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Court Reverses 'Ponzi-Like' Fraudulent Transfer Ruling

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The United States Court of Appeals for the Fifth Circuit, on March 20, 2012, reversed a district court's fraudulent transfer judgment based on a financially troubled entity's gift to a charity. *The American Cancer Society v. Cook*, 2012 WL 919 674 (5th Cir. 3/20/12) (Jones, Ch. J.). The transferor was the subject of a Securities and Exchange Commission (SEC) receivership, not a bankruptcy case, and the plaintiff was its court-appointed receiver. Because the Fifth Circuit found no evidence in the record of "a traditional Ponzi scheme," it held that "the district court erred in applying the presumption of [actual] fraudulent intent." *Id*. at *3. As the court stated, "[n]ot all securities frauds are Ponzi schemes." *Id*. at *1.

Relevance

The defendant charity in *Cook* had a difficult defense. Courts (bankruptcy and non-bankruptcy) have regularly held that so-called "Ponzi scheme" debtors presumptively make transfers to their investors with actual fraudulent intent to hinder, delay or defraud other creditors. *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006) (held, receiver satisfied burden of showing fraudulent intent with evidence that transferor had created Ponzi scheme, and was thus, "as a matter of law, insolvent from its inception"), citing *Cunningham v. Brown*, 265 U.S. 1 (1924).

Bankruptcy Code § 548(c) and § 8(a) of the Uniform Fraudulent Transfer Act, applicable in 43 states, insulate a transferee from liability, however, if it can prove that it took "for a reasonably equivalent value and in good faith." This defense applies in bankruptcy cases and in state law fraudulent transfer cases like *Cook*. According to the court in *Warfield*, when "analyzing the exchange of value for any transfer," it had to look at "the degree to which the transferor's net worth is preserved." *Id*. at 560. Because the defendant in the *Warfield* Ponzi scheme could not argue that its "broker services … were reasonably equivalent value for transfers it had received," it could hardly argue that "the … Ponzi scheme benefited from his efforts to extend the fraud by securing new investments." *Id*. *In re Fin. Federated Title & Trust, Inc.*, 309 F.3d 1325, 1332-1333 (11th Cir. 2002) (defendant's services deepened debtor's insolvency and may have been part of fraudulent transfer, but services did constitute value; upon remand, court must determine whether those services represented reasonably equivalent value for the payments defendant received.); *AFI Holding, Inc. v. MacKenzie* (*In re AFI Holding, Inc.*, 525 F.3d 700 (9th Cir. 2008) (defendant investor in Ponzi scheme not barred as matter of law from establishing good-faith receipt of his initial investment in exchange for extinguishment of claim of restitution); *Securities & Exchange Commission v. Res. Dev. Int'l LLC*, 487 F.3d 295, 302 (5th Cir. 2007) (held, good-faith defense failed because defendants could not show they exchanged reasonably equivalent value for transfer from "debtor.").

A defendant, in any event, is entitled to show the value of its good-faith services despite the existence of the debtor's Ponzi scheme and its actual fraudulent intent. *In re Bayou Group LLC*, 439 B.R. 284, 3214-15 (S.D.N.Y. 2010) (reversing, the bankruptcy court held, "a transferee is entitled to offer evidence and to argue to the finder of fact that no diligent investigation would have disclosed the transferor's insolvency or fraudulent purpose. If the transferee can meet its burden of demonstrating that a diligent investigation would not have led to discovery of the fraud, it may prevail on this prong of the good faith affirmative defense."). Had the plaintiff receiver in *Cook* been able to rely on the Ponzi scheme presumption, the defendant charity would have been liable because, regardless of its good faith, it could not prove reasonably equivalent value, having admittedly received a gift.

Ponzi Scheme Defined

The receiver's entire fraudulent transfer case, based on the transferor's actual intent in *Cook*, turned on the existence of a Ponzi scheme. According to the Fifth Circuit, however, a "Ponzi scheme is a 'fraudulent

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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.'" 2012 WL 919674, at * 2, citing *Janvey v. Alguire*, 647 F.3d 585, 597 (5th Cir. 2011) (quoting Black's Law Dictionary, 1198 (8th ed. 2004)). Accord, *Perkins v. Haines*, 661 F.3d 623, 625n.1 (11th Cir. 2011) ("The essence of a Ponzi scheme is to use newly invested money to pay off old investors and convince them that they are earning profits rather than losing their shirts."). The receiver here had only her affidavit and meaningless documents attached as exhibits, but "[n]othing in these documents demonstrates that investor funds were used to issue 'returns' to other investors — a *sine qua non* of any Ponzi scheme." *Id*., at *3. Moreover, the receiver "failed to identify in those exhibits any instance in which a single payment was made to an investor," enabling the court of appeals to find that the lower court had "erred in placing determinative weight on the [receiver's] declaration that [the transferor] operated as a Ponzi scheme." *Id*.

The debtor and its related entities, referred to as "Giant" by the court, had raised substantial funds from investors through unregistered securities offerings, promising "considerable returns within twelve months." *Id*. at *1. In fact, according to the complaint filed by the SEC, "a considerable portion of investor funds was transferred" and diverted for personal use by Giant's insiders, causing the SEC to charge Giant with "multiple violations of federal securities laws," *Id*.

The allegations of the complaint, however, did not support the existence of a Ponzi scheme. "Giant may well have operated as a fraudulent or at least badly mismanaged drilling investment program, but there was no proof that its perpetuation, unlike that of a traditional Ponzi scheme, was based on the manufacturing of 'returns' to investors from other investor's contributions." *Id*. at *3.

Nor could the plaintiff receiver support her fraudulent transfer claim with circumstantial evidence showing actual fraudulent intent, an essential element of her claim under the UFTA. Although the receiver asserted that "the purpose of the … donations was to lure new investors into Giant's fraudulent scheme, and that the donations were not an authorized use of the investors' money," she could only support these assertions with her "conclusory" affidavit that was "factually bare." *Id*. The receiver could provide "no explanation" for her conclusions, "nor any supporting facts … ." *Id*. And the SEC's complaint was hardly "evidence of the charges contained in it." *Id*., quoting *Scholes v. Lehmann*, 56 F.3d 750, 762 (7th Cir. 1995). Because of the absence of hard factual evidence, the Fifth Circuit found that the district court had "clearly erred in finding that the donations … were fraudulent transfers," making it unnecessary for the court to consider any defenses that the charity had as to reasonably equivalent value and good faith. *Id*. at n.1.

Other Flaws in the Receiver's Case

1. Defendants' counsel in *Cook* waged an effective defense against a court-appointed receiver. They attacked the very premise of the receiver's claim, enabling the appellate court to confirm the precise definition of a Ponzi scheme.
2. The *Cook* decision further confirmed the need for hard facts in fraudulent transfer litigation, regardless of whether a creditor or a fiduciary prosecutes the claim. Despite the receiver's good-faith belief in Giant's misconduct, she had no facts to prove a Ponzi scheme. As Dickens put it 158 years ago, "[f]acts alone are wanted in life." C. Dickens, Hard Times, ch 1 (1854).
3. The plaintiff receiver also inexplicably failed to allege constructive fraud under the Uniform Fraudulent Transfer Act (UFTA). Had she done so, she could have merely alleged insolvency and the debtor's failure to receive "reasonably equivalent value." UFTA § 5(a) (transfer voidable by present creditors when debtor makes transfer "without receiving a reasonably equivalent value in exchange for the transfer" and "the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer … ."). Accord, Texas UFTA § 24.006(b); Bankruptcy Code § 548(a)(i)(B)(ii).
4. The Fifth Circuit summarily rejected the receiver's other claims. Her reliance on a receivership order enabling her to recover assets was thus "meritless." 2012 WL919674, at *4. She failed to "establish an independent legal basis to justify their recovery." *Id*. Similarly, the court rejected the receiver's attempt to have it "impose a constructive trust on" the transferred cash. *Id*. Aside from a lack of equity for such a remedy against a charitable entity, the receiver offered "no evidence that Giant's contributions furthered any fraudulent scheme or were … made with intent to defraud investors." *Id*.

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