectives is the use of fraudulent transfer laws. Fraudulent transfer actions allow trustees and receivers to recover certain payments made to investors in order to redistribute the recovered funds to the victims.<sup>3</sup> Such lawsuits are commonly referred to as “claw-back” actions.

The central purpose of fraudulent transfer law is to protect creditors from debtors’ attempts to place property beyond the reach of their creditors. A transfer made by a debtor is fraudulent to a creditor if the debtor made the transfer with the actual intent to hinder, delay, or defraud any creditor of the debtor.<sup>4</sup> Generally, the plaintiff who files a fraudulent transfer action must look to certain factors—which courts commonly refer to as “badges of fraud”—to demonstrate, by inference, that a transfer was made with actual intent to defraud a creditor.<sup>5</sup> This can be a laborious and expensive undertaking, especially

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2. See 11 U.S.C. § 704 (2012) (providing a list of duties a trustee must fulfill); see also *SEC v. Schooler*, No. 3:12-cv-2164-GPC-JMA, 2015 WL 1510949, at \*3 (S.D. Cal. Mar. 24, 2015) (setting forth standards a receiver should follow, including a “duty to protect, preserve, administer, and distribute appropriately the receivership estate’s assets”).

3. *Donell v. Kowell*, 533 F.3d 762, 776 (9th Cir. 2008).

4. See generally UNIF. FRAUDULENT TRANSFER ACT 2, 32 (1984), available at [https://www.stcl.edu/faculty\\_pages/faculty\\_folders/rosin/ufta84.pdf](https://www.stcl.edu/faculty_pages/faculty_folders/rosin/ufta84.pdf).

5. *Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22, 34 (Bankr. D. Minn. 2012), *motion to certify appeal denied*, No. 12–3038 (SRN), 2013 WL 2455981, at \*4 (D. Minn. June 6, 2013), *appeal denied*, No. 12–3038 (SRN), 2014 WL 1386724, at \*36 (D. Minn. Jan. 6, 2014).

because the factfinder must examine each transfer independently. But when trustees and receivers prove that the companies now under their control operated as a Ponzi scheme, they are entitled to a presumption of actual fraudulent intent.<sup>6</sup> Indeed, as the Ninth Circuit notes, “[t]he mere existence of a Ponzi scheme is sufficient to establish actual intent to defraud.”<sup>7</sup>

Equipped with this claw-back weapon and the powerful presumption of fraud, receivers and trustees pursue fraudulent transfer claims against certain parties connected to the Ponzi scheme. One of the well-defined fraudulent transfer claims that they possess is their claim to recover the “net winnings” received by investors.<sup>8</sup> Ponzi scheme investors fall into two categories: “net winners” and “net losers.”<sup>9</sup> Net losers either fail to receive a full return on their principal investment or, in most cases, receive no return at all.<sup>10</sup> “Net winners,” on the other hand, are those investors who receive a full return of their principal investment and amounts in excess of their total investment.<sup>11</sup> These excess amounts are generally referred to as “fictitious profits.”<sup>12</sup> These fictitious profits represent the investor’s “winnings.”<sup>13</sup> When trustees and receivers prevail in these claw-back actions, the winnings must be turned over for the benefit of the estate and its victims.<sup>14</sup>

The Ponzi presumption allows trustees and receivers to perform their duties like well-oiled machines. They can file a plethora of fraudulent transfer lawsuits against the net winners. After proving that the entities under their control were operated as a Ponzi scheme, their summary judgment burden is conclusively established. The burden then shifts to the defendant to demonstrate that he or she received the subject transfers in good faith and for reasonably equivalent value. However, because reasonably equivalent value is not exchanged for fictitious profits, investors cannot establish an affirmative defense to the fraudulent transfer claim over and above their principal investment. Thus, in claw-back actions, absent the de-

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6. *Id.* at 35.

7. *Donell*, 533 F.3d at 770 (quoting *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008)) (internal quotation marks omitted).

8. *Id.* at 776.

9. *In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 132 (Bankr. S.D.N.Y. 2010).

10. *In re Dreier LLP*, 452 B.R. 391, 399–400 (S.D.N.Y. 2011).

11. *Id.*

12. *Donnell*, 533 F.3d at 772.

13. *Id.* at 770.

14. *Id.* at 775 (“[V]ictims who did not receive payments in excess of the initial amount they were fraudulently induced to put into the scheme are the ‘creditors’ that [the Uniform Fraudulent Act] protects.”).

fendant's insolvency, trustees and receivers are certain to recover an investor's "winnings" for the benefit of the estate and the victims of the fraudulent scheme.

Requiring investors to return their winnings is the most equitable way to balance the harm after the collapse of a Ponzi scheme. And the Ponzi presumption clearly facilitates this recovery, equipping receivers and trustees with a unique and significant pleading advantage. But there is a problem. What happens when a perpetrator's wrongful scheme falls just shy of the classic scenario of a Ponzi scheme? What happens when nearly all of the hallmarks of a Ponzi scheme are present, including proof that at least some of the returns paid to existing investors came not from legitimate business activities, but from funds infused into the fraudulent enterprise by other investors, yet the court still refuses to make a Ponzi scheme finding? What if there are parties who profited as a result of the scheme? Can receivers and trustees still recover those profits? How are the victims of the fraud—albeit not the classic Ponzi scheme fraud—treated? Finally, and most importantly, how does this outcome affect the collection of assets and the distribution to victims of these fraudulent schemes?

The likely response to these questions is that each transaction subject to clawback must be examined closely on an individual basis and free from any presumptions. Such a transaction-by-transaction assessment of fraudulent intent for transfers is detrimental, if not fatal, to the estate. Standing alone, the substantial costs involved in undertaking independent examinations of the specific facts and circumstances of each transaction—without the advantage of the actual fraud presumption—will almost always outweigh the benefit that the estate might derive from prevailing against each individual defendant.

This Article argues that receivers and trustees should be entitled to the same actual fraud presumption that courts employ in classic Ponzi scheme cases if they establish—based on certain factors and other considerations suggested by this Article—that the entities now under their control operated a comparable fraudulent enterprise. Under current case law, once the court makes a finding of the existence of a Ponzi scheme, the trustee or receiver is allowed to use that finding to invoke the "Ponzi presumption" in all fraudulent transfer actions against transferees. This Article contends that if the court fails to make a Ponzi scheme finding, the presumption door should not be closed—the law should still entitle trustees and receivers to a presumption of fraud. Why should winners in Ponzi schemes be treated differently than those who profit in comparable fraudulent schemes? Why should losers in Ponzi schemes have a greater chance of being

made whole than in comparable fraudulent schemes? The restitution available to victims of fraudulent enterprises should not change because of an enterprise's label. Accordingly, rather than limiting the presumption to Ponzi scheme cases, this Article advocates for an expansion of the presumption to other cases where the characteristics of a Ponzi scheme are present. Ultimately, this Article maintains that trustees and receivers should be able to invoke a similar burden-shifting presumption so that those who come out ahead in similar fraudulent investment schemes stand a higher likelihood of defraying the losses of those investors who lose.

## II. FEATURES OF A CLASSIC PONZI SCHEME

### A. *Charles Ponzi and His Scheme*

The term “Ponzi scheme” originates from a fraudulent scheme Charles Ponzi dreamed up in December 1919.<sup>15</sup> Ponzi's scheme involved “the business of borrowing money on his promissory notes.”<sup>16</sup> Following World War I, Ponzi began to tell would-be victims that he was purchasing international postal coupons and selling them for more than twice the price because of the unsettled foreign exchange rates.<sup>17</sup> To prove his point, Ponzi sold the coupons to investors, and then bought them back for 150% of what the investor had paid within approximately ninety days.<sup>18</sup> He induced his victims to continue investing by faithfully paying them the promised returns within the promised period of time.<sup>19</sup> Within eight months, Ponzi had lured thousands of investors and was receiving \$1,000,000 a week.<sup>20</sup> However, the coupons were Ponzi's own creation—he never purchased any stamps or used the investors' money for any other business venture.<sup>21</sup> Instead, he simply paid returns to early investors with money he received from later investors.<sup>22</sup>

Approximately nine months later, having received word that a public investigation into Ponzi's activities had commenced, several lenders stormed his bank and withdrew the principal amount of their loans.<sup>23</sup>

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15. See generally *Cunningham v. Brown*, 265 U.S. 1 (1924).

16. *Id.* at 7.

17. *Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc.*, 189 F.3d 321, 323 n.1 (3d Cir. 1999).

18. David A. Gradwohl & Karin Corbett, *Equity Receiverships for Ponzi Schemes*, 34 SETON HALL LEGIS. J. 181, 185 (2010).

19. *Cunningham*, 265 U.S. at 7–8.

20. *Id.* at 8.

21. MITCHELL ZUCKOFF, *PONZI'S SCHEME: THE TRUE STORY OF A FINANCIAL LEGEND* 114–16 (2005).

22. *Cunningham*, 265 U.S. at 8.

23. *Id.* at 10–11.

But when Ponzi was declared insolvent, the trustee sought recovery from the “lucky” investors who were successful in recouping their money.<sup>24</sup> Recognizing the unfortunate position in which all of Ponzi’s victims found themselves, the Supreme Court stated:

[W]hen the fund with which the wrongdoer is dealing is wholly made up of the fruits of the frauds perpetrated against a myriad of victims, the case is different . . . .

. . . [T]he victims of Ponzi were not to be divided into two classes, those who rescinded for fraud and those who were relying on his contract to pay them. They were all of one class, actuated by the same purpose to save themselves from the effect of Ponzi’s insolvency. Whether they sought to rescind, or sought to get their money as by the terms of the contract, they were, in their inability to identify their payments, creditors and nothing more. It is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt law. Those who were successful in the race of diligence violated not only its spirit but its letter and secured an unlawful preference.<sup>25</sup>

Accordingly, the Court required the bankruptcy court to treat the investors’ withdrawals from the bank as unlawful preferential transfers.<sup>26</sup>

### B. *What Qualifies as a Ponzi Scheme?*

Although Ponzi’s scheme was not the largest of its kind, and certainly not the most complex, the phrase “Ponzi scheme” has stuck and, generally, has become the American label for investment fraud. In fact, people often throw the term around, albeit incorrectly, whenever investors have been duped and lose their money. And with names such as Bernie Madoff, Scott Rothstein, Allen Stanford, Kenneth Lay, Dennis Kozlowski, and the like plastered all over the media, it is no wonder that the public misuses the term and likens any individual tied to fraudulent transactions and financial improprieties with Charles Ponzi and his scheme. After all, as the saying goes, if it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck. But while “[a]ll Ponzi schemes are frauds . . . [n]ot all frauds are Ponzi schemes.”<sup>27</sup> Ponzi schemes are their own animal. Unfortunately, courts also struggle to come up with a precise description and characterization of a Ponzi scheme. One court may label a scheme a “Ponzi scheme,” while another court might call that same scheme an

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24. *Id.* at 13.

25. *Id.*

26. *See id.* at 13–14.

27. *Gold v. First Tenn. Bank (In re Taneja)*, No. 08–13293–RGM, 2012 WL 3073175, at \*7 (Bankr. E.D. Va. July 30, 2012), *aff’d*, 743 F.3d 423 (4th Cir. 2014).

investment fraud. At first glance, it would seem that affixing the proper label to the scheme is trivial, as it relates to the victims of that scheme. But that is not true. As set forth below, a court's decision that a fraudulent investment scheme is not a Ponzi scheme could result in substantial losses to the estate and the victims of the scheme.

The Securities and Exchange Commission (SEC) defines a Ponzi scheme as follows:

[A]n investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors to create the false appearance that investors are profiting from a legitimate business.<sup>28</sup>

The SEC also provides a list of “red flags” commonly present in Ponzi schemes and offers explanations regarding these warning signs. According to the SEC, the following are typically found in classic Ponzi scheme cases: (1) high investment returns with little or no risk;<sup>29</sup> (2) overly consistent returns;<sup>30</sup> (3) unregistered investments;<sup>31</sup> (4) unlicensed sellers;<sup>32</sup> (5) secretive strategies, complex strategies, or both;<sup>33</sup> (6) issues with paperwork;<sup>34</sup> and (7) difficulty receiving payments.<sup>35</sup>

While the definition the SEC provides is helpful and may lend guidance to the courts, it is certainly not binding. Furthermore, the list of

28. *Ponzi Schemes—Frequently Asked Questions*, SEC, <http://www.sec.gov/answers/ponzi.htm> (last visited July 5, 2014).

29. “Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any ‘guaranteed’ investment opportunity.” *Id.*

30. “Investment values tend to go up and down over time, especially those offering potentially high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions.” *Id.*

31. “Ponzi schemes typically involve investments that have not been registered with the SEC or with state regulators. Registration is important because it provides investors with access to key information about the company’s management, products, services, and finances.” *Id.*

32. “Federal and state securities laws require investment professionals and their firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.” *Id.*

33. “Avoiding investments you do not understand, or for which you cannot get complete information, is a good rule of thumb.” *Id.*

34. “Do not accept excuses regarding why you cannot review information about an investment in writing. Also, account statement errors and inconsistencies may be signs that funds are not being invested as promised.” *Ponzi Schemes—Frequently Asked Questions*, *supra* note 28.

35. “Be suspicious if you do not receive a payment or have difficulty cashing out your investment. Keep in mind that Ponzi scheme promoters routinely encourage participants to ‘roll over’ investments and sometimes promise returns offering even higher returns on the amount rolled over.” *Id.*



red flags is not an exhaustive or all-inclusive list of the hallmarks of a Ponzi scheme. Accordingly, an examination of case law and the various descriptions of a Ponzi scheme is an important part of the analysis. The difficulty in labeling a scheme as a Ponzi scheme, however, is that “there is no precise definition of a Ponzi scheme.”<sup>36</sup> Instead, courts typically look for a general pattern of conduct, rather than specific requirements, to determine whether a Ponzi scheme exists.<sup>37</sup>

Since *Cunningham*, the Supreme Court has not discussed the substantive law of Ponzi schemes. In dicta, however, the Supreme Court accepted that the scheme is generally one where the fraudster pays earlier investors with funds from later investors.<sup>38</sup> Circuit decisions provide more insight.

Courts in the Second Circuit have adopted a very broad definition of a Ponzi scheme: “any sort of inherently fraudulent arrangement under which the debtor–transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.”<sup>39</sup> These courts have also provided this description: “In [a Ponzi scheme], money from new investors is used to pay artificially high returns to earlier investors in order to create an appearance of profitability and attract new investors so as to perpetuate the scheme.”<sup>40</sup>

Courts in the Third Circuit recognize that there exists no single, clear definition of what a Ponzi scheme is.<sup>41</sup> Nonetheless, Third Circuit courts, like those of the the Second Circuit, have stated that the common denominator among the different descriptions of a Ponzi scheme is that the schemer uses later investor money to repay earlier investors.<sup>42</sup>

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36. *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 12 (S.D.N.Y. 2007); *see also Carney v. Lopez*, 933 F. Supp. 2d 365, 380 (D. Conn. 2013) (stating that “there is no single, authoritative definition of a Ponzi scheme”).

37. *Bear, Stearns*, 397 B.R. at 12.

38. *See Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1064 (2014). Long after Allen Stanford’s scheme was found to be a Ponzi scheme, the Court stated, “Stanford and his associates used the money provided by new investors to repay old investors, to finance an elaborate lifestyle, and to finance speculative real estate ventures.” *Id.*; *see also Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 377 (1991) (Kennedy, J., dissenting) (stating that “Ponzi schemes . . . can maintain the illusion of a profit-making enterprise for years”).

39. *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC)*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) (emphasis added) (citing *Cuthill v. Kime (In re Evergreen Sec., Ltd.)*, 319 B.R. 245, 249 (Bankr. M.D. Fla. 2003) (finding a Ponzi scheme where the debtor “used most funds received from new investors to pay prior investor claims” (emphasis added))).

40. *Bear, Stearns*, 397 B.R. at 8.

41. *Deangelis v. Rose (In re Rose)*, 425 B.R. 145, 152 (Bankr. M.D. Pa. 2010).

42. *See id.* at 152–53.

Recently, a court in the Fourth Circuit examined the definition of a Ponzi scheme from four other courts and came to the same conclusion as courts in the Third Circuit: no single definition of a Ponzi scheme exists.<sup>43</sup> Yet, the court observed, “there are characteristics that occur repeatedly,” the most prominent being that the schemer uses later investor money to pay “artificially high dividends” to earlier investors.<sup>44</sup> This, the court determined, creates the illusion that the company is viable and highly profitable, which attracts additional investors.<sup>45</sup> Another hallmark pointed out by the court is the need for an ever-increasing number of new investors to participate in the scheme; otherwise, the scheme is bound to collapse because new money is the only “revenue” sustaining the fraudulent enterprise.<sup>46</sup> Indeed, “[t]here is a mathematical impossibility of continuing the fraud indefinitely, which is contrary to the impression given to the investors that the business venture will continue profitably for the indefinite future.”<sup>47</sup>

The Fourth Circuit court also recognized that because the scheme’s sustainability requires new investors, a classic Ponzi scheme contains “no legitimate business venture.”<sup>48</sup> Obviously, the purpose of a Ponzi scheme is not for the schemer to fund a legitimate business, but rather for her to pay back Paul, who was promised high rates of return, using Peter’s funds. The court did note, however, that there could be instances where real income exists within a legitimate portion of the business, but the court also recognized that such income would be relatively insignificant in relation to the overall fraudulent scheme.<sup>49</sup> It further noted that an unrealistic rate of return to investors, which induces them to invest, is another hallmark of a classic Ponzi scheme.<sup>50</sup>

In 1978, the Fifth Circuit described a classic Ponzi scheme as follows:

In a Ponzi scheme, a swindler promises a large return for investments made with him. The swindler actually pays the promised return on the initial investments in order to attract additional

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43. *Gold v. First Tenn. Bank (In re Taneja)*, No. 08–13293–RGM, 2012 WL 3073175, at \*4–6 (Bankr. E.D. Va. July 30, 2012) (citing *In re Rose*, 425 B.R. at 153; *Liebersohn v. Campus Crusade for Christ, Inc. (In re C.F. Foods, L.P.)*, 280 B.R. 103, 110 n.15 (Bankr. E.D. Pa. 2002); *Fisher v. Sellis (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 869 n.2 (Bankr. N.D. Ill. 2000)).

44. *In re Taneja*, 2012 WL 3073175, at \*6.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at \*7.

50. *In re Taneja*, 2012 WL 3073175, at \*7.

investors. The payments are not financed through the success of the underlying venture but are taken from the corpus of the newly attracted investments. The swindler then takes an appropriate time to abscond with the outstanding investments. As one author has described it, "he borrowed from Peter to pay Paul. And it worked . . . until Peter got wise."<sup>51</sup>

Other definitions within the Fifth Circuit have developed, including those it adopted from courts in the Ninth and Tenth Circuits:

A "Ponzi scheme" is a term generally used to describe an investment scheme that is not supported by any underlying business venture or investment opportunity but that has the illusion of profitability in order to recruit more investors and to sustain the program for the benefit of its operators. The operators induce investors into the program by promising exorbitant, unrealistic returns on their principal investments through lucrative investment opportunities or business ventures that do not exist. Typically, the initial investors of the program are paid the promised returns from either the principal investments of new investors or their own principal investments.<sup>52</sup>

In 1997, a court in the Fifth Circuit went beyond simply stating the definition of a Ponzi scheme, and instead announced the elements of one:

(1) deposits made from investors; (2) the Ponzi operator conducts no legitimate business as represented to investors; (3) the purported business of the Ponzi operator produces no profits or earnings, rather the source of funds is the new investments by investors; and (4) payments to investors are made from other investor's invested funds.<sup>53</sup>

But these elements have not been examined by every court within the Fifth Circuit analyzing Ponzi schemes.

The most infamous Ponzi scheme to come out of the Fifth Circuit was the multibillion dollar scam of R. Allen Stanford.<sup>54</sup> Based on the following definition, the Fifth Circuit found that the district court was correct in labeling Stanford's investment program a Ponzi scheme:

A Ponzi scheme is a "fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments." The Second Circuit also provides a good description of a Ponzi scheme: A Ponzi scheme is a scheme whereby

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51. *United States v. Cook*, 573 F.2d 281, 282 n.3 (5th Cir. 1978).

52. *Warfield v. Carnie*, No. 3:04-cv-633-R, 2007 WL 1112591, at \*10 (N.D. Tex. Apr. 13, 2007) (citations omitted) (citing *Jobin v. Youth Benefits Unlimited, Inc. (In re M & L Bus. Mach. Co.)*, 59 F.3d 1078, 1080 (10th Cir. 1995); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n.1 (9th Cir. 1991)).

53. *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 431 (Bankr. S.D. Tex. 1997).

54. See generally *Janvey v. Alguire*, 647 F.3d 585 (5th Cir. 2011).

a corporation operates and continues to operate at a loss. “The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors.” This Circuit has found that a Ponzi scheme “is, as a matter of law, insolvent from its inception.”<sup>55</sup>

In 1966, the Sixth Circuit heard one of the earliest cases since the scheme involving Charles Ponzi himself.<sup>56</sup> It summed up the facts rather succinctly:

Stickler’s scheme was the essence of simplicity, not to say of stupidity. At its inception he borrowed from A, then borrowed from B to repay A. The inducement to B was a high rate of interest on a short term, whereupon it became necessary to borrow from C to repay B.<sup>57</sup>

In a later case, another court in the Sixth Circuit defined a Ponzi scheme as “a fraudulent investment arrangement in which returns to investors are not obtained from *any* underlying business venture but are taken from monies received from new investors.”<sup>58</sup>

Courts within the Seventh Circuit have relied on the following elements to prove the schemer engaged in a Ponzi scheme:

(1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operation of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.<sup>59</sup>

The definition widely used by courts in the Eighth Circuit to describe a Ponzi scheme is “a multi-client investment arrangement executed over time, in which initial investors’ infusions are wrongfully siphoned off, the fund never maintains enough cash to meet all its obligations, and the earlier clients’ realization on investment is funded by later clients’ infusions.”<sup>60</sup>

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55. *Id.* at 597 (citations omitted) (quoting *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006)).

56. *Conroy v. Shott*, 363 F.2d 90, 91 (6th Cir. 1966).

57. *Id.* at 92.

58. *In re Taubman*, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993) (emphasis added).

59. *Forman v. Salzano (In re NorVergence, Inc.)*, 405 B.R. 709, 730 (Bankr. D.N.J. 2009).

60. *Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22, 33 (Bankr. D. Minn. 2012) (quoting *Manty v. Holmes (In re Nation-Wide Exch. Servs., Inc.)*, 291 B.R. 131, 148 n.20 (Bankr. D. Minn. 2003)); *see also Meeks v. Red River Entm’t of Shreveport (In re Armstrong)*, 285 F.3d 1092, 1093 n.3 (8th Cir. 2002) (stating that “[i]n a Ponzi scheme, the operator promises investors returns on their investment which the operator intends to pay from funds

Starting in the early 1980s, the Ninth Circuit adopted the Fifth Circuit's "borrowing from Peter to pay Paul" analogy in identifying a Ponzi scheme.<sup>61</sup> More recently, the Ninth Circuit has defined a Ponzi scheme as "a phony investment plan in which monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors."<sup>62</sup> The Ninth Circuit has further described a Ponzi scheme as follows:

[A] financial fraud that induces investment by promising extremely high, risk-free returns, usually in a short time period, from an allegedly legitimate business venture. "The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment."<sup>63</sup>

Courts in the Tenth Circuit has been using the following definition of a Ponzi scheme for over three decades:

A "Ponzi" scheme, as that term is generally used, refers to an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments. Typically, investors are promised large returns for their investments. Initial investors are actually paid the promised returns, which attract additional investors.<sup>64</sup>

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provided by new investors, rather than from profits generated by the underlying business venture").

61. See, e.g., *United States v. Rasheed*, 663 F.2d 843, 849 n.1 (9th Cir. 1981).

62. *Johnson v. Neilson (In re Slatkin)*, 525 F.3d 805, 809 n.1 (9th Cir. 2008) (quoting *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 759 n.1 (9th Cir. 2000)).

63. *Donell v. Kowell*, 533 F.3d 762, 767 n.2 (9th Cir. 2008) (quoting *In re United Energy Corp.*, 944 F.2d 589, 590 n.1 (9th Cir. 1991)); see also *Donell v. Ghadrnan*, No. CV 11-10517 DDP (AJWx), 2013 WL 692853, at \*1 (C.D. Cal. Feb. 26, 2013) (defining a Ponzi scheme as "any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors").

64. *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 41 B.R. 985, 994 n.12 (Bankr. D. Utah 1984) (internal quotation marks omitted), *aff'd in part, rev'd in part sub nom. Merrill v. Dietz (In re Universal Clearing House Co.)*, 62 B.R. 118, 128, 131 (Bankr. D. Utah. 1986). Three years after this opinion, the district court elaborated on the bankruptcy court's definition in an *en banc* consolidated appeal:

One can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. . . . A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which by definition[ ] are meant to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money.

*Barber v. Union Nat'l Bank of Macomb (In re KZK Livestock, Inc.)*, 190 B.R. 626, 630 (Bankr. C.D. Ill. 1996) (quoting *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 860 (D. Utah 1995)).

In 2008, the Tenth Circuit expounded on this definition:

A Ponzi scheme is “[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, usually without any operation or revenue-producing activity other than the continual raising of new funds.”<sup>65</sup>

Courts in the Tenth Circuit now appear to follow a hybrid of these definitions. For example, in a recent decision, the bankruptcy court for the District of Utah stated that there are four characteristics of a Ponzi scheme: (1) returns to investors are not financed through the success of the underlying business venture; (2) the returns to investors are taken from newly attracted investments; (3) investors are promised large returns; and (4) initial investors receive promised returns, which attracts additional investors.<sup>66</sup>

Finally, in 2011, an Eleventh Circuit bankruptcy court provided the following description of a Ponzi scheme:

[a] phony investment plan in which monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors. In order to prove the existence of a Ponzi scheme, the trustee must establish that: (1) deposits were made by investors; (2) the debtors conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the debtors produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.<sup>67</sup>

It would be imprudent to attempt to summarize the definitions and descriptions of a classic Ponzi scheme. Courts around the country have defined it in various ways, and even within each circuit, it appears that several definitions and characteristics are used. Indeed, some courts provide that a Ponzi scheme only exists when the “returns to investors are not obtained from *any* underlying business venture,” but instead are taken solely from funds “received from new investors.”<sup>68</sup> Yet, there are other courts that recognize that Ponzi schemes

65. *Mosier v. Callister, Nebeker & McCullough, P.C.*, 546 F.3d 1271, 1273 n.2 (10th Cir. 2008) (quoting BLACK’S LAW DICTIONARY 1198 (8th ed. 2004)).

66. *Gillman v. Ponzi Issue (In re Twin Peaks Fin. Servs.)*, Nos. 07-25399, 07-25401, 2012 WL 3309715, at \*5 (Bankr. D. Utah Aug. 13, 2012).

67. *Kapila v. Phillips Buick–Pontiac–GMC Truck, Inc. (In re ATM Fin. Servs., LLC)*, No. 6:08-bk-969-KSJ, 2011 WL 2580763, at \*4 (Bankr. M.D. Fla. June 24, 2011) (footnotes omitted) (quoting *United States v. Silvestri*, 409 F.3d 1311, 1317 n.6 (11th Cir. 2005)) (internal quotation marks omitted); see also *Wiand v. Waxenberg*, 611 F. Supp. 2d 1299, 1312 (M.D. Fla. 2009).

68. *In re Taubman*, 160 B.R. 964, 978 (Bankr. S.D. Ohio Oct. 25, 1993) (emphasis added) (citations omitted).

may involve some legitimate investment opportunities.<sup>69</sup> Some courts also state that Ponzi schemes are, by definition, insolvent at all times.<sup>70</sup> Still other courts have found a Ponzi scheme to exist despite the fact that the enterprise originated from a legitimate, solvent business.<sup>71</sup>

Notwithstanding the varying descriptions of a Ponzi scheme, and, in some cases, the contradictions, there appears to be one common thread among all courts: a Ponzi scheme requires proof that returns paid to existing investors came from funds infused into the fraudulent scheme by later investors. But beyond that, there is no reliable method or test to predict whether a court will label a fraudulent investment scheme as a Ponzi scheme. This uncertainty becomes particularly problematic when trustees and receivers initiate fraudulent transfer lawsuits to recover assets for the benefit of the estate.

### III. THE PONZI SCHEME PRESUMPTION

#### A. *Bankruptcy and Receiverships*

The bankruptcy and receivership processes are used frequently to redress the consequences of a failed Ponzi scheme or similar investment fraud in order to provide some relief to unsatisfied creditors of the scheme.<sup>72</sup> Recently, the Second Circuit reaffirmed that an equity receivership “accomplishes what a bankruptcy would” when dealing with financial fraud arising out of a Ponzi scheme.<sup>73</sup> Yet, there are some distinct differences between the two which are worth discussing.

Unlike bankruptcy, where Congress has spoken by setting forth a broad and detailed statute to guide the courts and bankruptcy trustees

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69. See *Gold v. First Tenn. Bank (In re Taneja)*, No. 08-13293-RGM, 2012 WL 3073175, at \*7 (Bankr. E.D. Va. July 30, 2012) (stating that “[l]egitimate income from the legitimate portion of the business, if any, is insignificant,” and that “[t]o the extent that there is a legitimate business venture, it is a veneer masking a fraud”).

70. *Picard v. Madoff (In re Bernard L. Madoff Inv. Sec. LLC)*, 458 B.R. 87, 110 n.15 (Bankr. S.D.N.Y. 2011); see also *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006) (finding that a Ponzi scheme “is, as a matter of law, insolvent from its inception”); *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 871 (D. Utah 1987) (noting that “[b]y definition, an enterprise engaged in a Ponzi scheme is insolvent from day one”).

71. *In re Bonham*, 251 B.R. 113, 135-36 (Bankr. D. Alaska 2000) (recognizing that “most Ponzi schemes have a least a semblance, if not a somewhat substantial, operating ‘front’” and that it is incorrect to state that a Ponzi operator is inherently insolvent at all times).

72. See, e.g., *SEC v. Huber*, 702 F.3d 903, 908 (7th Cir. 2012) (noting that “Ponzi schemes often end in bankruptcy court”); *Hewitt v. Westover*, 158 N.E. 631, 633-34 (Ind. Ct. App. 1927) (stating that the “[d]efendants knew that said company was a fraud and was being operated for fraudulent purposes, knew that it was insolvent, knew that its liabilities far exceeded its assets, and knew it was subject to be placed in bankruptcy or receivership at any time”).

73. *SEC v. Byers*, 609 F.3d 87, 92 (2d. Cir. 2010).

in the disposition of such cases, an equity receiver's authority is established by the "extremely broad" power of the court.<sup>74</sup> Indeed, "[i]t is a recognized principle of law that the district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership."<sup>75</sup> As noted by the Ninth Circuit, "The basis for broad deference to the district court's supervisory role in equity receiverships arises out of the fact that most receiverships involve multiple parties and complex transactions."<sup>76</sup> Because of this broad power and the lack of any statutory framework, the rights of creditors and, particularly, victims of fraudulent schemes are arguably less certain under an equitable receivership than they might be under bankruptcy law.

Furthermore, the justification for the appointment of a receiver is generally based on the SEC establishing a *prima facie* case of fraud and mismanagement.<sup>77</sup> However, in every bankruptcy case, a trustee is automatically appointed or, in the alternative, the debtor remains in control of its business as a debtor-in-possession.<sup>78</sup> Similarly, for injunctive relief in a receivership case, the SEC must establish by a preponderance of the evidence "that there is a reasonable likelihood that the defendant is engaged or about to engage in practices that violate the federal securities laws."<sup>79</sup> But the filing of a bankruptcy petition automatically stays—that is, it "restrains[ ] creditors from taking further action against the debtor, the property of the debtor, or the property of the estate to collect their claims."<sup>80</sup>

Despite these differences, "[t]he goal in both securities[ ] fraud receiverships and liquidation bankruptcy is identical—the fair distribution of the liquidated assets."<sup>81</sup> To that end, there are certainly more parallels between the two than contrasts. For example, similar to the steward of the bankruptcy estate—a trustee under Chapter 7 or a debtor-in-possession under Chapter 11<sup>82</sup>—an equity receiver is a neu-

74. *See id.*

75. *SEC v. Lincoln Thrift Ass'n*, 577 F.2d 600, 606 (9th Cir. 1978).

76. *SEC v. Hardy*, 803 F.2d 1034, 1037 (9th Cir. 1986).

77. *See SEC v. Keller Corp.*, 323 F.2d 397, 403 (7th Cir. 1963) ("The district court was vested with inherent equitable power to appoint a trustee-receiver under the facts of this case. The *prima facie* showing of fraud and mismanagement, absent insolvency, is enough to call into play the equitable powers of the court.").

78. 11 U.S.C. § 1107(a) (2012). In certain Chapter 11 cases—certainly any involving financial fraud or Ponzi-like characteristics—the debtor-in-possession may be removed from its position of authority and replaced by a Chapter 11 trustee, who then resumes control of the debtor. *Id.* § 1104(a).

79. *SEC v. First Fin. Grp. of Tex.*, 645 F.2d 429, 434 (5th Cir. 1981).

80. DAVID G. EPSTEIN, *BANKRUPTCY AND RELATED LAW IN A NUTSHELL* 44 (8th ed. 2013).

81. *SEC v. Wealth Mgmt. LLC*, 628 F.3d 323, 334 (7th Cir. 2010).

82. In every Chapter 7 case, a trustee is appointed. The Chapter 7 trustee is an impartial person representing the collective interest of the debtor's creditors. A Chapter 7 trustee is ac-



tral officer of the court appointed to marshal assets and determine claims subject to the district court's instructions and approval.<sup>83</sup> The Sixth Circuit explained as follows:

The receiver's role, and the district court's purpose in the appointment, is to safeguard the disputed assets, administer the property as suitable, and to assist the district court in achieving a final, equitable distribution of the assets if necessary. As an officer of the court, the receiver's powers are coextensive with his order of appointment.<sup>84</sup>

The Second Circuit commented similarly:

Receivers appointed at the SEC's request are equipped with a variety of tools to help preserve the status quo while the various transactions are unraveled . . . to obtain an accurate picture of what transpired. We have observed that a primary purpose of appointing a receiver is to conserve the existing estate. Receivers are directed to marshal the assets of the defendant, and prevent the dissipation of the defendant's assets pending further action by the court. This authority necessarily includes the power to investigate the defendant's transactions.<sup>85</sup>

These duties, as articulated by the Sixth and Second Circuits, are akin to that of a trustee, who is likewise charged with collecting and reducing to money the property of the estate.<sup>86</sup> Moreover, similar to a receiver in an equity receivership, in bankruptcy liquidation, it is ultimately the trustee's duty to collect property of the estate "as expeditiously as is compatible with the best interests of the parties in interest."<sup>87</sup> In fact, "[t]he provisions of the Bankruptcy Code governing trustees are *often* relied upon for guidance in . . . receivership cases."<sup>88</sup>

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tive, controlling and administering the bankruptcy estate as the representative of the estate. The trustee is essentially the successor of the debtor to collect and reduce to money the property of the estate. The trustee also represents the creditors. In that capacity, he may exercise rights that would have belonged to creditors before the beginning of the bankruptcy case. 11 U.S.C. § 323. Section 1107(a) of the Bankruptcy Code grants a debtor-in-possession in a Chapter 11 case all the rights and imposes all the duties of a trustee. *Id.* § 1107(a). Thus, just like a Chapter 7 trustee, a debtor-in-possession can exercise avoidance powers such as fraudulent transfer and preference lawsuits. Furthermore, by operation of law, a receiver appointed to ascertain the financial condition of entities involved in an alleged Ponzi scheme would automatically become the debtor-in-possession in the event of a bankruptcy filing. *SEC v. Byers*, 609 F.3d 87, 93 (2d Cir. 2010).

83. *SEC v. Sharp Capital, Inc.*, No. Civ.A.398-CV-2792-M, 2001 WL 169722, at \*5 (N.D. Tex. Jan. 16, 2001).

84. *Liberte Capital Grp., LLC v. Capwill*, 462 F.3d 543, 551 (6th Cir. 2006) (citations omitted).

85. *Eberhard v. Marcu*, 530 F.3d 122, 131 (2d Cir. 2008) (alteration in original) (citations omitted) (internal quotation marks omitted).

86. 11 U.S.C. § 704(a)(1).

87. *Id.*

88. *SEC v. Kirkland*, No. 6:06-cv-183-Orl-28KRS, 2008 WL 4491528, at \*9 n.10 (M.D. Fla. Sept. 30, 2008) (emphasis added).

Additionally, “[t]he receivership protects the assets of the estate, just as a stay would in bankruptcy.”<sup>89</sup> In this way, “equitable powers of the receivership court are similar to the powers of the bankruptcy court.”<sup>90</sup> Further, district courts when supervising receiverships also have the power to subordinate the claims of certain investors in financial investment schemes to ensure their equal treatment.<sup>91</sup> And the Bankruptcy Code codifies a similar doctrine of equitable subordination, granting bankruptcy courts the power to subordinate certain claims.<sup>92</sup> Finally, and particularly with respect to fraudulent investment schemes, the law charges both the equity receiver and the bankruptcy trustee with the same duty to maximize the estate for the benefit of the victims and any creditors.<sup>93</sup>

Thus, if, as the courts say, the primary goal in both securities fraud receiverships and liquidation bankruptcy is identical (i.e., the fair distribution of the liquidated assets), then the tools provided to the equity receiver and the trustee in bankruptcy to regain the investments acquired and dissipated by the perpetrators of the financial scheme must also be on equal footing. The use of fraudulent transfer laws helps to achieve this objective.

#### *B. The Ponzi Scheme Presumption Under Fraudulent Transfer Law*

To unravel the fraudulent scheme and provide relief to the victims, receivers and trustees often bring lawsuits to “claw back” the fraudulent transfer of funds belonging to the receivership or bankruptcy estate.<sup>94</sup> The Bankruptcy Court for the District of Minnesota described this general claw-back process:

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89. *SEC v. Byers*, 609 F.3d 87, 92 (2d Cir. 2010).

90. *Ritchie Capital Mgmt., L.L.C. v. Jeffries*, 653 F.3d 755, 762 (8th Cir. 2011).

91. *SEC v. Wealth Mgmt. LLC*, 628 F.3d 323, 334 (7th Cir. 2010).

92. *Id.*; *see also* 11 U.S.C. § 510(c)(1) (2012).

93. *See, e.g., Kalyna v. Swaine (In re Accomazzo)*, 226 B.R. 426, 429 (D. Ariz. 1998) (stating that “[p]art of the bankruptcy trustee’s fiduciary duty is to conserve assets of the estate and maximize distributions to creditors”); *Scholes v. Lehmann*, 56 F.3d 750, 755 (7th Cir. 1995) (noting that “[the receiver’s] only object is to maximize the value of the corporations for the benefit of their investors and any creditors”).

94. It is important to note that a trustee in bankruptcy, or debtor-in-possession, has two statutory tools that enable her to claw back funds from creditors who received disbursements prior to bankruptcy: fraudulent transfers and preferential transfers. This Article does not concern preferential transfers because the Ponzi presumption is not applicable to such transfers. It should be noted, however, that a preference action’s burden of proof is much lower than that in fraudulent transfer actions because *any* funds transferred by the debtor to a creditor within ninety days of the bankruptcy filing are unlawful preferences and, absent a defense, must be returned to the estate. The problem, nonetheless, with preference lawsuits is that, in Ponzi schemes or similar fraudulent investment schemes, most of the transfers occur outside the ninety-day time period.

Via “clawback,” a trustee or receiver puts all parties that transacted with the purveyor of a failed Ponzi scheme onto a parity in the matter of restitution. This would be done by invoking remedies of avoidance (under theories of fraudulent transfer, unjust enrichment, and the like) against those lenders and investors who got repaid in whole or in part before the collapse. The extant wreckage of the scheme, i.e., the property that had remained in-hand with the purveyor as of the collapse, would be augmented by recoveries of funds from those lenders and investors who got out early. The identity of parties subject to the trustee’s claims would be fixed by a temporal measurement, as those that had been paid during the periods of vulnerability to avoidance or recovery specified by the law of fraudulent transfer or other invoked remedies. Those with debts unsatisfied at the downfall would share pro rata with those whose claims would perforce be revived via the avoidance of the payments to them and the recovery from them of corresponding amounts of money.<sup>95</sup>

When it comes to Ponzi schemes, “[c]ourts have routinely applied [the Uniform Fraudulent Transfer Act (UFTA)] to allow receivers or trustees in bankruptcy to recover monies lost by Ponzi-scheme investors.”<sup>96</sup> “The Ponzi scheme operator is the ‘debtor,’ and each investor is a ‘creditor.’”<sup>97</sup> “The profiting investors are the recipients of the Ponzi scheme operator’s fraudulent transfer.”<sup>98</sup> These profiting investors are oftentimes referred to as “winners” and the profits they receive are typically referred to as “fictitious profits.”<sup>99</sup>

Under UFTA, payments to “innocent investors” are avoidable as fraudulent transfers to the extent those investors “received payments in excess of the amounts of principal that they originally invested.”<sup>100</sup> As the Ninth Circuit explained, “The policy justification is ratable distribution of remaining assets among all the defrauded investors.”<sup>101</sup> Hence, “[t]he ‘winners’ in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to ‘enjoy an advantage over later investors sucked into the Ponzi scheme who were not so

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95. *Kelly v. Hofer (In re Petters Co.)*, 440 B.R. 805, 806 (Bankr. D. Minn. 2010).

96. *Donell v. Kowell*, 533 F.3d 762, 767 (9th Cir. 2008).

97. *Id.*

98. *Id.*

99. *See Picard v. Cohmad Sec. Corp. (In re Bernard L. Madoff Inv. Sec. LLC)*, 454 B.R. 317, 325 (Bankr. S.D.N.Y. 2011) (holding that “[n]one of the purported purchases of securities in the . . . customer accounts actually occurred, however, and the reported gains were entirely fictitious (‘Fictitious Profits’)”); *see also Donell*, 533 F.3d at 766–67 (stating that “[t]he ‘winners’ in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to enjoy an advantage over later investors sucked into the Ponzi scheme who were not so lucky” (internal quotation marks omitted)).

100. *Donell*, 533 F.3d at 770.

101. *Id.*

lucky.’”<sup>102</sup> To meet this goal—to essentially put all parties that transacted with the schemer onto parity in restitution—those “lucky” investors who got out early are legally obligated to pay into the receivership or bankruptcy estate and then share pro rata with all of the other victims of the scheme. After all, “[a]ll [the winning investor] is being asked to do is to return the net profits of his investment—the difference between what he put in at the beginning and what he had at the end.”<sup>103</sup>

UFTA provides for two theories under which a receiver or bankruptcy trustee may collect assets for the benefit of creditors and victims: “actual fraud” and “constructive fraud.”<sup>104</sup> The court may allow avoidance under the actual fraud theory on proof of only one element: the debtor (the Ponzi scheme operator) made transfers to the transferee (the winning investor) “with actual intent to hinder, delay, or defraud” the creditors (the losing investors).<sup>105</sup>

Generally, a creditor who files a fraudulent transfer action must look to the factors enumerated in the UFTA—known as the “badges of fraud”—to prove actual intent.<sup>106</sup> But there is a general rule—known as the “Ponzi scheme presumption”—that when the debtor engages in a Ponzi scheme, proof of that scheme satisfies “actual intent” as a matter of law because “transfers made in the course of a Ponzi operation could have been made for no purpose other than to hinder,

102. *Id.* (quoting *In re United Energy Corp.*, 944 F.2d 589, 596 (9th Cir. 1991)); see also *Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22, 33–34 (Bankr. D. Minn. 2012) (stating that “the notion behind the use of avoidance remedies against a satisfied, earlier investor is that its payment was made with money of later victim–investors, and very much to the detriment of them, their contemporaneous fellow-creditors, and future creditors of the entities purveying the scheme”).

103. *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995).

104. See generally UNIF. FRAUDULENT TRANSFER ACT § 4 (1984). This Article analyzes the Ponzi scheme presumption, which deals with the “actual fraud” component of the UFTA. The constructive fraud alternative is not as straightforward. A transfer is fraudulent under a theory of constructive fraud if the transferor does not receive reasonable value in exchange and the transferor either (1) was engaged or was about to engage in a business or a transaction for which the remaining assets of the transferor were unreasonably small in relation to the business or transaction; (2) intended to, believed, or reasonably should have believed that he or she would incur debts beyond his or her ability to pay them as they became due; or (3) was insolvent at the time of the transfer. *Id.* However, although more complicated and, at times, difficult to prove, “whether the receiver seeks to recover from winning investors under the actual fraud or constructive fraud theories generally does not impact the amount of recovery from innocent investors.” *Donell*, 533 F.3d at 771.

105. See UNIF. FRAUDULENT TRANSFER ACT § 4 (stating that a transfer made by a debtor is fraudulent to a creditor if the debtor made the transfer “with actual intent to hinder, delay, or defraud any creditor of the debtor”); see also 11 U.S.C. § 548(a)(1) (2012) (providing that a bankruptcy trustee may avoid any transfer if it was made “with the actual intent to hinder, delay, or defraud any entity”).

106. *In re Polaroid Corp.*, 472 B.R. at 34.

delay or defraud creditors.”<sup>107</sup> The Ninth Circuit holds that “the mere existence of a Ponzi scheme is sufficient to establish actual intent” to defraud.<sup>108</sup> Thus, an equity receiver or bankruptcy trustee is not required to undertake the “badges of fraud” analysis, but is instead entitled to a presumption of actual intent if he or she proves the existence of a Ponzi scheme.

In the context of a Ponzi scheme, under the actual fraud theory, the receiver or bankruptcy trustee may recover the *entire* amount paid to the winning investor, including amounts which could be considered “return of principal” (i.e., the initial investment in addition to the “fictitious profits”).<sup>109</sup> However, neither the trustee nor the receiver is typically successful in achieving this full recovery against the winning investor. And that is because there is a “good-faith defense” that allows innocent winning investors to retain funds up to the amount of the initial investment if they can demonstrate that they took the payments in good faith<sup>110</sup> and for a reasonably equivalent value.<sup>111</sup> When the receiver or trustee is able to use the Ponzi presumption, his burden of proving intent to defraud is satisfied; the burden then shifts to the transferee to establish this good-faith defense.

Thus, drawing from this theory, one can conclude that investors of a failed Ponzi scheme are almost always entitled to keep their principal,

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107. *Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510, 517–18 (Bankr. S.D.N.Y. 2007). However, several courts have looked to cases interpreting section 548 of the Bankruptcy Code in order to give meaning to their state statutes. *See, e.g.*, *PHP Liquidating, LLC v. Robbins (In re PHP Healthcare Corp.)*, 128 F. App'x 839, 847 (3d Cir. 2005) (“We need not discuss the [actual-intent fraudulent transfer] provisions of the Delaware Fraudulent Transfer Act, because they are substantially the same as the relevant parts of the Bankruptcy Code.” (citation omitted)); *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 365 (S.D. Tex. 2008) (“Thus, although ASARCO has not brought an action under section 548, the Court may look to cases interpreting actual-intent fraudulent transfer provisions of the Bankruptcy Code to predict the standard that would be applied . . .”).

108. *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008) (internal quotation marks omitted); *see also Field v. Lindell (In re Mortg. Store, Inc.)*, No. 10–90146, 2011 WL 3878355, at \*2 (Bankr. D. Haw. Sept. 1, 2011) (“Evidence that the Debtor operated a Ponzi scheme proves fraudulent intent. . . . The transfer is fraudulent under 11 U.S.C. § 548(a)(1) and Haw. Rev. Stat. § 651C–4(a).”); *Gowan v. Patriot Grp., LLC (In re Dreier LLP)*, 452 B.R. 391, 435 (Bankr. S.D.N.Y. 2011) (“Applying the Ponzi scheme presumption, the Complaint here sufficiently pleads the transferor’s actual fraudulent intent. Therefore, the motion to dismiss Count III—actual fraudulent conveyance under [New York state law]—is denied.”).

109. *Donell*, 533 F.3d at 771.

110. A Ponzi scheme investor claiming good faith must meet an objective standard, and possibly prove that a diligent inquiry would not have discovered the fraudulent purpose of the transfer. *Hayes v. Palm Seedling Partners (In re Agric. Research & Tech. Grp.)*, 916 F.2d 528, 535 (9th Cir. 1990). This defense is conjunctive; the investor must show that she both exchanged reasonably equivalent value and took in good faith.

111. 11 U.S.C. § 550 (2012); UNIF. FRAUDULENT TRANSFER ACT § 8 (1984).

but must return the “fictitious profits.”<sup>112</sup> Case law supports this notion. “[E]very circuit court to address this issue has concluded that an investor’s profits from a Ponzi scheme, whether paper profits or actual transfers, are not ‘for value.’”<sup>113</sup> The corollary to this is that a bankruptcy trustee or equity receiver will not prevail against innocent investors in a Ponzi scheme under fraudulent transfer law for the return of their principal because transfers of an investor’s principal are “for value.”<sup>114</sup> As stated by the Ninth Circuit, “[T]he general rule is that to the extent innocent investors have received payments in excess of the amounts of principal that they originally invested, those payments are avoidable as fraudulent transfers . . . .”<sup>115</sup>

Lawsuits that receivers file against investors are considered to be ancillary to the receivership action itself and are the equivalent of an independent and separate lawsuit.<sup>116</sup> Lawsuits filed in bankruptcy—called “adversary proceedings”—are likewise separate from the main bankruptcy proceeding. Indeed, “[a]n adversary proceeding is essentially a separate lawsuit within the context of bankruptcy case and has all the attributes of a lawsuit, including due process service requirements as well as application, with some adaptation, of the Federal Rules of Civil Procedure.”<sup>117</sup> Thus, because the role of a receiver or trustee in the aftermath of an investment scheme is to bring suits under UFTA against those who unfairly profited by the schemer’s wrongdoing, it would not be uncommon for the trustee or receiver to be required to file hundreds of lawsuits to recover the fraudulent transfers.<sup>118</sup> Because of this enormous undertaking, the purpose in establishing the existence of a Ponzi scheme makes perfect sense. If receivers and trustees are allowed to use that finding to invoke the Ponzi presumption in all the cases related to the bankruptcy or receivership, they can save hundreds of thousands of dollars because they will not be required to examine every transfer on a transaction-by-

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112. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 235 (2d Cir. 2011), *cert. dismissed*, 132 S.Ct. 2712 65 (2012) (quoting *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (*In re Bernard L. Madoff Inv. Sec. LLC*), 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010)).

113. *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (*In re Madoff Sec.*), 476 B.R. 715, 725 (S.D.N.Y. 2012).

114. *See Donell*, 533 F.3d at 770.

115. *Id.* (emphasis added).

116. *See, e.g., Pulitzer Pub. Co. V. Transit Cas. Co.* (*In re Transit Cas. Co.*), 43 S.W.3d 293 (Mo. 2001) (holding that a lawsuit filed in a receivership case is independent of the receivership).

117. *Dean v. Global Fin. Credit, LLC* (*In re Dean*), 359 B.R. 218, 221 (Bankr. C.D. Ill. 2006).

118. Jordan Maglich, *Madoff Ponzi Scheme, Five Years Later*, FORBES (Dec. 9, 2013, 10:30 AM), <http://www.forbes.com/sites/jordanmaglich/2013/12/09/madoff-ponzi-scheme-five-years-later/> (stating that the trustee in the Bernard Madoff case “had filed thousands of lawsuits seeking to increase the pot of money available to victims”).

transaction basis.<sup>119</sup> The savings, of course, will be passed on to the victims of the fraud.

The Ponzi scheme presumption clearly provides a shortcut around a transaction-by-transaction analysis of fraudulent intent for transfers made by the schemer in which the entire operation constitutes a Ponzi scheme. But what if a receiver or trustee is not given this pleading benefit because the scheme falls just shy of a classic Ponzi scheme? Is that fair to the victims of the fraud, most of whom have lost everything they invested? Is it equitable that results of the same case might be different based on the jurisdiction of the suit alone? Should the Ponzi scheme presumption be so myopic in scope? Cases discussed in the next Part highlight this problem.

#### IV. THE PONZI PRESUMPTION PROBLEM

In 2014, a bankruptcy court in the Second Circuit heard a case involving a Chapter 11 trustee's partial motion for summary judgment, in which the trustees sought to claw back "profits" transferred to two defendants in an alleged Ponzi scheme.<sup>120</sup> The issue in that case is whether the trustee established as a matter of law that Marc Dreier, the sole equity partner of Dreier LLC, operated a Ponzi scheme.<sup>121</sup> The undisputed facts of the case show that, until he was arrested in 2008, Dreier regularly forged the signature of the CEO of a realty company on promissory notes, sold them to innocent investors, and deposited the profits into the LLC.<sup>122</sup> Dreier was charged with securities fraud, mail fraud, money laundering, and conspiracy.<sup>123</sup> His indictment alleges that he used the note proceeds to fund his law firm, buy extravagant personal property and real estate, and "pay interest and principal back to certain previous purchasers of the notes."<sup>124</sup> Dreier pled guilty and admitted to these allegations in his plea allocution.<sup>125</sup> Despite these fraudulent acts, which affected several innocent investors, the court found that the trustee failed to establish the existence of a classic Ponzi scheme as a matter of law and denied her

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119. See *SEC v. Mgmt. Solutions, Inc. (MSI)*, No. 2:11-CV-1165-BSJ, 2013 WL 4501088, at \*3 (D. Utah Aug. 22, 2013) (finding that "[t]he purpose of the Receiver's motion is to gain an early overall characterization of a Ponzi scheme in order to take future advantage of the 'Ponzi presumption,' a pleading benefit in classic Ponzi scheme cases").

120. *Gowan v. Amaranth Advisors, L.L.C. (In re Dreier LLP)*, No. 08-15051 (SMB), 2014 WL 47774, at \*1 (Bankr. S.D.N.Y. Jan. 3, 2014).

121. *Id.*

122. *Id.* at \*2.

123. *Id.*

124. *Id.*

125. *Id.*

motion for partial summary judgment to recover the fraudulent transfers.<sup>126</sup>

The court recognized as valid previous formulations of the Ponzi scheme definition discussed above, but also articulated a four-factor test that some courts use to determine whether a Ponzi scheme exists:

- (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operation of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.<sup>127</sup>

The court determined that the first three elements required little discussion because the parties did not dispute the accuracy of those assertions.<sup>128</sup> But the court ruled that the trustee failed to establish that Dreier used new investors' money to pay older investors.<sup>129</sup> The court explained that evidence to prove a Ponzi scheme must be admissible, and the bulk of the trustee's proof of the fourth element was not.<sup>130</sup> First, Dreier's indictment was inadmissible as hearsay.<sup>131</sup> Second, a judgment of conviction is admissible only to prove a fact essential to the judgment.<sup>132</sup> The court reasoned that Dreier could have admitted to the four counts against him—money laundering, conspiracy, mail fraud, and wire fraud—without admitting to operating a Ponzi scheme.<sup>133</sup> According to the court, the trustee failed to explain how a Ponzi scheme was essential to those counts.<sup>134</sup>

The court held, as is consistent with other courts, that Dreier's plea allocution was admissible.<sup>135</sup> Yet, while Dreier admitted to his fraudulent note scheme in his plea, he never admitted that he used the proceeds of his fraud to pay earlier investors (as was charged in the inadmissible indictment).<sup>136</sup> All of the cases the trustee cited were—at least in the court's eyes—distinguishable from the case at bar; either the fraudster admitted to the operation of a Ponzi scheme within the realm of admissible evidence, or the defendant-transferees did not truly dispute the Ponzi scheme's existence.<sup>137</sup>

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126. *In re Dreier*, 2014 WL 47774, at \*1.

127. *Id.* at \*9.

128. *Id.* at \*10.

129. *Id.*

130. *Id.*

131. *Id.*

132. *In re Dreier*, 2014 WL 47774, at \*11.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at \*10.

137. *Id.* at \*11–12.



Next, the court addressed Dreier's admission in a deposition in another proceeding, in which he admitted to running a "massive Ponzi scheme."<sup>138</sup> The court found that it could not consider the deposition admission because the defendants in the case at bar did not have an opportunity to attend the deposition or cross-examine Dreier.<sup>139</sup> Finally, the court concluded that the trustee's only other evidence—various bank records evidencing transfers—failed to establish as a matter of law that Dreier ran a Ponzi scheme because they, too, did not show that Dreier paid earlier investors with later investors' funds.<sup>140</sup> In accord with its various findings, the court denied the trustee's motion for summary judgment as to the existence of a Ponzi scheme.<sup>141</sup> The court stated that its ruling did not dictate that the trustee could not prevail at trial.<sup>142</sup> But that very statement evinces the problem. A receiver or trustee seeks to establish a Ponzi scheme as a matter of law in order to take advantage of the Ponzi presumption, and for the express purpose of *avoiding* additional discovery and trials where thousands of dollars will be spent relying on an inferential process from circumstantial evidence to prove the transferor's malign intent in relation to the specific transfers at issue.

Thus, for the victims of the fraud in the *Dreier* case who were hoping to recover the transferred funds, the court's statement that the trustee might prevail at a lengthy trial is essentially nugatory. It is no secret that the receiver, trustee, and their professionals get the first slice of pie when the transferred funds are recovered. But after an expensive trial and a transaction-by-transaction analysis with no pleading benefit to use in all of the other ancillary cases, the receiver's slice of pie grows substantially larger and, in the end, there may only be a few crumbs left for the victims of the fraud. Other cases around the country illustrate this problem.

In *In re National Audit Defense Network*,<sup>143</sup> the trustee of a Chapter 7 debtor brought fraudulent transfer claims to avoid transfers that the debtor had made to individual corporate insiders. The debtor in that case "engaged in the selling of tax shelters and other products designed to take advantage of people's disdain for paying taxes."<sup>144</sup> As noted by the court, the debtor's products "were close to worthless,"

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138. *In re Dreier*, 2014 WL 47774, at \*12.

139. *Id.* at \*12–13.

140. *Id.* at \*13–14.

141. *Id.* at \*14.

142. *Id.* at \*12.

143. *Leonard v. Coolidge (In re Nat'l Audit Def. Network)*, 367 B.R. 207 (Bankr. D. Nev. 2007).

144. *Id.* at 212.

which ultimately lead to the bankruptcy filing.<sup>145</sup> The bankruptcy left thousands of customers “with unsupported and unsupportable tax positions.”<sup>146</sup>

In the fraudulent transfer lawsuit, the trustee sought to avoid approximately \$5 million in transfers to the insider defendants.<sup>147</sup> One of the issues before the court was whether the transfers at issue were made with actual intent to defraud.<sup>148</sup> A “full trial” was held on the matter, but some of the participants of the fraudulent scheme refused to testify, having elected early on to invoke the Fifth Amendment with respect to any question related to the scheme.<sup>149</sup> Accordingly, trial was conducted under an alternate testimony rule, whereby the trustee was required to submit direct testimony by declaration and then make the declarants available for cross-examination.<sup>150</sup>

At trial, the trustee painted a “grim picture of an enterprise run primarily to bilk gullible taxpayers out of their hard-earned money.”<sup>151</sup> However, the court made note that this was “technically not a Ponzi scheme,” but rather a business “designed to maximize sales of dodgy tax products through high-pressure sales tactics and overblown advertising, all to the benefit of the defendants.”<sup>152</sup> The court also found that the products sold were “bogus or unlawful.”<sup>153</sup> Nonetheless, the trustee’s forensic accountant testified that the debtor’s tax scams could be *compared* with a Ponzi scheme:

[The debtor] offered unrealistic tax savings to customers, which its representatives knew could never be delivered as promised. . . . Although not a classic Ponzi scheme in the sense that new money was the source of paying earnings on prior money, [the debtor] had many characteristics of a Ponzi scheme. [The debtor] utilized customer payments to fund extensive advertising services to attract new customers for its tax products and services. . . . [The debtor] spent most of this money for an increased telemarketing presence and never produced adequate resources to do the tax return work it had promised customers . . . .

. . . [The debtor] was able to survive for the period 2001 to its demise because it took the majority of its receipts on the premise that it would perform future services which were never performed. The receipts for future services were then utilized for sales and

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145. *Id.*

146. *Id.*

147. *Id.* at 212–13.

148. *Id.* at 213.

149. *In re Nat'l Audit*, 367 B.R. at 213.

150. *Id.*

151. *Id.* at 214.

152. *Id.*

153. *Id.*

boiler-room operations. The resources needed to perform the future services required of the company were never set aside or adequately funded. [The debtor] . . . was a boiler room fraud scheme; it was not a legitimate accounting firm . . . . [The debtor] masked the nature of its operations and represented itself to be a solvent company through the use of improper revenue-recognition procedures, which were not in accordance with Generally Accepted Accounting Principles.<sup>154</sup>

Moreover, the trustee's forensic accountant further testified that the debtor was insolvent "during all relevant periods."<sup>155</sup>

Because the debtor enterprise was not technically a Ponzi scheme, the court was required to examine the intent of the debtor through circumstantial evidence and inferences, because "it will be the rare case in which the debtor testifies under oath that he or she intended to defraud creditors."<sup>156</sup> In this regard, the court discussed the "badges of fraud"—i.e., the "recurring actions that historically have been associated with the actual intent to hinder, delay, or defraud creditors."<sup>157</sup> The court then examined the eleven badges of fraud found in Nevada's version of the UFTA, pointing out that the list is nonexclusive.<sup>158</sup> In doing so, the court analyzed the specific transfers at issue: (1) when the transfers were made; (2) to whom they were made; (3) the transferee's relationship to the transferor; (4) whether there was collusion on the part of the transferee; (5) the sort of "value" given in return for the transfers; and (6) the effect of the transfers on the creditors' recoveries.<sup>159</sup>

After examining the specific transfers at issue, and after two days of trial and argument, the court held that the trustee met his burden of showing that the transfers were fraudulent and that they were made with actual intent to hinder, delay, or defraud creditors.<sup>160</sup> Clearly, the court came to the correct conclusion, but the case also reveals the underlying problem: if the trustee brings other fraudulent transfer actions against parties who profited from the scheme, will she be required to go through the same badges-of-fraud analysis to examine each specific transaction she alleges was fraudulent because the scheme was not technically a Ponzi scheme? That is what one judge held recently in a federal receivership case out of the district of Utah.

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154. *Id.* at 214–15.

155. *In re Nat'l Audit*, 367 B.R. at 215.

156. *Id.* at 219.

157. *Id.* at 220.

158. *Id.*

159. *Id.* at 220–21.

160. *Id.* at 213–14.

In that case, the SEC filed a complaint in 2011 against Management Solutions, Inc. (MSI) and its two principals, Wendell and Allen Jacobson (the Jacobsons), alleging that they had “operated [MSI] as a wide-scale Ponzi scheme since *at least* January 1, 2008.”<sup>161</sup> The scheme took in more than \$200 million from about 225 investors, and is likely one of the largest financial frauds in Utah history.<sup>162</sup> In the complaint, the SEC states that the case involves affinity fraud, in which members of a group are solicited for investments because of their shared bonds of trust.<sup>163</sup> What follows is a brief summary of the court’s findings of fact.

Wendell created MSI in 1991 to facilitate his activities as a real estate investor and manager.<sup>164</sup> In return for investing in MSI, the Jacobsons granted investors an interest in real property or, alternatively, characterized the funds received as loans.<sup>165</sup> The Jacobsons promised investors 5–8% returns on their investments, and induced later victims to invest by boasting that MSI had never defaulted on a promised monthly payment to earlier investors.<sup>166</sup> The court explained the scheme as follows:

While not always followed by the Jacobsons, there seems to have been a general pattern for raising money from MSI investors. An “underperforming” apartment complex or other property would be located. An investor LLC would be organized. A property-owning LLC would be organized. An investor would acquire a defined percentage in the investor LLC. The Jacobsons (or a Jacobson entity) would acquire a percentage interest in the investor LLC—often fifty percent, sometimes more or less—with the representation that, like the other investors, such was a cash investment by the Jacobsons (or a Jacobson entity). The investor LLC would then contribute capital to the property-owning LLC and own one-hundred percent of the property-owning LLC.<sup>167</sup>

In order to keep investors at bay and maintain control over the properties and the funds, the Jacobsons created over 208 entities and

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161. SEC v. Mgmt. Solutions, Inc. (*MSI*), No. 2:11–CV–1165–BSJ, 2013 WL 4501088, at \*3 (D. Utah Aug. 22, 2013).

162. Tom Harvey, *Alleged Ponzi Scheme Tied to Utah Father, Son Among Biggest*, SALT LAKE TRIB. (Dec. 15, 2011, 8:42 PM), <http://www.sltrib.com/sltrib/money/53124909-79/investors-law-suit-utah-investor.html.csp>.

163. *Id.* (“Wendell Jacobson and Allen Jacobson both belong to The Church of Jesus Christ of Latter-day Saints, and appear to have used their membership and the connection arising there . . . to find and obtain the trust of prospective investors.” (alteration in original) (quoting the SEC’s complaint)).

164. *MSI*, 2013 WL 4501088, at \*3.

165. *Id.* at \*4.

166. *Id.*

167. *Id.*

represented to their investors that each entity was completely self-sustaining and independent from the others.<sup>168</sup> But when a particular property failed to be self-sustaining—i.e., when it could not satisfy the monthly returns promised to its investors—the Jacobsons would pay the returns with funds received

from new investors in a newly-created “stand-alone” investment entity, from borrowing on the assets of one entity to meet the obligations of another, or from selling a property owned by one Jacobson-controlled entity to another Jacobson-controlled entity to produce on paper a “profit” to the investors in the earlier entity.<sup>169</sup>

This was a classic Ponzi scheme on its face, one would think. Indeed, as the court recognized, “Peter often paid Paul’s obligations.”<sup>170</sup>

The central hub of the enterprise was an entity owned by the Jacobsons called Thunder Bay Mortgage, Inc. (Thunder Bay). Although each entity had its own bank account, almost all investment funds were commingled into, and funneled through, the Thunder Bay accounts before being distributed to the appropriate property LLC, where the funds would then be used to pay for management fees, returns on investment, and other obligations.<sup>171</sup> When an LLC’s account ran dry or had insufficient funds to pay monthly returns to investor accounts, the money came from the Jacobsons’ grand piggy bank, the Thunder Bay account, which consisted of money from investors of other LLCs the Jacobsons had created.<sup>172</sup>

When the Jacobsons had promised to make a capital contribution to a particular investment entity, Thunder Bay would often transfer funds to the entity’s account, immediately withdraw that payment the next day, and substitute on the books a bookkeeping entry showing that Thunder Bay had “borrowed” the sum and owed it to the entity, and on the Thunder Bay books show it as a “note payable.” [sic] Yet, there were no physical notes payable, no payment date or dates on such notes or in the books, no interest rates—nothing but bookkeeping entries.<sup>173</sup>

These “notes payable” reached over \$103 million in 2010.<sup>174</sup>

Part of the Jacobsons’ scheme involved placing investor funds into an entity to purchase real property, improve the property, create a new entity consisting of new investor funds, cause the new entity to make an offer to buy the property of the old entity, and cause the old

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168. *Id.*

169. *Id.*

170. *MSI*, 2013 WL 4501088, at \*4.

171. *Id.* at \*5.

172. *Id.*

173. *Id.* (footnotes omitted).

174. *Id.*

entity to accept the offer.<sup>175</sup> The buyer entity was kept a secret, so the original investors, perceiving a successful investment and transaction with a separate non-MSI entity, would roll their profits from the sale into a new investment entity.<sup>176</sup> Additionally, sometimes a “straw man” associate would purchase a property with Thunder Bay funds, and the Jacobsons would then create a new entity with investor funds, cause the entity to buy the property from the straw man, and keep some of the purchase price as “fees.”<sup>177</sup>

Other than for bookkeeping purposes, the Jacobsons treated the multitude of MSI investment entities as a family, or in short, as one enterprise. Generally, monies from multiple operations, banking, sales, and rents were swept into Thunder Bay accounts and divided up from there to meet the multiple demands of multiple MSI entities. Most funds from multiple sources were commingled in Thunder Bay and consequently most lost their individual identity as to source.<sup>178</sup>

As a result of the Jacobsons’ fraudulent activities, Thunder Bay—along with all of the other MSI straw entities—became increasingly insolvent.<sup>179</sup> In 2010, a confidential informant alerted the SEC, which led to its investigation and the eventual receivership.<sup>180</sup>

The court’s opinion was in response to the receiver’s motion for findings regarding the existence of a Ponzi scheme.<sup>181</sup> The motion was filed in the main receivership proceeding. At the time the receiver filed the motion, there were over forty ancillary lawsuits filed for fraudulent transfers and other causes of action.<sup>182</sup> Thus, the receiver’s purpose in filing the motion and pursuing the court’s finding of the existence of a Ponzi scheme was to allow the receiver to use that finding to invoke the Ponzi presumption in all of the MSI ancillary cases.<sup>183</sup> Such a finding would clearly benefit the receivership estate as a whole because all those entities that profited as a result of the fraud would likely suffer and an adverse judgment of avoidance and would be required to turn over the profits for the benefit of the receivership estate.

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175. *Id.* at \*6.

176. *MSI*, 2013 WL 4501088, at \*6.

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. Motion for Findings Regarding the Existence & Start Date of a Ponzi Scheme & for Approval To Pool Claims & Assets, *SEC v. Mgmt. Solutions, Inc.*, 2013 WL 4501088 (D. Utah filed Nov. 13, 2012) (No. 2:11-CV-1165-BSJ).

182. *MSI*, 2013 WL 4501088, at \*6.

183. *Id.*

Accordingly, the main issue in the case was “whether the Jacobsons’ investment scheme, MSI, can be classified, from the beginning, as a ‘Ponzi scheme.’”<sup>184</sup> The court noted, like many others, that no absolute list of Ponzi scheme elements exists.<sup>185</sup> Instead, courts look for a pattern of conduct evidencing “any sort of inherently fraudulent arrangement under which the debtor–transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.”<sup>186</sup>

The court then went on a detailed excursion of available case law, examining the various definitions and descriptions of Ponzi schemes throughout the circuits to identify a common theme.<sup>187</sup> It concluded that a receiver must prove, by a preponderance of the evidence, two elements to establish the existence of a Ponzi scheme: (1) “the *sine qua non* of a Ponzi scheme: that returns to earlier investors were paid by funds from later investors”; and (2) “that returns to investors could not be paid by the underlying business venture.”<sup>188</sup>

Other factors, though [nonessential] to the definition of a Ponzi scheme, have been used by courts to decide if an investment scheme fits into the Ponzi definition. These include the promise of large returns; the promise of returns with little to no risk; the promise of consistent returns; the delivery of promised returns to earlier investors to attract new investors; the general insolvency of the investment scheme from the beginning; the secrecy, exclusivity, and/or complexity of the investment scheme; and the general stability of the investment scheme, among other factors. Although the presence or absence of these factors does not [necessarily] make or break a Ponzi scheme, these factors are typically present in Ponzi schemes.<sup>189</sup>

Miraculously, the court ruled that the receiver had not proven the existence of a Ponzi scheme.<sup>190</sup> It reasoned that the “maze of facts and transactions” involved made it unique and incomparable to Charles Ponzi’s original scheme or to Madoff’s scheme which, unlike the court’s conclusions about MSI, was “an assetless shell” from the beginning.<sup>191</sup> With 208 entities involved, the court reasoned that there were hundreds of transactions “which may involve some innocent or

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184. *Id.*

185. *Id.* at \*7.

186. *Id.* (quoting *Bayou Superfund, LLC v. WAM Long/Short Fund II, LP (In re Bayou Grp., LLC)*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007)).

187. *Id.* at \*7–19.

188. *MSI*, 2013 WL 4501088, at \*19 (citations omitted).

189. *Id.* (footnotes omitted).

190. *Id.* at \*22.

191. *Id.* at \*20.

some culpable participants,” and found it “difficult to characterize all of such transactions as Ponzi-related.”<sup>192</sup> It explained that it would be “inappropriate” to apply the Ponzi scheme presumption to *all* securities fraud cases, and doing so here might penalize innocent transferees “not for Ponzi-related and inappropriate action on their part, if any, but for the Jacobsons’ actions, not their own.”<sup>193</sup> The court denied the receiver’s request that it declare the MSI enterprise a Ponzi scheme, reasoning as follows:

Often it seems, depending on the time and context, a particular transaction [involving MSI] might be subject to a “Ponzi presumption” which itself may be refutable, and at other times, depending on the time and context, another particular transaction may not.

. . . As to intervening objectors and others who may be subject to claw back . . . [e]ach [transaction] needs to be examined on an individual basis. . . .

. . . [Presumption] is not a shortcut or substitute for proof. . . .

It seems to me that the “Ponzi presumption”, [sic] in equity, as to third parties, should be of limited use—indeed, only in those cases as blatant and as plain as the original Charles Ponzi case and the more recent Madoff case: assetless and fraudulent from day one.

This is not that case. The Receiver asserts this was a Ponzi scheme from the beginning . . . and the intervenor objectors assert this was not a Ponzi scheme at all. In a sense, each is correct. Depending on time, circumstance, and transaction, the Jacobson enterprise has, of course, many Ponzi characteristics which often come and go depending on time, circumstance, money source, and transaction.

. . . [The split personality of MSI] compels us in future actions by the Receiver to look at transactions closely, at the specific facts and circumstances of each transaction, free from any alleged, all-embracing presumption, but footed on whether a target of the Receiver’s action has received funds or assets knowingly, unfairly, or unlawfully.<sup>194</sup>

The court’s decision is troubling; it made findings of fact which clearly establish *both* of the elements a receiver must prove to invoke the Ponzi scheme presumption. First, it was undisputed that earlier investors were paid with the funds of later investors—i.e., the classic “rob Peter to pay Paul” scenario. Indeed, Thunder Bay often transferred later-received, commingled funds of new investors to an account of an earlier-created LLC (funded by older investors) so that the LLC could pay its promised returns to its investors, as its funds were insufficient to do so. In addition, the Jacobsons regularly created

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192. *Id.*

193. *Id.*

194. *MSI*, 2013 WL 4501088, at \*21–22.



new entities, funded solely with new investor money, to purchase property from older LLCs, thereby paying the old investors with the new investors' money. With its finding that all of MSI's entities operated as essentially one economic unit, the court should have found that the facts established the first requirement.

Second, the court's finding that Thunder Bay often "covered" for the other entities while issuing promissory notes, coupled with the fact that Thunder Bay became increasingly insolvent as a result of this relationship, supports the court's second required element. The entities comprising MSI—which the court found was a single enterprise—transferred their insolvency into Thunder Bay (*also* part of the single enterprise) and were unable to fund returns to investors from their "underlying business venture."

Finally, in addition to satisfying the court's stated requirements, the MSI scheme also exhibited several of the court's suggested "typicalities" of a Ponzi scheme. First, while the Jacobsons did not promise investors unusually high returns, they *did* represent to later investors that they offered absolutely consistent monthly returns with little to no risk by explaining that they had never defaulted with earlier investors. Second, the Jacobsons' boastful representations induced new investors to enter the scheme and help fund the enterprise. Finally, the Jacobsons engaged in secretive and complex strategies to keep investors at bay. As the majority of investors were laypeople who simply trusted the Jacobsons, the complexity of the scheme made it very difficult, if not impossible, for the average person to uncover the fraud. The Jacobsons created 208 "separate" entities so their scheme could function under the radar.

In short, this court clearly ignored its own findings of fact under its stated rules of law to conclude that MSI was not a Ponzi scheme. But the most troubling aspect of the opinion is that the court overlooked the resulting consequences of its opinion and the impact its decision would have on the receivership estate and its victims. The purpose of the receiver's motion in the main receivership proceeding was to gain an early overall characterization of the fraud as a Ponzi scheme in order to take advantage of the Ponzi presumption. Such a characterization at an early stage would have given the receiver a pleading benefit in all ancillary cases in which he sought disgorgement of profits from earlier investors who received funds contributed by later investors. But the court made it clear that "[a]n effort to apply such a 'Ponzi presumption' in *all* securities fraud cases which have some

Ponzi scheme characteristics is inappropriate.”<sup>195</sup> Why is applying the presumption in all securities fraud cases inappropriate? Applying the presumption beyond classic Ponzi scheme cases ensures that those who “profited” from similar schemes will be expected to turn over their profits just like “winners” in Ponzi scheme cases.

If other courts follow the *MSI* holding, future trustees and receivers will be able to take advantage of the Ponzi presumption “*only* in those cases as blatant and as plain as the original Charles Ponzi case and the more recent Madoff case: assetless and fraudulent from day one.”<sup>196</sup> This should not be the case and this holding should not be followed.

## V. EXPANDING THE PRESUMPTION

Cases like *MSI*, *National Audit*, and *Dreier* highlight the problem associated with the narrow application of the Ponzi presumption. First, because the descriptions and characterizations of a Ponzi scheme are nebulous, there is great uncertainty for receivers and trustees appointed to take control of the fraudulent enterprise. Would the *MSI* scheme be labeled a Ponzi scheme under a court in the Second Circuit’s “*any* sort of inherently fraudulent arrangement under which the debtor–transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud” definition?<sup>197</sup> What about the Eighth Circuit court’s description: “a multi-client investment arrangement executed over time, in which initial investors’ infusions are wrongfully siphoned off, the fund never maintains enough cash to meet all its obligations, and the earlier clients’ realization on investment is funded by later clients’ infusions”?<sup>198</sup> If courts in those jurisdictions affixed the Ponzi label to the *MSI* scheme, would the victims of that scheme receive a greater distribution? The answer is an unequivocal “yes.” Those who profited would have been required to turn over their winnings, and it would have saved the receiver from an expensive and complex transaction-by-transaction assessment.

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195. *Id.* at \*20.

196. *Id.* at \*21 (emphasis added).

197. *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp., LLC)*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) (emphasis added).

198. *Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22, 33 (Bankr. D. Minn. 2012) (quoting *Manty v. Miller & Holmes, Inc. (In re Nation-Wide Exch. Servs., Inc.)*, 291 B.R. 131, 148 n.20 (Bankr. D. Minn. 2003)); *see also Meeks v. Red River Entm’t of Shreveport (In re Armstrong)*, 285 F.3d 1092, 1093 n.3 (8th Cir. 2002) (stating that “[i]n a Ponzi scheme, the operator promises investors returns on their investment which the operator intends to pay from funds provided by the underlying business venture”).

In addition to the problem of unpredictability, limiting application of the presumption to only those cases “as blatant and as plain as the original Charles Ponzi case and the more recent Madoff case”<sup>199</sup> is harmful and highly prejudicial to the victims of the underlying fraud. The bankruptcy and receivership processes are not just reserved for failed Ponzi schemes. They are oftentimes used to redress the consequences of similar investment frauds. To that end, there are still “losers” and “winners” associated with fraudulent schemes. In other words, there are still victims deprived of property by fraud and others who have benefited because of this fraud. While the winnings may not have necessarily come directly from the losers’ pockets, there are still investors and other participants who have profited from the financial wrongdoing. Expanding the presumption enables trustees and receivers to redress the victims of the fraud by recovering assets against those who profited from the wrongdoing. A few courts appear to be recognizing this benefit.

A. *Is Case Law Opening the Door for Expansion?*

Case law invites an opportunity to extend the Ponzi scheme presumption beyond the scope of a “classic” Ponzi scheme. In *In re NorVergence, Inc.*,<sup>200</sup> a New Jersey bankruptcy court addressed the defendants’ motion to dismiss against NorVergence’s bankruptcy trustee.<sup>201</sup> The defendants were thirty-four leasing companies.<sup>202</sup>

NorVergence held itself out as a provider of “low cost” telecommunications services to small businesses and organizations.<sup>203</sup> Its core product was the “Matrix Box.”<sup>204</sup> NorVergence leased the “magic box” to its customers for many times its retail value while representing that it would help them to save on their phone and internet billing.<sup>205</sup> But that was a lie. The Matrix Box was nonfunctional. It was nothing more than a mix of standard routers that helped connect equipment to long-distance providers’ lines and did nothing to lower the customers’ telephone bills.<sup>206</sup> NorVergence’s lease agreements allowed it to assign its interest in the equipment leases to third parties.<sup>207</sup>

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199. *MSI*, 2013 WL 4501088, at \*21.

200. *Forman v. Salzano (In re NorVergence, Inc.)*, 405 B.R. 709 (Bankr. D.N.J. 2009).

201. *Id.* at 716.

202. *Id.*

203. *Id.* at 719.

204. *Id.*

205. *Id.*

206. *In re NorVergence*, 405 B.R. at 719.

207. *Id.*

Consequently, after it signed its customers up for the services, NorVergence assigned the lease agreements at discount rates to third-party finance companies for quick cash.<sup>208</sup> NorVergence would then use that cash to perpetuate the fraud, to wit: “more call center payroll to acquire new customers, and . . . perks for . . . the insiders.”<sup>209</sup> But when the Matrix Box and services were not provided to new customers at the contracted time, the customers defaulted on their lease agreements. As a result, the third-party finance companies engaged in offsets (the subject of the trustee’s complaint), withholding up to fifty percent of the amount due to NorVergence under the lease-assignment agreements as a hedge against future first payment defaults.<sup>210</sup> The lack of funds rendered NorVergence insolvent, and it collapsed into bankruptcy.<sup>211</sup>

The trustee sought to avoid the setoffs by asserting that NorVergence was a Ponzi scheme and the setoffs were fraudulent transfers.<sup>212</sup> Among other things, the trustee alleged that NorVergence was able to provide a few early customers with “discounted” services because it used the proceeds of contracts from new customers to offset other costs and make the offers more attractive. The finance companies, however, argued that a Ponzi scheme requires “an effort to disguise new investor money as profits and to funnel that new investor money to initial investors who earn outsized returns,” and that the trustee had failed to make this allegation.<sup>213</sup>

In its holding, the court defined a Ponzi scheme as having four elements:

- (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations *as represented to investors*; (3) the *purported* business operation of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.<sup>214</sup>

The trustee contended that he met these elements, arguing the following:

The original victims were the early customers: they unsuspectingly invested in the scheme by being duped into expensive five year leases for a piece of equipment of tangential value, the matrix box. Their cash investment, however, was created by the Leasing Companies who immediately monetized the customer leases creating fast

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208. *Id.* at 722.

209. *Id.*

210. *Id.*

211. *Id.*

212. *In re NorVergence*, 405 B.R. at 722.

213. *Id.* at 728–29.

214. *Id.* at 730 (emphasis added).

cash (investor money for NorVergence). That money . . . was expended almost exclusively on the capture of new customers (victims) creating new cash for providing some telephone service (return on investment) to old customers and for lining the pockets of the principals.<sup>215</sup>

The court then explained:

Case law has revealed that a clever twist on the Ponzi concept will not remove a fraudulent scheme from the definition of Ponzi. In other words, *even if Debtor's business operations do not exactly match the description of a Ponzi Scheme*, the Trustee can still continue to characterize the business model as a Ponzi Scheme thereby meeting the intent prong of the fraudulent transfer or conveyance Counts.<sup>216</sup>

The court did not classify NorVergence as a Ponzi scheme because such a determination would require findings of fact outside of the motion presented.<sup>217</sup> Nor did the court indicate whether a finding that the debtor's business operated a comparable fraudulent enterprise could be used in all adversary proceedings brought by the trustee to demonstrate the intent prong of the fraudulent transfer. Nonetheless, its holding is promising. It invites courts to expand the Ponzi presumption beyond the scope of a "classic" Ponzi scheme.

Four years after *In re Norvergence*, an Illinois bankruptcy court decided a motion to dismiss in the bankruptcy of Equipment Acquisition Resource (EAR).<sup>218</sup> In an earlier proceeding, the court had determined that the facts involved did not "fit the classic Ponzi scheme model; the defendant is not an investor and the complaint itself alleges that EAR was in the *legitimate business* of 'refurbishing and selling high-tech machinery.'"<sup>219</sup> Although the court declined to find that EAR was a Ponzi scheme and apply the presumption, the important aspect of the case is that the Illinois court indicated its *willingness* to expand the Ponzi scheme presumption to "Ponzi-like" schemes.<sup>220</sup>

Other courts are amenable to modifying the Ponzi scheme presumption. Recently, a Minnesota bankruptcy court decided to apply the presumption in a rather unique way in the bankruptcy proceeding of

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215. *Id.* at 729–30 (citations omitted) (internal quotation marks omitted).

216. *Id.* at 730 (emphasis added) (citations omitted).

217. *Id.* at 733.

218. *Brandt v. PlainsCapital Leasing, LLC (In re Equip. Acquisition Res., Inc.)*, 502 B.R. 784 (Bankr. N.D. Ill. 2013).

219. *Brandt v. PlainsCapital Leasing, LLC (In re Equip. Acquisition Res., Inc.)*, 483 B.R. 823, 834 (Bankr. N.D. Ill. 2012) (emphasis added).

220. *In re Equip. Acquisition Res.*, 502 B.R. at 790 ("[T]he court noted [previously] that some courts have expanded the Ponzi scheme presumption to schemes that are not within the definition of traditional Ponzi schemes. . . . The court did not conclude, however, that this was a case in which such an expanded definition would apply.").

the Polaroid Corporation.<sup>221</sup> The key issue in that case was whether the Ponzi scheme presumption applies to transfers *outside* the “operational core” of a Ponzi scheme.

Polaroid filed for bankruptcy in 2008.<sup>222</sup> At the time, Polaroid’s ownership was “traceable through an intermediate holding entity to Petters Group Worldwide, LLC [(PGW)], itself a holding company.”<sup>223</sup> PGW’s sole shareholder and CEO was Tom Petters (who was also chairman of Polaroid), and PGW had entered bankruptcy only a few months prior to Polaroid.<sup>224</sup> Petters also operated Petters Corporation, Inc. (PCI).<sup>225</sup> Forensic accounting showed that Petters had operated a massive Ponzi scheme using PCI, PGW, and several other companies as instrumentalities of his fraud.<sup>226</sup> Petters and his coconspirators induced lenders to loan money to PCI for the purpose of purchasing and reselling electronics in bulk.<sup>227</sup> Petters forged documents for this purpose, and none of the purchases or sales ever took place.<sup>228</sup> PCI used the funds to pay other lenders in the Ponzi scheme and to fund operations for PGW.

Petters, acting as Chairman of Polaroid, granted a security interest in some of Polaroid’s trademarks to the “Ritchie Defendants” to secure the preexisting debt belonging to Petters, PCI, and PGW.<sup>229</sup> When Polaroid filed for bankruptcy, the “Ritchie Defendants” asserted their secured claims to the trademarks in the proceedings.<sup>230</sup> Polaroid’s trustee moved for summary judgment, seeking to avoid Petters’ grant of this security interest as actually fraudulent to Polaroid’s creditors.<sup>231</sup> The main issues in the case were whether the court would adopt the Ponzi scheme presumption and, if so, whether it would apply the presumption to avoid a transfer *outside* the “operational core” of the Ponzi scheme.<sup>232</sup> The court recognized that “[t]he question of whether a court may use the Ponzi scheme presumption as urged is a matter of first impression in a narrow body of case law that

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221. *Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22 (Bankr. D. Minn. 2012).

222. *Id.* at 27.

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.* at 27–28.

227. *In re Polaroid*, 472 B.R. at 27–28.

228. *Id.* at 28.

229. *Id.*

230. *Id.*

231. *Id.*

232. *Id.* at 32–33.

has burgeoned only since 2007–2008.”<sup>233</sup> And “thus far the courts have recognized and applied the presumption only as to transfers made by entities that directly purveyed the Ponzi schemes.”<sup>234</sup>

Notwithstanding the limited application of the presumption adopted by various courts, the *Polaroid* court held that Polaroid’s pledge was made in furtherance of the Ponzi scheme and, therefore, the presumption applied. Although Polaroid did not operate the Ponzi scheme, Petters did, and his fraudulent intent was imputed to Polaroid.<sup>235</sup> While the defendants contended that the justification for the presumption was absent—because a legitimate business (like Polaroid) will not “inevitably fail” like a Ponzi scheme would—the court found that argument to be “deliberately myopic and unduly constrained.”<sup>236</sup> It explained that “[t]he past operation of a freestanding business by the ‘legitimate’ related entity and the abstract possibility of continuing such an operation do not bar the application of the presumption.”<sup>237</sup> It further stated:

The Trustee’s expanded conception of the presumption is premised on common control within a larger structure. When this is the governing consideration, the automatic inference of fraudulent intent is made when the person in common control effects the transfer by the entity extrinsic to the Ponzi scheme, *but in order to further the scheme* as it has been maintained *through the central entity*. Yes, the creditors hindered, delayed, and defrauded by the transfer are not the direct victims of the Ponzi scheme in its operation, i.e., investors into the entity through which the scheme has been purveyed. Nonetheless, it is a readily-identifiable group: the creditors of the related entity that makes the transfer for the benefit of the purveyor–entity. The intent that is deemed via the inference is the intent to deprive *those* parties of the value of their legal recourse against the debtor with which they are in privity, i.e., the transferor that gives up its own assets at the beck of the person in common control, to satisfy a creditor of the purveyor–entity that is not a creditor of the transferor–entity.<sup>238</sup>

The court also explained that there was nothing inappropriate about applying the presumption to this case, as the “in furtherance” requirement of transfers in a Ponzi scheme is act oriented, not structure oriented; just because the transferees were not victims of the core scheme did not dictate a finding that “the basic willingness to

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233. *In re Polaroid*, 472 B.R. at 33.

234. *Id.* at 32–33.

235. *Id.* at 40–41.

236. *Id.* at 40.

237. *Id.* at 41.

238. *Id.*

prejudices others' rights is absent."<sup>239</sup> In concluding, the court stated as follows:

[A]s a matter of logic, judicial policy, and fundamental fairness, the Ponzi scheme presumption can be applied to the Polaroid Corporation's encumbrance of valuable intellectual property rights in favor of the Ritchie Defendants. Such an application does go beyond the matrix of phenomena on which the presumption was first conceived; but it does so on proper considerations of the basis and purpose of the presumption.<sup>240</sup>

Cases like *Polaroid* and *NorVergence* expand prior case law applying the presumption. In *Polaroid*, the court applied the presumption to transfers made by an entity that did not operate the Ponzi scheme. In *NorVergence*, the court indicated its willingness to expand the presumption to operations that have some hallmarks of Ponzi schemes, but that otherwise fail to fall within the classic definition of a Ponzi scheme. Clearly, these courts recognize the advantages of the presumption and the benefit of applying the presumption in cases sufficiently like the "classic" Ponzi scheme.

*B. Expanding the Presumption Maximizes Distribution to Victims of the Fraud.*

Receivers and trustees are equipped with fraudulent transfer remedies designed to redress the victims of fraudulent schemes. When they seek to recover transfers under the actual fraud theory, they only need to prove one element: whether the debtor made the transfer with actual intent to defraud. And when they can prove that the companies now under their control operated as a Ponzi scheme, they are entitled to a presumption of actual intent to defraud. But this means that in every other investment fraud case, including those that closely resemble Ponzi schemes, trustees and receivers must undertake the "badges of fraud" analysis. This approach is difficult and unpredictable. As one bankruptcy court noted, "[P]roof of intent under a badges-of-fraud analysis is not like a carnival dart game, where simply popping a given number of balloons entitles one to the big prize."<sup>241</sup> More importantly, proof of fraudulent intent outside of "classic" Ponzi scheme cases requires courts to examine the suspicious transaction at issue.

For example, among the badges of fraud courts consider are (1) gross inadequacy of the consideration provided by the transferee; (2)

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<sup>239</sup> *In re Polaroid*, 472 B.R. at 41–42.

<sup>240</sup> *Id.* at 42.

<sup>241</sup> *Sullivan v. Welsh (In re Lumbar)*, 446 B.R. 316, 331 (Bankr. D. Minn. 2011), *rev'd*, 457 B.R. 748 (B.A.P. 8th Cir. 2011).



a close relationship between the transferor and the transferee; (3) secrecy in the transfer between the transferor and the transferee; (4) the transferor's insolvency as a result of the conveyance to the transferee; (5) a questionable transfer not in the ordinary course of business; and (6) retention of control of the property by the transferor after conveyance to the transferee.<sup>242</sup> These badges share a commonality: they all involve analyzing a specific transaction vis-à-vis the actual transferee.

So in a case like *MSI*, in which the receiver had already commenced more than forty separate ancillary cases for the recovery of fraudulent transfers when he filed his motion to establish the existence of a Ponzi scheme, the court must examine each transfer on an individual basis to determine intent. The cost to the estate in producing evidence and analyzing the objective circumstances of each individual transaction is staggering. Tying the badges of fraud to each transaction will substantially dilute the estate and the recovery available for victims of the fraud. Moreover, if the presumption is defenestrated due to lack of "classic" Ponzi scheme circumstances, is there now an affirmative defense as to the profits the receiver or trustee seeks to recover? As this Article discussed, in Ponzi scheme cases, courts uniformly hold that an investor—even if innocent—does not exchange reasonably equivalent value for any payments received that represent fictitious profits. But does this mean that in cases like *MSI*—in which one can assume, for the sake of argument, that the receiver could prove actual intent—that there are no longer fictitious profits because it is not a "classic" Ponzi scheme and, therefore, investors will be able to establish a defense to the fraudulent transfer because they took the profits in good faith and for reasonably equivalent value? In an area where equity reigns supreme, this should not be the law.

If the goal in both securities fraud receiverships and liquidation bankruptcy is to maximize the return to creditors and victims and to orchestrate a fair distribution of the liquidated assets, expanding the actual fraud presumption beyond classic Ponzi schemes will achieve this objective. Proof of the existence and operation of a comparable fraudulent enterprise, and a judicial finding to that effect, should be sufficient to support an overall finding of intent on the part of the purveyor or purveyors of the fraud to defraud contemporaneous or future creditors of the enterprise. Such an expansive sweep with respect to all transfers flowing from the fraudulent enterprise is both fair and equitable.

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242. See, e.g., *DLJ Mortg. Capital, Inc. v. Kontogiannis*, 594 F. Supp. 2d 308, 320 (E.D.N.Y. 2009) (listing badges of fraud analyzed by courts).

First, because it is just a presumption, receivers and trustees will still be required to make a showing that the entities now under their control operated a fraudulent scheme. This will undoubtedly necessitate an evidentiary hearing where all parties in interest, including those that object to the finding of a fraudulent scheme, can participate. In other words, expanding the presumption does not mean that trustees and receivers will automatically be equipped with the presumptive sword. They will still be required to file a motion asking the court to establish the existence of a fraudulent enterprise and allow them to invoke the actual fraud presumption in all ancillary cases. This process allows all parties in interest to have their day in court. The likely scenario is that the “winners” will object to such a request, while the “losers” will support it.

Along those lines, the trial court should be afforded substantial discretion to determine the existence of a fraudulent enterprise and the application of the presumption. Accordingly, establishing an absolute list of required elements in order to prove the existence of fraud and invoke the presumption would be impractical and would likely promote similar myopic decisions like the *MSI* case. Instead, the trial court should be able to consider several nonexhaustive factors in making its determination. This Article suggests the following considerations: (1) whether the entities failed to observe corporate formalities; (2) whether investment funds were commingled with personal funds; (3) whether there were extensive intercompany transfers; (4) whether insiders were receiving substantial, unreported gains; (5) whether the operators induced investors to invest through exaggeration, lies, or deceit; (6) whether the business or businesses were self-sustaining without the infusion of other investments; (7) whether some of the returns paid to old investors came from funds contributed by new investors; (8) whether the entities engaged in secretive and complex strategies; (9) whether the investments were unregistered; (10) whether the entities failed to keep proper paperwork; (11) whether the operators used the funds to lead a lavish lifestyle; (12) whether investors were lied to regarding the existence of their investments and their promised returns; and (13) whether some investors profited at the expense of other investors.

Furthermore, once a trustee or receiver meets her burden, even this blanket finding of fraudulent intent will not automatically penalize innocent action. It is a presumption that has the effect of shifting the burden of production of evidence on the ultimate fact over to the trustee or receiver’s opponent. The opposing party may rebut the presumption by demonstrating that she took in good faith and for

reasonably equivalent value. But just like “classic” Ponzi scheme cases, those investors who profit from the financial wrongdoing should help defray the losses of those victims who come out behind. Why allow this form of restitution to operate strictly in “classic” Ponzi scheme scenarios?

Second, expanding the presumption beyond classic Ponzi scheme cases avoids the unpredictability problems receivers and trustees experience when seeking a Ponzi scheme finding. For example, in cases such as *MSI*, where courts in other jurisdictions could have easily reached a different conclusion and affixed the golden Ponzi-scheme label to the fraudulent enterprise, the receiver will still be able to take future advantage of an actual fraud presumption in all ancillary cases, regardless if the enterprise now under his control operated as a classic Ponzi scheme. The purveyors of the *MSI* fraud cheated others. At times, they robbed Peter to pay Paul. They created fictitious entities to disguise their fraud. Thus, a presumption that all transfers flowing from the fraudulent enterprise is logical.

Finally, one of the fiduciary duties of trustees and receivers is to conserve assets of the estate and maximize distributions to creditors. That means investigating and litigating potential lawsuits that might be brought on behalf of the entities now under their control. But failure to perform these duties expeditiously subjects trustees and receivers to removal, forfeiture of fees, or, in some cases, liability for damages.<sup>243</sup> Equipped with a presumptive element of fraud to utilize in claw-back actions will allow trustees and receivers to act diligently, equitably, effectively, and efficiently as they fulfill their fiduciary duties. Without the presumption, the transaction-by-transaction assessments will undoubtedly dilute the estate, and perforce will minimize distributions to victims and creditors. Victims of fraudulent schemes have already received a demoralizing blow; they should not be punished further because of a label.

## VI. CONCLUSION

Ponzi schemes and other investment frauds inevitably end up in bankruptcy or receivership, leaving behind numerous victims—many of whom invested their life savings in the scheme without any knowledge of its fraudulent nature. Although trustees and receivers can sometimes recover some of the fraudulently acquired funds from the assets of the perpetrators, in most cases, those assets fall woefully

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243. See *Ernst & Young v. Matsumoto (In re United Ins. Mgmt., Inc.)*, 14 F.3d 1380, 1386 (9th Cir. 1994).

short of the victims' losses. This leads to fraudulent transfer lawsuits against those who are suspected to have profited from the wrongdoing.

A transfer is fraudulent if it was made with the actual intent to defraud. But actual fraud is seldom proven by direct evidence. Rather, it is usually proven from inferences drawn from a course of conduct. Generally, to determine whether circumstantial evidence supports an inference of fraud, courts examine certain badges of fraud. While badges of fraud are helpful, the analysis requires individual examination of the specific transaction at issue, the effect of which diminishes the returns to the victims of the fraud because of the substantial costs involved in undertaking such assessments. However, courts nationwide have recognized that simply establishing the existence of a Ponzi scheme is sufficient to prove the perpetrator's intent to defraud. The presumption provides receivers and trustees with a significant pleading advantage and shifts the burden of showing the legitimacy of the benefits received to the target.

Courts define Ponzi schemes differently. The characteristics and descriptions vary, which creates uncertainty for receivers and trustees who are now required to take over the fraudulent enterprise and recover assets for the victims of the fraud. Expanding the actual fraud presumption beyond classic Ponzi-scheme cases avoids uncertainty and assists receivers and trustees in achieving a final, equitable distribution of assets. Courts like the one in *MSI* are missing the mark. The focus should not be whether applying the presumption is fair to those potential defendants who profited by the perpetrator's wrongful conduct. Instead, the focus should be whether applying the presumption will maximize the return to creditors and victims of the fraud.

