ALERTS

Eighth Circuit Rejects Ponzi Scheme Presumption To Protect Legitimate Loan Repayments

November 29, 2018

"... Ponzi scheme payments to satisfy legitimate antecedent debts to defendant banks could not be avoided" by a bankruptcy trustee "absent transaction-specific proof of actual intent to defraud or the statutory elements of constructive fraud – transfer by an insolvent debtor who did not receive reasonably equivalent value in exchange," held the U.S. Court of Appeals for the Eighth Circuit on Nov. 20, 2018. *Stoebner v. Opportunity Finance LLC*, 2018 WL 6055636 at *4 (8th Cir. Nov. 20, 2018), citing *Finn v. Alliance Bank*, 860 N.W. 2d 638, 653-56 (Minn. 2015). The Eighth Circuit affirmed the lower courts' dismissal of a bankruptcy trustee's $250-million fraudulent transfer suit against two banks ("Banks"), rejecting the so-called "Ponzi scheme presumption" that "allows a creditor to by-pass the proof requirements of a fraudulent-transfer claim by showing that the debtor operated a Ponzi scheme and transferred assets 'in furtherance of the scheme.'" *Id.*, at *3, quoting *Finn*, 860 N.W. 2d at 646 (Minn. 2015) (construing Minnesota Uniform Fraudulent Transfer Act ("MUFTA"), declined to apply Ponzi scheme presumption).

Relevance

The judge-made Ponzi scheme presumption has generated litigation in the past few years. The Eighth Circuit in *Stoebner* enthusiastically followed the Minnesota Supreme Court's 2015 *Finn* decision to reach the right result (i.e., rejecting the presumption). In contrast, two years ago, the Fifth Circuit begrudgingly accepted the Texas Supreme Court's similar

reading of the Uniform Fraudulent Transfer Act in *Janvey v. Golf Channel Inc.*, 834 F.3d 570, 572-73 (5th Cir. 2016) (because "the Supreme Court of Texas is the authoritative interpreter of [the Texas Uniform Fraudulent Transfer Act] and [because] we are bound by its answer to our certified question when applying that statute," the defendant's "media-advertising services had objective value and utility from a reasonable creditor's perspective at the time of the transaction, regardless of [the debtor's] financial solvency at the time."), quoting *Janvey v. Golf Channel Inc.*, 487 S.W. 3d 560, 581-82 (Tex. 2016). The Fifth Circuit in *Janvey* also ignored the Minnesota Supreme Court's 2015 *Finn* decision.

Facts

An entity known as PCI "purported to run a 'diverting' business that purchased electronics in bulk and resold them at high profits to major retailers." 2018 WL 6055636 at *1, quoting *Ritchie Capital Management LLC v. Stoebner*, 779 F.3d 857, 859 (8th Cir. 2015). PCI deceived investors into providing it with financing to acquire merchandise for resale, but never purchased merchandise or sold it to retailers. Like other classic Ponzi schemes, PCI's purported income came from investor loans that PCI used to repay earlier investors. *Id.*, n.1, citing *In re Armstrong*, 291 F.3d 517, 520 n.3 (8th Cir. 2002) (a Ponzi scheme is a "fraudulent business venture … in which investors' 'returns' are generated by capital from new investors rather than the success of underlying business venture.").

PCI also acquired legitimate businesses, including the debtor here, in 2005. When the PCI Ponzi scheme later collapsed, the debtor sought bankruptcy relief. The debtor's bankruptcy trustee later sued the Banks under MUFTA to recover $250 million in loan payments they received from the debtor's predecessor, claiming that the debtor was the successor in interest to a PCI affiliate.

The bankruptcy court granted the Banks' motion to dismiss, not only because of the trustee's lack of standing,[1] but also because the trustee had failed to state a claim for "actual or constructive fraudulent transfer under MUFTA." *Id.*, at *2. The district court affirmed. Both of the lower courts relied on the Minnesota Supreme Court's *Finn* decision.

Unlike other PCI companies, the debtor's predecessor "actually purchased, warehoused, and sold to prominent retailers high volumes of consumer electronic equipment." It funded most of the purchases with

loans from the Banks "bearing a 12% interest rate that was 'substantially in excess of the market rate for such loans.'" *Id.*, at *3.

The trustee sought to recover more than $250 million of loan repayments made by the debtor's predecessor before it acquired the debtor, linking the predecessor's financing of legitimate purchases of consumer electronics to the ongoing PCI Ponzi scheme. According to the trustee, PCI caused the debtor's predecessor "to finance and engage in these retail transactions 'at least in part to give his organization a physical presence in the market place and thereby to give a false appearance of legitimacy to [its] organization.'" *Id.* Moreover, alleged the trustee, PCI had "laundered proceeds from the Ponzi scheme through [the debtor's predecessor] and withdrew laundered funds from [that entity]." *Id.* The debtor's predecessor, according to the complaint, "consistently lost money," operated at a loss, and "could not realistically expect to make a profit." *Id.* PCI "knew that [the debtor's predecessor] was destined to fail, and … ultimately … did fail." *Id.* Not only was the predecessor insolvent at all material times, but "was capitalized and propped up with funds obtained by fraud through the Ponzi scheme." It "received less than reasonably equivalent value for loan repayments [to the Banks] because the 12% interest rate was 'significantly above-market' or constituted 'false profits.'" *Id.*

The Eighth Circuit

The "bankruptcy court and the district court correctly dismissed the Trustee's claims on the merits," said the Eighth Circuit, making it "unnecessary to decide the standing issues." *Id.* Like Bankruptcy Code ("Code") § 548, MUFTA "allows creditors to recover assets that debtors have fraudulently transferred to third parties." *Id.*, quoting *Finn*, 860 N.W. 2d at 644. It also "includes both actual and constructive fraud provisions."

Detailed Pleading Required. "The heightened particularity requirements of Fed. R. Civ. P. 9(b) apply to fraudulent transfer claims under MUFTA," held the court. *Id.*, at *4 n.6, citing *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (complaint "must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face'"; "threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice"; court "not bound to accept as true a legal conclusion couched as a factual allegation.").

No Actual Fraud. The Eighth Circuit rejected the trustee's claim of actual fraud based upon PCI's purported knowledge. "This theory flies in the face of *Finn*'s requirement that each transaction must be analyzed individually and presumes fraudulent intent based on 'the form or structure of the entity making the transfer.' … . [T]his theory is simply a repackaging of the Ponzi scheme presumption rejected by *Finn*." Although *Finn* said a court could infer from the existence of a Ponzi scheme "that a particular transfer was made with fraudulent intent … ," the complaint here "is bereft of facts demonstrating [the debtor's] intent to defraud its own creditors through the loan repayments." *Id.*, at *4. In fact, according to the complaint, the debtor's predecessor had "financed legitimate business transactions with capital from [the Banks]," repaying the loans through the proceeds "of 'real life' transactions." *Id.* And the trustee never even alleged that the loan proceeds "were diverted to the Ponzi scheme being perpetrated through PCI." *Id.*

No Constructive Fraud. The Eighth Circuit also rejected the trustee's constructive fraudulent transfer claim. "… [A]n unsupported allegation that 12% interest was above 'the market rate' does not plausibly assert with sufficient particularity the absence of reasonably equivalent value for the repayment of ongoing loans to finance legitimate transactions in a specific market – the purchase and sale of consumer electronics by a 'diverter.'" *Id.*, at *5.

No Insolvency or Inadequate Capitalization. Finally, the Eighth Circuit rejected the trustee's allegations of insolvency and inadequate capitalization. Conclusory allegations reciting the statutory elements "are insufficient to state a claim." *Id.*, at *5. Additional supporting facts as to the debtor's improper capitalization and operating losses were "insufficient to plausibly plead that, at the time of each of the hundreds of challenged transfers, [the debtor] had insufficient assets to carry on its legitimate business and would be unable to pay its debt as it became due." *Id.* The trustee could not merely assume that the debtor's predecessor was financially distressed because it received funds from the PCI Ponzi scheme. "That is contrary to *Finn*: 'it is not at all clear that every fraudulent investment arrangement that is later determined to be a Ponzi scheme necessarily will have been insolvent from its inception': 'a debtor could have assets or legitimate business operations aside from the Ponzi scheme … that it uses to stave off insolvency, at least for a while.'" *Id.*, quoting *Finn*, 860 N.W. 2d at 649.

Comment

1. The *Stoebner* decision properly followed *Finn*. In that case, the Minnesota Supreme Court specifically held that the Ponzi scheme presumption "cannot be used to establish three elements of a claim under MUFTA – fraudulent intent, the debtor's insolvency at the time of the transfer, and the lack of reasonably equivalent value." *Id.*, at *2, citing 860 N.W. 2d 645-53.

2. The debtor in *Finn* made loans to borrowers and then fraudulently sold participation interests to financial institutions, but those interests exceeded the amount of the loans or never rested on any underlying loans. The debtor had paid its early investors with funds provided by later investors. 860 N.W. 2d at 642. Relying on the Ponzi scheme presumption, the debtor's receiver sued in Minnesota under MUFTA to avoid payments to the investors. The Minnesota Supreme Court, however, stressed that "the focus of the statute is on individual transfers, rather than a pattern of transactions that are part of a greater 'scheme.'" *Id.*, at 646-53. Therefore, held the court, the presumption cannot "apply to actual or constructive fraudulent transfer claims." A plaintiff creditor must "prove the elements of a fraudulent transfer with respect to each transfer, rather than relying on a presumption related to the form or structure of the entity making the transfer." *Id.*, at 647. The receiver could not avoid payments made to satisfy legitimate antecedent debts to the defendant banks without "specific proof of actual intent to defraud or the statutory elements of constructive fraud." *Id.*, at 653-56.

3. The Eleventh Circuit had also held that a court, when evaluating whether an employee of a Ponzi scheme debtor provided value, "should focus on the value of the goods and services provided rather than on the impact the goods and services had on the bankrupt enterprise." *In re Fin. Federated Title & Trust Inc.*, 309 F.3d 1325, 1332 (11th Cir. 2002). Like *Finn*, the Eleventh Circuit "dismissed ... cases in which courts had held that value was lacking as a matter of law in compensation transactions involving a Ponzi scheme." *Id.* As the Texas Supreme Court held in *Janvey*, "value is value regardless of whether the debtor is insolvent or whether either party is acting in good faith." 487 S.W. 3d 560, 579.

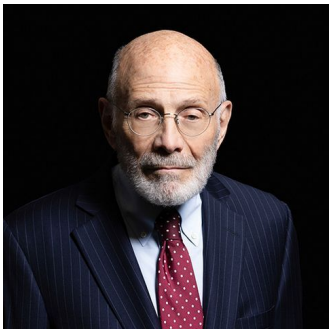
Authored by Michael L. Cook.

If you have any questions concerning this Alert, please contact your attorney at Schulte Roth & Zabel or the author.

---

[1] According to the Eighth Circuit, "[t]his is an unusual fraudulent transfer case because the trustee seeks to avoid transfers made by a party prior to the time it even arguably became a … debtor." 2018 WL 6055636, at *2.

Related People



Michael Cook

Of Counsel

New York

Practices

Attachments

Download Alert