The Rise and Fall of the Ponzi Scheme Presumption

Minnesota case law has undermined its application to state fraudulent transfer claims

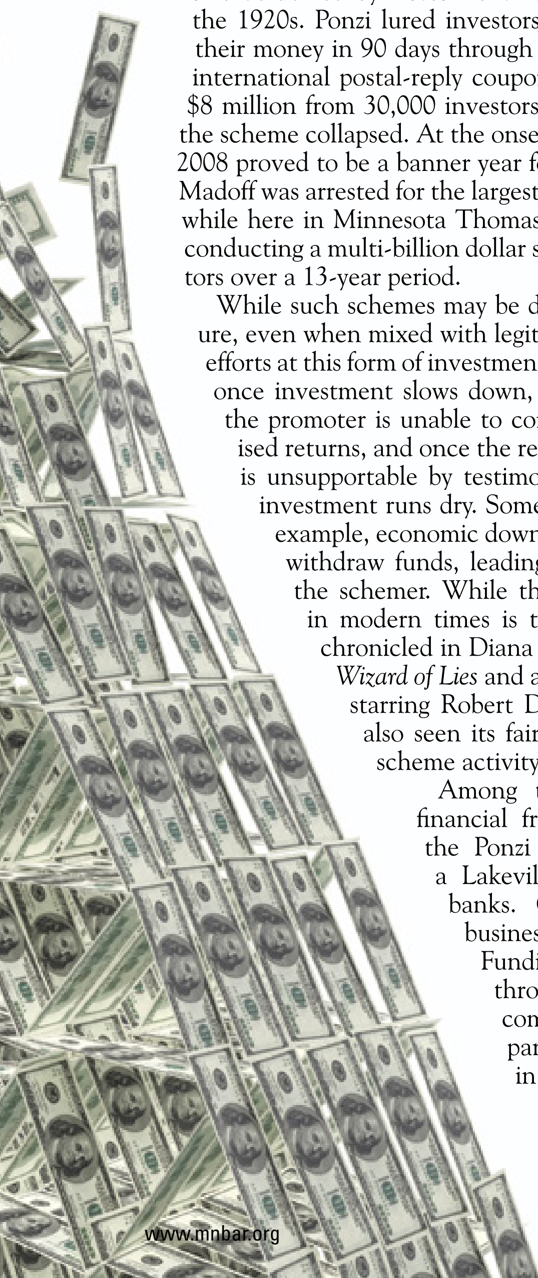
For many years, the evidentiary shortcuts associated with the so-called "Ponzi scheme presumption" reduced the pleading burden on a trustee with respect to claims seeking to claw back proceeds of fraudulent conveyances. But more recent Minnesota case law has effectively ended that presumption. Going forward, it would seem that trustees and receivers asserting fraudulent transfer claims under state law will need to prove the express statutory elements.

By Christopher R. Morris and Jeffrey D. Klobucar

Image Credit: vasabii/iStockphoto

Fraudulent financial schemes, it's safe to say, have been with us since the dawn of commerce. Common law and statutes have evolved to keep pace and provide remedies to victims. Among the many forms of financial fraud, one of the most publicized (and litigated) in the last century has been the "Ponzi scheme"—in which investors and lenders are tricked into providing funds for a business venture claimed to be entirely legitimate, but which uses funds of subsequent investors to pay off early investors, creating the illusion of handsome profits. The Minnesota Supreme Court once defined a Ponzi scheme as 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… usually without any… revenue-producing activity other than the continual raising of new funds."[1]

The concept of paying off early investors through funds from new investors was present in the fiction of Charles Dickens dating back to the 19th century.[2] Nearly 100 years later, the moniker "Ponzi scheme" arose from the notorious use of that device by Boston businessman Charles Ponzi in the 1920s. Ponzi lured investors by promising to double their money in 90 days through the purchase and sale of international postal-reply coupons, collecting more than $8 million from 30,000 investors in seven months before the scheme collapsed. At the onset of the Great Recession, 2008 proved to be a banner year for Ponzi schemes: Bernie Madoff was arrested for the largest investor fraud in history, while here in Minnesota Thomas Petters was charged for conducting a multi-billion dollar scheme that bilked investors over a 13-year period.



While such schemes may be destined for ultimate failure, even when mixed with legitimate business activities, efforts at this form of investment fraud persist. Inevitably, once investment slows down, the scheme collapses as the promoter is unable to continue paying the promised returns, and once the reputation for such returns is unsupportable by testimonials, the spigot of new investment runs dry. Sometimes market forces (for example, economic downturns) cause investors to withdraw funds, leading to a liquidity crisis for the schemer. While the most famous example in modern times is that of Bernie Madoff—chronicled in Diana B. Henriques's book *The Wizard of Lies* and a subsequent HBO movie starring Robert De Niro—Minnesota has also seen its fair share of criminal Ponzi scheme activity beyond the Petters case.

Among the many lesser-known financial frauds in Minnesota was the Ponzi scheme perpetrated by a Lakeville man who victimized banks. Corey Johnston ran a business known as First United Funding, which from 2002 through 2009 originated commercial loans and sold participation interests in the loans to banks. While First United sold participation interests at ordinary market interest rates, some were over-sold, and others were based on fictitious loans. Though it created only a fraction of the losses generated by more famous schemers such as Madoff and Petters, First United's business generated claims that ultimately reached the Minnesota Supreme Court, resulting in the first high-court decision in any state regarding application of the so-called "Ponzi-scheme presumption" to the state's version of the Uniform Fraudulent Transfer Act.

Before turning to the details of that case, we'll explore how the term "Ponzi scheme presumption" became a familiar part of the bankruptcy court lexicon, used by trustees and receivers to claw back payments or "profits" for allocation among competing creditors.

A brief history of Minnesota fraudulent conveyance law

The statute now known as the Minnesota Uniform Voidable Transactions Act (MUVTA), Minn. Stat. §513.41 et seq., and its predecessors—the Minnesota Uniform Fraudulent Transfers Act (MUFTA) (formerly Minn. Stat. § 513.44 et seq.)[3] and the prior fraudulent conveyance statute—were enacted to give creditors a direct remedy against a debtor who secretes away assets to hinder, delay, or defraud its creditors.[4] Specifically, the statute provides that transfers are subject to avoidance if the debtor made them "with actual intent to hinder, delay, or defraud any creditor of the debtor," or "without receiving a reasonably equivalent value in exchange for the transfer or obligation."[5] Even if fraudulent intent on the part of the debtor transferor is proven, the transferee still is not liable if it acted in good faith and accepted a reasonably equivalent value.[6]

The modern MUVTA is modeled after the Uniform Fraudulent Transfer Act.[7] The Uniform Act stems from the Statute of 13 Elizabeth, which was enacted to invalidate "covinous and fraudulent transfers designed to delay, hinder, or defraud creditors and others."[8] Likewise, the purpose of MUVTA is to prevent debtors from putting property that is available for payment of their debts beyond the reach of their creditors.[9]

Birth of the Ponzi scheme presumption

Bankruptcy courts must act with efficiency in administering the unwinding of failed business enterprises. There are limits on the courts' and the parties' resources, of course, and a limit on how much time and expense can be incurred litigating disputes, particularly when such cases involve a massive fraudulent scheme and myriad creditors victimized by the debtor's misconduct. While the Bankruptcy Code allows for preferential payments to creditors in the months immediately prior to a bankruptcy filing to be undone fairly easily, trustees are often inspired to go back years rather than months to claw back what might fairly be considered ill-gotten gains, to more equitably allocate payments among large groups of creditors, and to maximize the estate. Pursuant to a bankruptcy trustee's strong-arm powers,[10] it has at its disposal the ability to utilize state-law fraudulent transfer statutes, which permit a look-back period substantially larger than that afforded under other sections of the Bankruptcy Code. (For example, MUVTA has a six-year statute of limitations from the discovery of the fraudulent transfer, whereas the fraudulent conveyance section of the Bankruptcy Code permits only a two-year look-back.[11])

The Minnesota Supreme Court ruled that the MUFTA does not include a presumption that allows Ponzi scheme victims to bypass the proof requirements for a fraud claim.

From this context arose a judicially created rule that became known as the "Ponzi-scheme presumption." Bankruptcy courts adopted the presumption as an evidentiary shortcut—reducing the pleading burden on a trustee with respect to claims seeking to claw back proceeds of fraudulent conveyances, and complicating the defendant-transferee's ability to establish its defenses. In a typical fraudulent transfer claim, the plaintiff must plead and prove the existence of "badges of fraud" that are identified specifically by statute and used to determine whether a transfer was made in violation of the creditor's rights. The plaintiff must demonstrate that the debtor was insolvent at the time of the transfer and that the transfer was not made in exchange for reasonably equivalent value. It is on these evidentiary points that the presumption most often rested. The Ponzi presumption effectively assumed that a debtor engaged in such a churn could not be solvent and could not be effecting transfers for reasonably equivalent value, as no actual value existed by definition. That is, "any acts taken in furtherance of [a] Ponzi scheme" constitute fraudulent transfers because "the Ponzi scheme is by definition fraudulent."[12] As sometimes applied, the Ponzi presumption provided a shortcut to establish a fraudulent transfer as a matter of law by the mere showing that the transferor was involved in a fraudulent Ponzi scheme.

The presumption was most often used in cases where the transferor promised and delivered exorbitant returns on investments, but engaged in little or no legitimate business activity.[13] The presumption expanded into Minnesota in the context of such a case—*Petters*—where the trustee brought fraudulent transfer claims against a variety of investors, including churches and charitable organizations. But the Minnesota Bankruptcy Court found these complaints to be viable even against former employees who were "said to have received only a modest end-of-year bonus" and who were not alleged to have engaged in any sort of wrongdoing.[14]

Beginning of the end for the Ponzi scheme presumption

While the massive and ongoing *Petters* litigation venued in the Minnesota Bankruptcy Court continued, a relatively unknown lawsuit was commenced in the Dakota County District Court by a receiver seeking to wind up the business of the Ponzi scheme perpetrated by Johnston through First United. Johnston was charged by the U.S. Attorney and pled guilty to bank fraud. The receiver of First United, Patrick Finn, pursued state law claims in an attempt to claw back interest on loan participations received by various banks dating back to the early 2000s. The receiver alleged that First United "forged borrowers' signatures, cut and pasted or otherwise appended borrowers' signatures… and altered bank statements and other financial documents" in order to sell participations in loans that did not exist and participation interests that exceeded the actual loan amounts.

The district court entered summary judgment in favor of the receiver against two bank defendants, based on application of the Ponzi scheme presumption. One of the banks appealed, arguing that until the recent decisions stemming from the *Petters* Ponzi scheme, no other court in the 8th Circuit had ever applied the Ponzi scheme presumption as a device for fact-finding, and emphasizing factual differences in the particular First United loans at issue, for which there did exist an actual borrower who was repaying the loan.

The court of appeals reversed the district court judgment, and declined to fully apply the Ponzi scheme presumption in light of the evidence that the bank received payments in good faith and for reasonably equivalent value—a defense to the receiver's fraudulent transfer claims.[15] That decision is consistent with established Minnesota law, which dictates that a payment to one creditor to the detriment of another, or the preference of one creditor over another, is not enough to make the transfer avoidable under non-bankruptcy law. It was also consistent with decisions from a handful of federal courts that had previously ruled that the Ponzi scheme presumption contradicted the plain language of the Uniform Fraudulent Transfer Act.[16]

On petition by the trustee, the Minnesota Supreme Court accepted review, and ruled that the MUFTA does not include a presumption that allows Ponzi scheme victims to bypass the proof requirements for a fraud claim. Writing for the Court, Justice Stras reasoned that the Minnesota statute "does not contain a provision allowing a court to presume anything based on the mere existence of a Ponzi scheme." The word "Ponzi" does not appear in the Minnesota statute and the statute does not address "schemes." In short, the Court ruled the Minnesota statute (an example of the Uniform Fraudulent Transfer Act) does not contain a provision allowing a court to presume fraudulent intent based on the existence of a Ponzi scheme.

Justice Stras further noted that fraudulent transfer laws were intended only to keep the debtor from depleting its assets—not paying legitimate obligations. Quoting a decision dating back to the 1920s, when the term Ponzi scheme was popularized, the *Finn* court observed: "Payment of an honest debt is not fraudulent under the general statutes against fraudulent conveyances, although it operates as a preference."[17]

Continued fall: Court decisions subsequent to *Finn*

The *Finn* decision had an immediate impact on the ongoing *Petters* bankruptcy litigation, related to the trustee's efforts to claw back "profits" from Petters investors going back six years or more, through the MUFTA or other state laws.[18] Ruling on motions presented after the *Finn* decision, the *Petters* court concluded that while the *Finn* court had categorically rejected all three components of a Ponzi scheme presumption, the plaintiff may still plead and prove intent with the aid of an inference, by bringing forward enough evidence of fraud in surrounding circumstances, consistent with the badges of fraud approach specifically provided in the Uniform Fraudulent Transfer Act.[19]

One year after the *Finn* ruling, a second state high court—the Texas Supreme Court—considered the Ponzi scheme presumption and came to a similar conclusion regarding its applicability. That case arose from the infamous Allen Stanford Ponzi scheme, which sold fraudulent high-yield certificates of deposit to unwary investors, and a claim by the related receiver that the Golf Channel should disgorge transfers of nearly $6 million spent on television advertisements. Although litigation was venued in the federal courts, the 5th Circuit certified the following question regarding the Texas version of the Uniform Fraudulent Transfer Act to the Texas Supreme Court: "Considering the definition of 'value' in section 24.004(a) of [TUFTA], the definition of 'reasonably equivalent value' in section 24.004(d) of [TUFTA], and the comment in [UFTA] stating that 'value' is measured 'from a creditor's viewpoint,' what showing of 'value' under TUFTA is sufficient for a transferee to prove the elements of the [good-faith] affirmative defense under section 24.009(a) of [TUFTA]?"[20]

The Texas court followed Minnesota's lead in *Finn*, noting that "Like the Minnesota Supreme Court… we discern nothing in TUFTA's text suggesting the Legislature intended a different value standard to apply in the Ponzi-scheme context."[21] Applying that principle to the circumstances faced by the Golf Channel, the court noted that the media-advertising services offered to Stanford's business "had objective value and utility from a reasonable creditor's perspective at the time of the transaction, regardless of Stanford's financial solvency at the time." Moreover, as services were provided, each payment had value "by extinguishing claims against the estate for the value of those services."[22] The court thus concluded that a business can demonstrate it provided reasonably equivalent value for the money it was paid by showing that it performed under a lawful arms-length contract for fair market value, provided consideration that had objective value at the time of the transaction, and made the exchange in the ordinary course of business.

Conclusion

Despite the spectacular failures of Bernie Madoff, Tom Petters, and others, it seems likely that fraudsters will continue to replicate Charles Ponzi's business model, and thus, efforts to unwind such schemes in order to compensate creditors and victims will persist. Going forward, however, it would seem that rather than asking courts to create new evidentiary shortcuts applied to commonly known frauds such as Ponzi schemes, trustees and receivers asserting fraudulent transfer claims under *state* law will need to prove the express statutory elements. Absent the Ponzi scheme presumption, claw-back attempts through state law claims may be limited largely to businesses that received extraordinary returns or had reason to suspect the existence of the criminal scheme. Such claims should not typically extend to ordinary business transactions, such as a bank receiving a market interest rate on a loan, a radio station selling advertising, or an electrician providing maintenance work at a fraudster's office, even though all these service providers could be considered as furthering, in some fashion, the ongoing business of a Ponzi schemer. ▲

***CHRISTOPHER R. MORRIS** is a shareholder and officer at Bassford Remele, P.A., and a past president of the Hennepin County Bar Association. He defends financial institutions and firms against consumer and regulatory lawsuits and advises businesses on compliance with federal credit and collection laws. He also defends attorneys, engineers, and other professionals, and represents businesses and individuals in commercial and employment disputes.*

CMORRIS@BASSFORD.COM

***JEFFREY D. KLOBUCAR** is an attorney at Bassford Remele, P.A. who regularly represents commercial creditors in bankruptcy cases, as well as in federal and state court litigation. The scope of such litigation includes contract rights enforcement, including cases regarding security agreements, and commercial leases involving both real estate and personal property, commercial post-judgment collection matters, including enforcement of judgment liens and guaranties, and commercial garnishment actions. He also has significant class-action and multi-district litigation experience.*

JKLOBUCAR@BASSFORD.COM

Notes

[1] *In re Murrin*, 821 N.W.2d 195, 197 n.1 (Minn. 2012) (citing *Black's Law Dictionary* 1198 (8th ed. 2004)).

[2] Charles Dickens, *The Life and Adventures of Martin Chuzzlewit*, 1842. Chuzzlewit's nephew, Jonas, joins with Montague Tigg in an insurance scam. As Tigg describes the scheme to Jonas: "we grant annuities on the very lowest and most advantageous terms known in the money market; and the old ladies and gentlemen down in the country, buy'em. Ha, ha, ha! And we pay'em too – perhaps. Ha, ha ha!... Then there are the Life Insurances without loans: the common policies. Very profitable, very comfortable. Money down, you know; repeated every year; capital fun!"

[3] Many of the citations below refer to cases decided during the period of the MUFTA, and references to that statute are maintained—though they likely apply equally to MUVTA as well.

[4] *See In re Butler*, 552 N.W.2d 226, 232 (Minn. 1996).

[5] Minn. Stat. §513.44(a); *see also* Minn. Stat. §513.45(a) (specifically addressing fraudulent transfers to present creditors).

[6] Minn. Stat. §513.48(a).

[7] *Butler*, 552 N.W.2d. at 231.

[8] *Id.* (quotations omitted).

[9] *Kummet v. Thielen*, 210 Minn. 302, 306, 298 N.W. 245, 247 (1941).

[10] *See* 11 U.S.C. §544.

[11] *See* 11 U.S.C. §548

[12] *E.g.*, *In Re World Vision Entm't, Inc.*, 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002).

[13] *See, e.g.*, *In re Polaroid Corp.*, 472 B.R. 22, 43 (Bankr. D. Minn. 2012) (a massive, multi-year scheme that offered, in one instance, promised returns of "20% interest … 80% annualized … backed by the entire Polaroid corporation" for a non-existent loan); *Donell*, 533 F.3d 762, 767 (business promised returns of 20% for a non-existent scheme that involved purchasing accounts receivables of Malaysian glove manufacturer).

[14] *In re Petters Co.*, 495 B.R. 887, 912 (Bankr. D. Minn. 2013).

[15] *Finn v. Alliance Bank*, 838 N.W.2d 585 (Minn. Ct. App. 2013).

[16] *See, e.g.*, *In re Carrozella & Richardson*, 286 B.R. 480, 491 (D. Conn. 2002); *In re Unified Commercial Capital*, 260 B.R. 343, 354 (Bankr. W.D.N.Y. 2001).

[17] *Thompson v. Schiek*, 171 Minn. 284, 287, 213 N.W. 911, 912 (1927).

[18] See *Kelley v. Opportunity Fin., LLC*, 550 B.R. 457 (Bankr. D. Minn. 2016).

[19] *Kelley*, 550 B.R. at 468; Minn. Stat. §513.44(b).

[20] *Janvey v. Golf Channel, Inc.*, 487 S.W.3d 560, 564 (Tex. 2016).

[21] *Id.* at 581.

[22] *Id.* at 581-582.