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The Ponzi Scheme Presumption and Fraudulent Conveyances in the 21st Century: It's not Just Black and White

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Introduction

Section 548(a)(1)(A) of the Bankruptcy Code (the "Code")[1] allows the trustee of a bankruptcy estate to avoid a transfer made by the debtor "with actual intent to hinder, delay, or defraud" an entity to which the debtor was or became indebted, as long as the transfer was made within two years of filing. Because it is difficult to prove that a transfer was made with such actual intent, courts have applied the so-called "Ponzi scheme presumption." In cases involving conveyances in Ponzi schemes, the "Ponzi scheme presumption" allows the court to assume that a transfer was made with the "actual intent to hinder, delay, or defraud,"[2] because "it is impossible to imagine any motive for such conduct other than the actual intent to hinder, delay or defraud."[3] The presumption applies in cases where a transfer was used to perpetuate a Ponzi scheme or was necessary to the continuance of the scheme.[4]

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[1] 11 U.S.C. § 548(a)(1)(A) (2006).
[2] *Id.*
[3] *In re* Bayou Group, LLC, 362 B.R. 624, 634 (Bankr. S.D.N.Y. 2007).
[4] *See, e.g.*, *In re* Bayou Group, LLC, 362 B.R. at 633–34 (applying Ponzi scheme presumption where redemption payments of non-existent investment account balances and fictitious profits were made to earlier investors requesting redemption using funds invested by subsequent investors).

The first court to explicitly mention and apply the "Ponzi scheme presumption" was the United States District Court for the Southern District of New York, in 2002.[5] In the last ten years, Ponzi scheme cases have come before federal courts across the country, and a black and white analysis has developed.[6] This means that if a transfer was made during the course of a Ponzi scheme, it was clear to the court that there was no rationale to be considered other than that of actual intent to defraud.[7] Recently, however, there has been a shift in some courts' use of the Ponzi scheme presumption, affecting how it is applied.[8]

The shift is partly a result of bankruptcy trustees in Ponzi scheme cases requesting the application of the presumption in more attenuated situations—situations where the transfers in question are not clear and classic Ponzi scheme transfers (clear and classic being, for instance, payments to old investors to attract new ones). Recently, for example, two Florida District

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[5] Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 288 B.R. 52, 57 (S.D.N.Y. 2002). The district court affirmed the bankruptcy court's decision and labeled the bankruptcy court's presumption of fraud the "Ponzi scheme presumption." The bankruptcy court found that:

> When a debtor operating a Ponzi scheme makes a payment with the knowledge that future creditors will not be paid, that payment is presumed to have been made with actual intent to hinder, delay or defraud other creditors—regardless of whether the payments were made to early investors, or whether the debtor was engaged in a strictly classic Ponzi scheme.

In re Manhattan Inv. Fund, Ltd., 310 B.R. 500, 509 (Bankr. S.D.N.Y. 2002). Courts have been applying the concept of the Ponzi scheme presumption for a while, but this was the first case to apply the actual term.

[6] Courts were easily able to determine whether transfers made were in furtherance of the Ponzi scheme. *See, e.g.*, *In re* Bayou Group, LLC, 362 B.R. at 633.

[7] *See supra* note 5 and accompanying text.

[8] *See, e.g.*, *In re* Pearlman, 440 B.R. 900 (Bankr. M.D. Fla. 2010). *See also In re* Phoenix Diversified Inv. Corp., No. 10-03005-EPK, 2011 WL 2182881 (Bankr. S.D. Fla. June 2, 2011). Both of these Florida bankruptcy courts did not apply the Ponzi scheme presumption, finding that there was insufficient evidence to show that the transfers were made in furtherance of the Ponzi scheme.

Courts[9] have declined to apply the Ponzi scheme presumption, because the trustees in these newer cases were trying to expand the presumption's limits, and the courts could imagine possible motives for the transfers other than fraudulent intent.

This article will focus on the nature of the Ponzi scheme presumption, including how it has been and should be applied. Part I will provide an overview of Section 548(a) of the Code and the Ponzi scheme presumption. Part II will examine the case law that has previously applied the Ponzi scheme presumption. Using the cases that have delved into a thorough analysis, it will show how a black and white approach was taken, because the cases were clear-cut. Part III will argue that a black and white rule for applying the Ponzi scheme presumption is ineffective when a case is borderline or unclear in the sense that it is not obviously motivated by fraudulent intent.

I. Overview of § 548(a)(1)(A) and the Ponzi Scheme Presumption

"Ponzi schemes present unique problems for bankruptcy courts. One of the most common of these problems is how to deal with pre-bankruptcy investor redemptions made within the fraudulent transfer or conveyance recovery period."[10] Because it is difficult to prove that a transfer was made with such actual intent, when faced with a Ponzi scheme, courts generally invoke the "Ponzi scheme presumption." The presumption allows the court to presume that every transfer the debtor made was with the intent to "hinder, delay, or defraud" its creditors.[11]

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[9] *See In re* Pearlman, 440 B.R. at 905 (refusing to apply the Ponzi scheme presumption to loan repayments, even where the loan was taken out in order to perpetuate the Ponzi scheme). *See also In re* Phoenix Diversified Inv. Corp., 2011 WL 2182881, at *1 (declining to apply the Ponzi scheme presumption to transfer of Ponzi scheme investor funds used to purchase large amounts of groceries).

[10] Craig T. Lutterbein, *Note: "Fraud and Deceit Abound" But Do the Bankruptcy Courts Really Believe Everyone Is Crooked: The Bayou Decision and the Narrowing of "Good Faith,"* 18 AM. BANKR. INST. L. REV. 405, 405–06 (2010).

[11] *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 174 (1998) (explaining Ponzi scheme presumption).

Bolstered by the presumption, a bankruptcy trustee has the ability to avoid nearly every transfer made by the debtor as fraudulent.[12]

A Ponzi scheme is "a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating the illusion of profitability, thus attracting new investors."[13] For example, in *In re Bayou Group, LLC,* the principles distributed redemption payments to investors, as well as:

> various types of documents containing false information about Bayou's performance to current . . . clients of Bayou which made it appear that Bayou was performing better than it truly was" and that their intent in doing so was to "induce [ ] new investors to invest in Bayou and [to] lull [ ] existing investors into retaining their investments in the Bayou Hedge Funds".[14]

The court applied the Ponzi scheme presumption, reasoning that all of the facts fit the description of a Ponzi scheme.[15] The trustee wished to avoid only the redemption payments, which correlated with the falsely inflated account statements, and were made to induce new investors and perpetuate the Ponzi scheme.[16] Because the payments were made to perpetuate the Ponzi scheme presumption in *Bayou*, it is a classic example of the presumption's general purpose.

Bankruptcy courts, like the *Bayou* court, have typically used a black and white approach to determine whether they should apply the Ponzi scheme presumption. Recently, however, there has been a shift in the application of the presumption.[17] Accordingly, in a case that is not necessarily dealing with paying old investors to attract new ones (the crux of a Ponzi scheme),

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[12] *See* Lutterbein, *supra* note 10, at 407.
[13] Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (*In re* Bayou Group, LLC), 439 B.R. 284, 307 (S.D.N.Y. 2010) (quoting Ades-Berg Inv. v. Breeden (*In re* The Bennett Funding Group, Inc.), 439, F.3d 155, 157 n.2 (2d Cir. 2006)).
[14] *Id.* at 306 (quoting Pltf. Ex. 3 at 15–24; Pltf. Ex. 4 at 20; Pltf. Ex. 5 at 8).
[15] *Id.* at 307.
[16] *Id.* The basic requirement for application of the Ponzi scheme presumption is that the transfer in question was made "in furtherance" of the Ponzi scheme. Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 13 (S.D.N.Y. 2007).
[17] *See supra* note 8 (pointing to two recent cases where bankruptcy courts did not apply the Ponzi scheme presumption).

the analysis cannot be simply that a transfer in a Ponzi scheme case must equal actual intent to defraud.[18]

II. Case law and the "Black and White" Application of the Presumption

As noted in Part I of this article, most cases involving Ponzi schemes have applied the Ponzi scheme presumption where the transfers at issue were made in furtherance of the Ponzi scheme.[19] Application of the presumption ensures that the difficult-to-infer, subjective intent of the transferor is not a barrier to avoiding transfers made in furtherance of Ponzi schemes. The presumption has been applied in cases where the transfer at issue was payment to an investor in the Ponzi scheme.[20] This part will go through a number of cases that fall under this category.

As mentioned in Part I,[21] one of the first of these "black and white" approach cases is *In re Bayou Group, LLC*.[22] In *Bayou*, the debtors were three hedge funds operated as a massive Ponzi scheme.[23] The debtors sought to recover payments to the investors of "over $135 million in inflated redemption payments of non-existent principal and fictitious profits."[24] The false profits were reflected in documents containing false information about Bayou's performance, which made it appear that Bayou was performing better than it actually was.[25] The *Bayou* Court applied the Ponzi scheme presumption, stating, "it is impossible to imagine any motive for such

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[18] *See infra* Part III (discussing need for shifting analysis towards transfers that are not clearly "in furtherance" of the Ponzi scheme).
[19] *See supra* Part I and note 16 (requiring that the transfer was made "in furtherance" of the Ponzi scheme).
[20] *See supra* note 4 and accompanying text (noting quick and simple application of the Ponzi scheme presumption where the transfers are made to investors in the Ponzi scheme or to bring more money into the scheme).
[21] *See supra* Part I (discussing the district court's application of the Ponzi scheme presumption in *Bayou*).
[22] 362 B.R. 624 (Bankr. S.D.N.Y. 2007).
[23] *Id.* at 626.
[24] *Id.* at 627.
[25] *Id.*

conduct other than actual intent to hinder, delay or defraud."[26] Without the Ponzi scheme presumption, the payments may have been unavoidable as actual fraudulent conveyances because the statute requires the court to determine the transferor's subjective intent at the time of the transfer.[27] Thus, application of the Ponzi scheme presumption allowed the court to bypass this hard-to-prove step.

In *In re Manhattan Investment Fund Ltd.*, [28] the court further elaborated on the reasoning behind applying the Ponzi scheme presumption. In *Manhattan Investment*, the debtor was a hedge fund controlled by Michael Berger, whose scheme of short selling technology stocks was financially devastating to the Fund.[29] Berger concealed the losses by getting new investors—which ultimately reached $394 million—and fraudulently represented that the Fund was profitable.[30] By obscuring the Fund's status, he convinced new individuals to invest, and paid off old investors with the newly acquired funds.[31] In order to support its trading activity, in addition to the short account, the Fund was required to keep a separate "margin account" at Bear Stearns.[32] The transfers to the margin account were the transfers in question before the court.[33] The court reasoned, "if a transfer serves to further a Ponzi scheme, then the [Ponzi scheme] presumption applies and 'actual intent' under § 548(a)(1)(A) is present."[34]

Using the same black and white approach as the *Bayou* court, the district court in

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[26] *Id.* at 634.
[27] § 548(a)(1)(A) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made.").
[28] 397 B.R. 1 (S.D.N.Y. 2007).
[29] *Id.* at 4.
[30] *Id.*
[31] *Id.*
[32] *Id.* at 5.
[33] *Id.*
[34] *Id.* at 11 (citing Cuthill v. Greenmark, LLC (*In re* World Vision Entm't, Inc.), 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002)).

Manhattan Investment held that although the transfers were not as "clearly tainted" as payments from a Ponzi schemer to reward those who help attract new investors, the transfers were clearly essential to the furtherance of the scheme.[35] Because the Fund's only strategy was to short-sell stocks, it had to keep its margin account active in order to continue.[36] If it had not made the transfers to the margin account, the Fund would have buckled almost instantly, "because Baer Sterns could have closed out its short positions and used the money already in the account to cover its own liabilities."[37] Accordingly, the district court concluded that the transfers were obviously "in furtherance" of the Ponzi scheme, and that the presumption should apply.

Another example of a black and white application of the presumption was in *In re ATM Financial Services, LLC*,[38] where the court concluded that "all of the hallmarks of a classic Ponzi scheme [were] present."[39] In *ATM Financial*, the debtor tricked people into purchasing ATMs that either never existed or never were owned by the conspirators.[40] Purchasers "bought" ATMs from the debtor or from separate companies, and would sign an agreement with the debtor to service the ATMs.[41] The debtor promised to pay the purchasers a percentage of the withdrawal fees collected from the ATMs.[42] These agreements, however, were a total sham.[43]

Accordingly, the debtor conned people into making purchases that they believed would produce future income, based on the debtor's misrepresentations about the amount of withdrawal fees each ATM could earn. The court stated,

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[35] *Id.* at 13.
[36] *Id.*
[37] *Id.*
[38] No. 6:08-bk-969-KSJ, 2011 WL 2580763 (Bankr. M.D. Fla. June 24, 2011).
[39] *Id.* at *4.
[40] *Id.* at *1.
[41] *Id.*
[42] *Id.*
[43] *Id.*

> [A]ny acts taken in furtherance of [a] Ponzi scheme . . . are [ ] fraudulent. Every payment made by the debtor to keep the scheme on-going [is] made with the actual intent to hinder, delay, or defraud creditors, primarily the new investors. Therefore . . . the trustee can establish the debtor's actual fraudulent intent by showing the transfers to the defendant were in furtherance of a Ponzi scheme.[44]

The court found that the purchasers were the equivalents of investors hoping to make above-market returns on phony investments; the debtor made almost all payouts to initial ATM "owners" with the money fraudulently obtained from the later "purchasers."[45]

III. Why a Fact-Specific Approach is Necessary

As explained in Part II of this article, the black and white approach to the Ponzi scheme presumption works well in the context of the classic Ponzi scheme transfer, which is one that is clearly in furtherance of the scheme.[46] However, this part will show that such an approach is not well-suited to transfers whose connections to the Ponzi scheme and its operations are more attenuated. For example, in 2010, the United States Bankruptcy Court for the Middle District of Florida decided that the Ponzi scheme presumption *might* apply to a transfer of loan repayments in *In re Pearlman*, a Ponzi scheme case.[47] This was the first time that a trustee attempted to stretch the limits of the presumption to an attenuated transfer, thereby displaying a shift away from an automatic application of the presumption in Ponzi scheme cases, to a more nuanced view.

As part of a bank fraud scheme, the debtor in *Pearlman* obtained various loans, and the trustee wished to avoid the loan repayments using the Ponzi scheme presumption.[48] The debtor

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[44] *Id.* at *4.
[45] *Id.*
[46] *See supra* Part II (discussing application of the Ponzi scheme presumption where the transfers in question were obviously made in order to perpetuate the Ponzi scheme).
[47] *In re* Pearlman, 440 B.R. 900, 905 (Bankr. M.D. Fla. 2010).
[48] *Id.* at 902–03.

had used the loans in order to repay investors in two of his Ponzi schemes.[49] The court stated that the trustee had to come forward with specific facts demonstrating how the transfers to repay the loans furthered the debtor's Ponzi scheme, before the court would apply the presumption to the transfers.[50] The court noted that although the loans themselves were used to further the Ponzi scheme, there was not enough information to suggest that the repayment of those loans furthered the scheme.[51]

In re Pearlman is a new type of case that is emerging. In *Pearlman*, unlike in the three Ponzi scheme cases mentioned above,[52] the bankruptcy court had to address the issue of a transfer that may not fit the Ponzi scheme presumption's classic application, even though it appeared in a Ponzi scheme case. As the Florida bankruptcy court noted, the fact that the loans themselves were fraudulently obtained has no bearing on whether the loan repayments defrauded other creditors.[53] Cases like *Pearlman*, fall within a grey area, and show that the presumption's application cannot be so black and white.

The latest case to address this shift is *In re Phoenix Diversified Investment*.[54] In *Phoenix Diversified*, the debtor, who was operating a Ponzi scheme, purchased $43,384.37 worth of groceries and other personal items for himself and his family using funds from investors in his scheme.[55] The trustee sought to avoid the transfers as actually fraudulent transfers and argued that the Ponzi scheme presumption should apply[56] because the debtor had admitted to using his

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[49] *Id.* at 905.
[50] *Id.*
[51] *Id.*
[52] *See supra* Part II.
[53] *In re* Pearlman, 440 B.R. at 905.
[54] *In re Phoenix Diversified Investment Corp.*, No. 08–15917–EPK, 2011 WL 2182881 (Bankr. S.D. Fla. June 2, 2011).
[55] *Id.* at *1.
[56] *Id.* at *3.

investor's funds to purchase the items from Publix.[57] Nevertheless, the United States Bankruptcy Court for the Southern District of Florida declined to apply the Ponzi scheme presumption.[58] Like the *Pearlman* court, the *Phoenix Diversified* court held that fraudulent intent alone is insufficient, and that the application of the presumption also requires the trustee to show that the transfer was made "in furtherance" of the Ponzi scheme.[59]

Pearlman and *Phoenix Diversified* focus attention on the nuanced, fact-specific nature of the court's inquiry into the transfers. Such transfers, when standing alone, may or may not be subject to the Ponzi scheme presumption, particularly when there is no admission of fraudulent intent. The *Phoenix Diversified* court stated that although the existence of a Ponzi scheme supports a finding of a generalized intent to defraud, that is not sufficient, by itself, to show that the transfers in question were made with fraudulent intent.[60] The court explicitly emphasized that the Ponzi scheme presumption is limited to transfers that "perpetuate the scheme, or that are necessary to the continuance of the [ ] scheme," which is why the presumption is typically applied automatically in claims against "investors, brokers, and others who assisted in perpetrating the scheme."[61] Therefore, it is clear from the court's analysis that a "black and white" approach would not work in this situation. When it comes to such borderline transfers, all of the specific facts surrounding the transfer must be taken into account.

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[57] *Id.* at *1 ("Mr. Meisner states that he knowingly, willfully, and with an intent to defraud failed to tell prospective investors in Phoenix Diversified that only a small portion of investor monies was actually used for trading; that the investor monies used for trading maintained a significant loss; that he knowingly, willfully and with an intent to defraud failed to tell potential investors that a large portion of investor monies was not invested but was instead used to make fraudulent, Ponzi-type interest payments to prior investors; and that he knowingly, willfully and with an intent to defraud failed to tell potential investors that a large portion of investor monies was not invested but, instead, was used to support his family's luxury lifestyle.").
[58] *Id.* at *3.
[59] *Id.*
[60] *Id.*
[61] *Id.*

Cases like *Pearlman* and Phoenix *Diversified* raise issues that may arise in future cases. Unlike the obvious transfer of funds from new to old investors, with the intent to keep the scheme under wraps,[62] transfers such as the ones made in these cases are more questionable. Such instances will likely require courts to analyze each case on a fact-specific basis to clearly determine what transfers qualify under the Ponzi scheme presumption. Applying a black and white test would be unworkable.

Conclusion

The courts can no longer hold on to the notion that the application of the Ponzi scheme presumption to the avoidance powers of section 548 of the Code is black and white. In the wake of some of the more recent cases, it is becoming less likely that such a black and white approach can be taken in applying the presumption to all Ponzi-scheme-related situations. Such an approach may fail to serve its purpose when a borderline transfer—involving some fraudulent intent, but not clearly "in furtherance" of the scheme—comes before the court.

[62] *See In re* Bayou Group, LLC, 362 B.R. 624, 633–34 (Bankr. S.D.N.Y. 2007) (applying Ponzi scheme presumption where redemption payments of non-existent investment account balances and fictitious profits were made to earlier investors requesting redemption using funds invested by subsequent investors).