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In the Wake of Collapse: Approaches to Ponzi Scheme Litigation

Upon the inevitable collapse of any Ponzi scheme, investors, financial institutions and others — even the innocent — will face challenging and complex legal issues. The steps our clients take soon after the collapse may have a lasting impact on their rights going forward. We discuss below several key issues relating to post-Ponzi scheme litigation.

What is a Ponzi Scheme?

A Ponzi scheme is a financial arrangement where the Ponzi operator, without a legitimate underlying business, makes payments to past investors with funds collected from new investors. While Ponzi schemes can last for years, eventually the operator is unable to recruit enough new investors to fund the withdrawal requests of the earlier investors. When this happens, the scheme crashes, as all Ponzi schemes ultimately do.

Ponzi schemes are inherently fraudulent, and the operator will face a raft of criminal charges, typically in federal court. Because these schemes are criminal in nature, courts have held them to be insolvent from their inception. *See Scholes v. Lehman*, 56 F. 3d 750, 755 (7th Cir. 1995) (Claims of investors made a Ponzi scheme insolvent from inception); *In re Randy*, 189 B.R. 425, 441 (N.D. Ill. 1995) ("Having been convicted of a Ponzi scheme, Randy was insolvent from its inception as a matter of law."); *In re Independent Clearing House*, 77 B.R. 843, 871 (D. Utah 1987) ("By definition, an enterprise engaged in a Ponzi scheme is insolvent from day one.").

As Ponzi schemes progress, some investors — usually those who were recruited early in the scheme — receive more money than their principal investment. In essence, these investors receive fictitious "profits" on their principal investments. Of course, other investors receive no return on their principal investment before the Ponzi scheme collapses, or receive less money than they invested. Whether an investor receives more or less than its principal investment looms large in determining the investor's status in future litigation.

Who Brings Claims When a Ponzi Scheme Collapses?

A Ponzi scheme's collapse often leads to a bankruptcy, SEC receivership, SIPC liquidation or other formal dissolution proceedings. In addition to their personal estates, Ponzi operators often have other business entities they created over the course of their schemes that also must be liquidated. Depending on the circumstances, the Ponzi operators' personal estates and related business entities may also file for liquidation — whether in a bankruptcy case or through a receiver appointed pursuant to securities laws and regulations.

While investors may have standing to pursue several different claims, the trustee or receiver will also pursue claims against co-conspirators, financial institutions and certain investors. Recoveries from these claims often are among the largest assets available to the trustee or receiver to pay creditor and investors' claims.

Trustees and receivers have many similar tools to use in seeking to obtain money from co-conspirators or certain investors. But some of those tools differ between trustees and receivers. Bankruptcy trustees, for example, are empowered under the Bankruptcy Code to avoid many financial transactions the Ponzi operator conducted in the 90 days leading up to the bankruptcy filing. Undoing these transactions, known as "preferences," is designed to spread the effect of the bankruptcy across a greater number of creditors and prevent earlier-paid creditors — who received money immediately prior to the bankruptcy–from receiving a windfall. Unlike a bankruptcy trustee, receivers are not empowered to void preferences.

Investors: Net Winners Versus Net Losers

Upon appointment, a trustee or receiver must take stock of the financial affairs of the debtor. This can take months (if not longer), as fraud-artists rarely keep pristine books and records. The trustee or receiver will attempt to use bank records to re-create the activity which predated their appointment. They will then (i) identify creditors (those who are owed money); (ii) identify debtors (those who owe money to the estate); (iii) initiate litigation against the debtors to recover the sums owed; and (iv) ultimately, distribute the proceeds to the creditors.

The first two steps will involve a calculation of cash in and cash out, comparing the investor's payments to and withdrawals from the Ponzi operator. Simply put, "net winners" (whose payments *from* the scheme exceeded their payments *to* the scheme) may be at risk of having those fictitious profits clawed back.

Given this reality, it is critical for Ponzi scheme investors — even those unaware of the fraud prior to the collapse — to immediately identify the amount of money invested with the Ponzi operator, and compare that sum to their actual returns. Investors who have made money will likely face litigation by a trustee or receiver seeking to claw back the overpayments.

Nearly all investors in Ponzi schemes consider themselves innocent victims. Most will have a recent "account statement" of some variety which will report a large balance in the account. In most cases, the receiver or trustee will view these account statements as meaningless. All that ultimately matters is the calculation of cash-in versus cash-out, and not what the Ponzi operator reported as an account balance, based on fictitious profits.

Avoidance of Fraudulent Transfers

Receivers and trustees share a powerful tool: the ability to avoid fraudulent transfers. Many states have now adopted some version of the Uniform Fraudulent Transfer Act. *See, e.g.,* Cal. Civ. Code § 3439, *et seq*. Other states still utilize the Uniform Fraudulent Conveyance Act, or UFCA. Although New York has not adopted the UFTA, it has passed Debtor and Creditor Law Section 273-276, which creates a very similar construct to the UFTA. In addition to fraudulent transfers under state law, the Bankruptcy Code contains its own fraudulent transfer provisions. *See* 11 U.S.C. § 548(a)(1). The Bankruptcy Code also empowers bankruptcy trustees with state law avoidance rights of a creditor, thus allowing the trustee to bring state law fraudulent transfer claims. *See* 11 U.S.C. § 544(b); *In re United Energy Corp.*, 944 F.2d 589, 593 (9th Cir. 1991) ("A bankruptcy trustee has the power to avoid fraudulent transfers pursuant to state law and/or the provisions of the Bankruptcy Code.").

Under all of these statutory provisions, an intentionally fraudulent transfer is a transfer made with the "actual intent to hinder, delay, or defraud" any creditor. A constructively fraudulent transfer is a transfer made by the Ponzi operator without receiving reasonably equivalent value when he was: (i) engaged in, or was about to engage in, a business or a transaction for which his remaining assets were unreasonably small in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

A. Actual Fraud

The test for determining whether the Ponzi operator made a transfer with the "actual intent to hinder, delay, or defraud any creditor of the debtor" generally requires an inquiry into the operator's subjective state of mind. *See In re Cohen*, 199 B.R. 709, 716 (B.A.P. 9th Cir. 1996). In this claim, only the mental state of the Ponzi operator is relevant; whether the investor received the money with any mal intent is not part of the analysis.

With a collapsed Ponzi scheme, the trustee or receiver often uses affirmative evidence, such as admissions or a plea agreement, from the operator. Such admissions can be admissible and binding. *See Scholes v. Lehman*, 56 F.3d 750, 762 (7th Cir. 1995); *see also Rosen v. Neilson (In re Slatkin)*, 310 B.R. 740, 748 (C.D. Cal. 2004), *aff'd*, 222 Fed. Appx. 545 (9th Cir. 2007) (affirming partial summary judgment re actual intent to defraud as a matter of law based on Ponzi operator's plea agreement).

Actual intent to defraud can be established if the court finds that the operator was engaged in a Ponzi scheme. *See In re Cohen*, 199 B.R. 709, 717 (BAP 9th Cir. 1996) ("Proof of a Ponzi scheme is sufficient to establish the Ponzi operator's actual intent to hinder, delay, or defraud creditors for purposes of actually fraudulent transfers …."); *In re Agric. Research and Tech. Group, Inc.*, 916 F.2d 528, 535 (9th Cir. 1990) ("The mere existence of a Ponzi scheme … has been found to fulfill the requirement of actual intent on the part of the debtor.").

B. <u>Constructive Fraud</u>

If the trustee or receiver is unable to demonstrate actual fraud, net winners are still at risk via a constructive fraud claim. In constructively fraudulent transfer cases, the key issues are whether the transfers were made at a time of insolvency, and whether the recipient provided reasonably equivalent value. Insolvency is rarely an issue in Ponzi scheme litigation because, by their very nature, Ponzi schemes are insolvent from their inception.

Whether the recipient provided reasonably equivalent value turns on the nature of the payments received. Courts have held that there is no reasonably equivalent value given for false profits in a Ponzi scheme. *See, e.g., In re United Energy Corp.*, 944 F.2d 589, 595 n.6 (9th Cir. 1991) ("such excess amounts [like the fictitious profits the Trustee seeks to avoid here] would be avoidable because the debtor would not have received reasonably equivalent value for them."); *In re Independent Clearing House*, 77 B.R. 843, 857, 859 (D. Utah 1987) ("If the use of the [investors'] money was of value to the debtors, it was only because it allowed them to defraud more people of more money. . . . In such a situation, the use of the defendant's money cannot objectively be called 'reasonably equivalent value.'").

In contrast, most courts will allow innocent investors to retain the payments they received, up to the amount of their principal investment. Critical to this analysis, however, is whether the investor received the payments in "good faith." In fraudulent transfer litigation, good faith has a different meaning than it does in other areas of the law. *See In re Bayou Group, LLC*, 396 B.R. 810, 844 (S.D.N.Y. 2008) (Good faith determination rests on an objective standard, and not the subjective belief of the recipient of the transfers).

How Far Back Can Payments Be Avoided?

Another key issue in Ponzi scheme litigation relates to how far back the trustee or receiver can reach to avoid the fictitious profits distributed to net winners.

Federal bankruptcy law provides a two-year reach back for fraudulent transfer claims. *See* 11 U.S.C. § 548(a)(1)(A) (actual fraud) & § 548(a)(1)(B) (constructive fraud). But federal bankruptcy law also empowers a bankruptcy trustee to bring fraudulent transfer claims under applicable state law.

State law claims to recover fraudulent transfers vary, and can exceed the bankruptcy code's two year reach-back period. California law, for example, provides a seven-year statute of repose for actually fraudulent transfer claims. *See* Cal. Civ. Code § 3439.09(c). Certain claims for transfers beyond four years must be brought under California law within one year after the fraudulent transfers could reasonably have been discovered by the claimant. *See* Cal. Civ. Code § 3439.09(a).

Thus, depending on the jurisdiction, and whether the claims are brought by a receiver or a trustee, investors could be faced with disgorging all payments they received anywhere from one year up to seven years or more before the collapse of the scheme.

Financial Institutions and Other Third Parties

A Ponzi operator's co-conspirators and financial institutions also face litigation risk associated with Ponzi schemes, often via claims brought by investors who have suffered damages. Class actions are not uncommon.

Co-conspirators, including individuals and business entities, can face direct liability for damages if they independently committed torts against investors or other parties suffering harm. Among other things, co-conspirators might have engaged in fraud, negligent misrepresentation, breach of fiduciary duty, or other torts, depending on the co-conspirator's relationship with the plaintiff.

Aggrieved investors may also pursue vicarious liability theories against third-parties, including financial institutions. The most common of these theories are conspiracy and aiding and abetting.

Under basic tort principles in many states, a claim for conspiracy is proper if there is an underlying tort, and the defendant makes an agreement with the tortfeasor and commits an overt act that causes damage to the plaintiff. *See, e.g., Applied Equip. Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503, 514 (1994).

Co-conspirators or other third parties may also be liable for aiding and abetting. Under this theory, "liability may ... be imposed on one who aids and abets the commission of an intentional tort if the person (a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortious result and the person's own conduct, separately considered, constitutes a breach of duty to the other person." *Fiol v. Doellstedt*, 50 Cal. App. 4th 1318, 1325-26 (1997). New York law also recognizes aiding and abetting torts. *See Dubai Islamic Bank v. Citibank, N.A.*, 256 F. Supp. 2d 158, 167 (S.D.N.Y. 2003).

Aiding and abetting claims do not require that the defendant owe an independent duty to the plaintiff, or that that the defendant financially gain from the tort. *See Neilson v. Union Bank of California, N.A.*, 290 F. Supp. 2d 1101, 1127 (C.D. Cal. 2003) ("such a cause of action does not require that the aider and abettor owe plaintiff a duty so long as it knows the primary wrongdoer's conduct constitutes a breach of duty, and it substantially assists that breach of duty").

Kirkland & Ellis LLP

Given recent turmoil in world financial markets and publicity associated with large Ponzi schemes, complex litigation involving fraudulent investment enterprises will likely continue to emerge in the near future. Kirkland & Ellis LLP is positioned to assist clients in litigating and resolving these disputes. We offer significant expertise in all of the areas of civil litigation discussed above, along with related expertise in the bankruptcy, white collar criminal defense and regulatory areas.

Kirkland & Ellis LLP lawyers have been instrumental in litigating many of the largest and most complex Ponzi scheme matters in the history of our legal system. Our Firm's expertise is distributed across all of its offices, including Los Angeles, Chicago, New York, San Francisco and Washington, D.C.

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Selected Members of our White Collar Criminal Defense & Securities Enforcement Practice Group

In addition, if you have any specific questions about Ponzi Schemes or any other matters as they relate to White Collar Criminal Defense & Securities Enforcement, Kirkland has attorneys in each of its domestic offices who have vast experience in handling such complex issues. To learn more, please contact the following Kirkland attorneys:

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