**Using Fraudulent Transfer Law in Ponzi Scheme Cases:**

***A Remedy in Search of a Doctrine***

Federal Judicial Center

2025 Bankruptcy Judges’ Workshops

**I. Defining a Ponzi Scheme – HLB**

 A. Various Definitions

 1. SEC[[1]](#footnote-1)

A Ponzi scheme is an investment fraud that pays existing investors with funds collected from new investors. Ponzi scheme organizers often promise to invest your money and generate high returns with little or no risk. But in many Ponzi schemes, the fraudsters do not invest the money. Instead, they use it to pay those who invested earlier and may keep some for themselves.

With little or no legitimate earnings, Ponzi schemes require a constant flow of new money to survive. When it becomes hard to recruit new investors, or when large numbers of existing investors cash out, these schemes tend to collapse.

 2. Ninth Circuit

“A Ponzi scheme is a financial fraud that induces investment by promising high returns, usually in a short time period, where in fact no legitimate profit-making business opportunity exists.”[[2]](#footnote-2)

A Ponzi scheme is a fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any “profits” of the underlying business venture. The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.[[3]](#footnote-3)

 3. Eleventh Circuit

“The ‘modus operandi 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’”[[4]](#footnote-4)

A Ponzi scheme is generally defined as a “phony investment plan in which monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors.”[[5]](#footnote-5)

 4. Second Circuit

A Ponzi scheme is “an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors.”[[6]](#footnote-6)

 B. Typical Features of a Ponzi Scheme[[7]](#footnote-7)

* Investments involving foreign currency transactions
* Unregistered investments/unlicensed sellers
* High pressure sales tactics
* Narrow group of targeted investors, e.g., members of a church or other house of worship
* Secretive or vague investment strategy
* Little or no documentation for the investment
* Unreasonably high or consistent returns, touted as having little to no risk
* Evasive answers to investor questions
* Promotor with an extravagant or opulent lifestyle
* Difficult or obscure cancellation terms
* Lack of audited financial statements or financial statements prepared by small, local accounting firms

 C. Difficulties with Definitions and “Typical” Features

 1. Many Ponzi schemes involve enterprises that began as legitimate business or that involve activities that are legitimate

 a. PFI – a real estate ownership and management business; many properties had positive cash flow

 b. Fox Ortega/Premier Cru – a well-regarded wine store

 c. Dreier LLP – a law firm with 250 attorneys

 2. Identifying when an enterprise becomes a Ponzi scheme can be very difficult . . . and expensive

 a. Access to business records might be difficult, if they even exist

 b. Forensic accountants are very expensive and their work takes time

 c. Identifying and separating the legitimate part(s) of the business from those used for the fraud can be challenging

 d. Criminal proceedings tend to make for reluctant witnesses

 e. Proving the so-called “Badges of Fraud” can involve a very fact-intensive trial, which takes time and costs money

 3. Ponzi Schemes are Very Different from Other Fraud-Based Bankruptcies

 a. The investors are victims but also tools of the fraud

 b. Institutional lenders or other creditors might get swept up in the scheme

**II. Commencement of the Bankruptcy Case – SG**

 A. Bankruptcy Case as First Proceeding Commenced

1. Involuntary petition by defrauded creditors (sometimes this happens after an arrest or indictment of the Debtor’s principal)

2. Voluntary petition

a. Sometimes a Debtor’s principal may see the writing on the wall and in a moment of clarity and responsibility, agrees to resign, appoint a Chief Restructuring Officer, and authorize the immediate filing of a voluntary chapter 11 petition

b. Some cases even start off as a voluntary chapter 7 case filed by the Debtor

B. Receivership as First Proceeding Commenced

1. Sometimes a receivership proceeding will first be commenced against the Debtor

a. Sometimes this is in state court

b. Other times (particularly when sought by the SEC) this can happen in District Court

2. Sometimes the Receiver will request authority of the appointing court to commence a voluntary bankruptcy case for the debtor

3. Another variation is when, notwithstanding a receivership for certain entities, other related entities may either file voluntary bankruptcy cases, or involuntary bankruptcies may be filed against one or more receivership entities or affiliates

a. This can lead to a turf war, and may require negotiations amongst the bankruptcy professionals, the receiver, the SEC, and the U.S. attorney

b. Where the case ultimately ends up can depend on the timing and order of filings

C. SIPA Liquidation

1. Another way Ponzi scheme cases can end up in bankruptcy court is through a liquidation under the Securities Investor Protection Act of 1970 (SIPA)[[8]](#footnote-8)

2. The details and nuances of a SIPA liquidation are beyond the scope of this session, other than to note that it is a separate statutory liquidation for registered broker-dealers

3. A SIPA liquidation is commenced in District Court but is then “removed” to bankruptcy court after issuance of a “protective decree” and appointment of a trustee[[9]](#footnote-9)

4. To the extent consistent with SIPA, Bankruptcy Code chapters 1, 3, 5, and subchapters I and II of chapter 7 then apply to the SIPA liquidation[[10]](#footnote-10)

**III. Common Issues that Arise – SG**

 A. Related Criminal Cases

1. In almost every Ponzi scheme case, there is usually a related criminal case

2. The pendency of a criminal case often raises fifth amendment issues for many witnesses

3. This can create some issues for a trustee in trying to gather information necessary to asset recovery

4. Competing SEC enforcement action and receivership can create disputes amongst fiduciaries, professionals, and the government, about the best forum to maximize recovery for victims

 B. Estate Fiduciary

1. Ponzi scheme cases may involve some nontraditional fiduciaries

2. This may include a bankruptcy trustee, a receiver, a custodian excused from turnover under 11 U.S.C. § 543(d), or a chief restructuring officer

3. Professionals already involved in the case (e.g., receivers, CROs, their counsel) will usually push to keep the fiduciary in place and attempt to negotiate with the U.S. Trustee and federal government for an acceptable arrangement

a. The U.S. Trustee’s preference, however, is usually to have a bankruptcy trustee

b. Sometimes the federal government’s preference is to have a receiver in District Court

4. In SIPA liquidations, the court is required to appoint the person specified by SIPC as trustee[[11]](#footnote-11)

 C. Creditor Bodies

 1. Degree of organization varies from case to case

 2. Common to have multiple creditor committees

 a. Can be grouped by form of investment (Note/DOT, LLC membership interest, security, TIC interest) or by other similar characteristics

 b. Official committees vs. *ad hoc* committees

 D. Notice issues

 It can be very challenging to identify who the investors were and who holds the investment now, due to the length of time Ponzi schemes can last, poor or nonexistent business records, reluctant or nonexistent witnesses

**IV. Common Litigation Tools – HLB**

 A. Clawback actions are a defining feature of Ponzi scheme cases

 1. Clawback actions are aimed at recovery funds that allegedly were fraudulently transferred to certain investors during certain periods of time

 a. Governing statutes are 11 U.S.C. § 548(a)(1)(A) and/or 11 U.S.C. § 544(b) and state fraudulent transfer law

 b. Statutes of Limitations vs “Lookback” Periods

 i. “Lookback” Periods define the period within which allegedly fraudulent transfers can be recovered

 aa. 11 U.S.C. § 548(a)(1) – 2 years prior to Petition Date; in some jurisdictions, this might be subject to equitable tolling

 bb. 11 U.S.C. § 544(b) – Lookback period established by state law

 ii. Statutes of Limitation

 aa. 11 U.S.C. § 546(a) – trustee/plaintiff must file the fraudulent transfer action by the later of 2 years after entry of the order for relief or 1 year after the appointment of the first trustee, if that occurs within 2 years after entry of the order for relief OR the time the case is closed or dismissed

 bb. This period has been found subject to equitable tolling where the trustee, despite exercising due diligence, remains unaware of the cause of action or when extraordinary circumstances exist beyond the trustee’s control[[12]](#footnote-12)

 iii. Discovery Rule – when does the clock start ticking?

 aa. When the plaintiff determines that they have a valid claim[[13]](#footnote-13)

 c. Proving that a transfer was actually (as opposed to constructively) fraudulent requires the plaintiff to prove the existence of the transfer and that the transferor made it with actually fraudulent intent

 i. The Ponzi Scheme Presumption

 aa. Applied in some circuits,[[14]](#footnote-14) the PSP presumes the existence of actually fraudulent intent for *every allegedly fraudulent transfer* where the existence of a Ponzi scheme is proven. The PSP is a very powerful weapon in the arsenal of plaintiffs charged with prosecuting the clawback actions on behalf of the bankruptcy estate.

 bb. But proving the existence of a Ponzi scheme can itself be very challenging, especially if the enterprise began as a legitimate business or had legitimate components (like a law firm)

 cc. Common sources of evidence of a Ponzi scheme include: plea agreements (admissions by the architects of the scheme); indictments (same); bank records (tracing funds and proving insolvency); sentencing hearing transcripts; applications/affidavits for search warrants (will identify property to be searched or seized and potential witnesses); records of prior lawsuits against the perpetrators/business; and social media (marketing materials

 ii. Some jurisdictions do not apply the PSP[[15]](#footnote-15)

 aa. Plaintiff must prove all elements of an actually fraudulent transfer, including fraudulent intent

 bb. These courts typically decline to read into state fraudulent transfer statutes presumptions that are not in the statutory text and instruct that each transaction must be evaluated separately

 cc. Fraudulent intent may be proven by analyzing the “Badges of Fraud”, which include: **(i)** whether the transfer was made to an insider; **(ii)** whether the debtor retained possession or control of the property transferred; **(iii)** whether the transfer was concealed; **(iv)** whether, before the transfer, the transferor had been threatened with litigation; **(v)** whether the transfer consisted of all or substantially all of the transferor’s assets; **(vi)** whether the transferor absconded; **(vii)** whether the transferor removed or concealed assets; **(viii)** whether the value of any consideration received by the transferor was reasonably equivalent to the value of the property transferred; **(ix)** whether the transferor was insolvent at the time of the transfer or became insolvent as the result of the transfer; **(x)** whether the transfer occurred shortly before or after the transferor incurred substantial debt; **and (xi)** whether the transferor transferred essential assets of the business to a lienholder who then transferred the same assets to an insider of the transferor

 B. Litigation Management – common for dozens of AVPs to be filed on the same day; need to manage court workload on the Clerk’s Office side and the Chambers side (Do you really want to convene 75 scheduling conferences on one day?)

 B. Forced mediation – Sunwest (D. Ore.)

 C. Litigation steering committees

 D. Coordinated briefing of common issues

 E. Identification and prioritization of test cases for motion practice and/or trial

 F. Common defenses (good faith; reasonably equivalent value)

 G. Difficulties with template or boilerplate complaints

**V. Distributions Issues in Brokerage Liquidations – SG**

 A. Net investment method (“cash in/cash out”)[[16]](#footnote-16)

1. Calculates a customer’s net equity by starting with the principal amounts that the customer deposited in an investment account and then subtracting amounts the customer withdrew

2. Proponents contend it is the fairest method because only investors who deposited more money than they withdrew will have allowable claims

3. Critics say it favors later investors and net losers, and only considers limited account activity relating to deposits and withdrawals

 B. Last statement method[[17]](#footnote-17)

1. Based on the securities positions listed on the last account statement received before liquidation

2. Allows all investors (net winners and net losers) to pursue net equity claims and recover a pro rata distribution of expected profits

3. Credits customers for “owning” the securities and paying taxes on their “earnings,” while also accounting for the time value of money

4. But these statements represent wholly fictitious profits and, “would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real”

 C. Inflation adjustments[[18]](#footnote-18)

1. For Ponzi scheme that lasts for years (like Madoff), the Net Investment Method disadvantages early investors because the net equity calculation assigns the same value to dollars invested decades earlier as it does to dollars invested much later

2. An inflation adjustment might result in greater fairness to investors by taking into account the real economic value of investments

D. Modified net investment method (“cash in/cash out” + amounts “reinvested”)[[19]](#footnote-19)

1. Begins with the cash in/cash out calculation but adds amounts that were “reinvested” to the investor’s principal

2. This method favors customers who decided to “roll over” accumulated profits (rather than withdraw them from their accounts) and treats those profits (even if potentially illusory) as an additional investment of principal

 E. Rising Tide Method[[20]](#footnote-20)

1. Attempts to provide investors with a relatively proportionate share of their lost investments after considering what has already been paid to them from the Ponzi scheme

2. Implemented in two phases:

a. First, a pro rata percentage for all claimants is calculated based on total investments, as well as on assets available for distribution

b. Second, the pro rata percentage is reduced by all distributions received by the investors during the Ponzi scheme

3. Has the effect of essentially excluding net winners from any distributions and providing each net loser with a pro rata distribution of their investment principal minus any amounts paid previously

4. A number of courts have adopted the Rising Tide Method finding it more equitable than other approaches, especially when compared to the Net Investment Method, which allows certain net loser investors to receive more than their proportionate share when compared to other net losers

**VI. Hypotheticals – On this presentation, would you make a finding that the subject business was a Ponzi Scheme? – HLB/SG**

A. Scenario #1

Debtor borrows $10.0 MM from bank to finance a business. Business is not profitable, and debtor is unable to pay debt when it matures. Debtor is hopeful that with just a little more time, its business is going to start to turn a profit. Debtor finds another lender willing to refinance the debt at a significantly higher interest rate, and with substantial related fees. Refinancing closes, original lender gets paid off with proceeds of refinancing, and business fails a few months later.

B. Scenario #2

Debtor is an importer of “gray goods” shampoo and other health and beauty products [“gray goods” are products manufactured and shipped for sale to foreign countries, and then reimported to the U.S. in violation of the manufacturer’s licensing and distribution agreements]. To finance the business, Debtor borrows money from a bank on a revolving credit line, secured by accounts receivable with borrowing availability based on a percentage of accounts receivable (the “Borrowing Base”) that Debtor must certify each month before making a request to draw on the credit line.

Due to international shipping logistics, it sometimes takes longer than anticipated for a shipment to arrive in the U.S., resulting in some liquidity constraints for Debtor. Debtor is confident its shipments will arrive soon, and that once the product is delivered to its customers they will pay for the product. Debtor is short on cash, but has a great opportunity to buy some more product at a low price. It just needs $200,000 more and will be able to turn a great profit and pay down its credit line. So Debtor knowingly falsifies the receivables on its borrowing base certificate, so it can draw an extra $200,000 on its credit line.

This works in the short term, so Debtor keeps doing it. Ultimately the bank gets suspicious and asks Debtor to take its business elsewhere. Conveniently, Debtor’s loan officer decides to leave the bank at the same time for another bank and offers to bring his client (Debtor) with him. New bank then makes a loan to Debtor to pay off the credit line with old bank. Debtor then continues its practice of falsifying its borrowing base certificates to new bank in order to draw more on its credit line than permitted. New bank figures this out, calls the FBI, and Debtor’s principal is arrested for bank fraud.

C. Scenario #3

Debtor sponsors a real estate project. It gets a bank loan for most of the construction but needs additional investments to put the finer “luxury” touches on this project. Debtor solicits a bunch of friends and family, and other “mom & pop” investors, for loans totaling an additional $10.0 MM. 100 investors invest $100,000 each, in exchange for notes promising repayment within 2 years, at 18% interest.

Two years pass, and the real estate project has run into problems with permits, construction, and other delays. Debtor approaches investors about extending the maturity of their loans for another year. Some agree; others do not and demand repayment. Debtor fails to repay those investors, some of whom sue.

Debtor fears the publicity and downward spiral if more lawsuits get filed, so Debtor solicits some new investors for the project. Debtor uses proceeds from the new investors to repay those original investors who did not extend the maturity of their loans, although Debtor told these new investors their money would be used to fund the real estate project. Debtor also failed to disclose to the new investors that the old investors had not yet been repaid and that some had filed lawsuits. Debtor remains hopeful that permitting issues, construction issues, and other delays will get resolved shortly, that the project will get completed, and everyone will get repaid. These issues persist, and with more and more investors demanding repayment, Debtor keeps soliciting new investors to raise the funds to repay the earlier investors.

Unfortunately the real estate market takes a downward turn, the bank construction loan comes due, and the investors, seeing that the project is not making progress, get together, file suit in state court, and seek appointment of a receiver for Debtor. The receiver immediately stops the real estate project, and puts Debtor into bankruptcy.

D. Scenario #4

An attorney founded a seven-lawyer labor and employment law firm. The firm ultimately grew into a multi-disciplinary practice with 70 attorneys and 80 support staff. The founding attorney remained a practicing attorney, 50% owner, and an officer of the firm. While most attorneys in the firm continued to properly practice law, at some point the founding attorney began “selling” fake legal settlements.

The most common narrative involved the founding attorney claiming that he had a client who had settled a sexual harassment or whistleblower claim pre-suit. But the settlement required absolute confidentiality and had a structured payout over time, usually three to six months. The founding attorney would tell the target of the scheme that his client was prepared to take a substantial reduction in the settlement in return for receiving funds sooner. Accordingly, the founding attorney would claim to broker a deal whereby the target would receive the funds that the defendant had allegedly deposited into the law firm’s account and the target would pay the client a lesser amount of money – often significantly less – in exchange for the right to the entire settlement fund in the future. In many instances, the transaction was structured as a loan to the law firm instead of a purchase. In truth, there were no clients of this sort, no defendants, and no settlement funds. Instead, the scheme rested on the illusion that the founding partner was a highly successful, politically connected CEO of a thriving 70-lawyer law firm.

Eventually the other named partner figured this out, filed suit, and sought appointment of a receiver in state court. Shortly thereafter, several creditors filed an involuntary chapter 11 petition against the law firm. An order for relief was entered and the receiver was appointed as trustee.

E. Scenario #5

Debtor lives in an over-55 community. He creates fake marketing materials for a new artificial intelligence/hologram program that will let senior citizens communicate with their departed loved ones in an almost-lifelike manner. The marketing materials look convincing, even though the Debtor doesn’t know the first thing about AI or holograms. He convinces the members of the community that this is a can’t miss opportunity, and now is the time to get in on the ground floor. If he can raise $10 million, he’ll have the additional funds necessary for the last pieces of this technology. For $100,000 each, he promises a 15% return within a year.

A few months after raising the $10 million, one of the investors, whose daughter is a bankruptcy lawyer, starts asking a bunch of questions. Concerned that others may start asking similar questions, Debtor offers to cash out that investor early. Having already spent most of the $10 million on himself, however, he doesn’t have enough cash to make good on that offer. So he goes across the street to another over-55 community and solicits new investments there.

As the new investments start flowing in, Debtor pays off the original investor with the pesky bankruptcy lawyer/daughter who had started asking questions. Seeing how easy it was to come by this money, the Debtor decides to keep marketing this idea elsewhere. Rolling in cash, he starts taking luxurious vacations and even considers buying a yacht.

Nearing the end of the first year, of course Debtor cannot repay his original $10 million investors. He tries to convince some of them to roll over their investments for another year, but for those who want to get paid, he goes to a neighboring town’s over-55 community and raises the money there to pay off the original investors.

1. https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme (last visited Nov. 15, 2024). [↑](#footnote-ref-1)
2. *In re EPD Inv. Co. LLC*, 114 F.4th 1148, 1156 (9th Cir. 2024) (citation omitted). [↑](#footnote-ref-2)
3. *In re United Energy Corp.*, 944 F.2d 589, 590 n. 1 (9th Cir. 1991); *Donell v. Kowell*, 533 F.3d 762, 767 n. 2 (9th Cir. 2008) (same, citing *United Energy*). [↑](#footnote-ref-3)
4. *In re Rothstein, Rosenfeldt, Adler, P.A.*, 717 F.3d 1205, 1207 (11th Cir. 2013) (quoting *U.S. v. Orton*, 73 F.3d 331, 332 (11th Cir. 1996). [↑](#footnote-ref-4)
5. *In re Pearlman*, 440 B.R. 569, 575 (Bankr. M.D. Fla. 2010) *aff’d*, 478 B.R. 448 (M.D. Fla. 2012) (quoting *U.S. v. Silvestri*, 409 F.3d 1311, 1317 n. 6 (11th Cir. 2005)). [↑](#footnote-ref-5)
6. *In re Bernard L. Madoff Inv. Sec. LLC*, 12 F.4th 171, 179 (2d Cir. 2021) (quoting *Picard v. Gettinger* (*In re BLMIS*), 976 F.3d 184, 188 n. 1 (2d Cir. 2020)). [↑](#footnote-ref-6)
7. https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme (last visited Nov. 15, 2024); Kathy Bazoian Phelps and Hon. Steven Rhodes (Ret.), *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*, § 1.05 (2012). [↑](#footnote-ref-7)
8. 15 U.S.C. §§ 78aaa-78lll. [↑](#footnote-ref-8)
9. 15 U.S.C. § 78eee(b)(4). [↑](#footnote-ref-9)
10. 15 U.S.C. § 78fff(b). [↑](#footnote-ref-10)
11. 15 U.S.C. § 78eee(b)(3). [↑](#footnote-ref-11)
12. *The Ponzi Book*, § 4.04[2][c]. [↑](#footnote-ref-12)
13. *Donell v. Mojtahedian*, 976 F. Supp. 2d 1183, 1187-88 (C.D. Cal. 2013); *In re Bernard L. Madoff Inv. Sec. LLC*, 445 B.R. 206, 232 (Bankr. S.D.N.Y. 2011). [↑](#footnote-ref-13)
14. *E.g.*, *In re AFI Holdings, Inc.*, 525 F.3d 700, 704 (9th Cir. 2008) (applying Ponzi Scheme Presumption in 9th Cir.); *Janvey v. Brown*, 436 F.3d 551, 558 (5th Cir. 2006) (Ponzi Scheme Presumption applies in 5th Cir.); *Klein v. Cornelius*, 786 F.3d 1310, 1320 (10th Cir. 2015) (same, 10th Cir.); *Wiand v. Lee*, 753 F.3d 1194, 1201 (11th Cir. 2014) (same, 11th Cir.). [↑](#footnote-ref-14)
15. *E.g.*, *Finn v. Alliance Bank*, 860 N.W. 2d 638 (Minn. 2015). [↑](#footnote-ref-15)
16. *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 235 (2d Cir. 2011). [↑](#footnote-ref-16)
17. *Id.* [↑](#footnote-ref-17)
18. Steven M. Witzel, *Victim Recovery After Ponzi Scheme Unravels*, 248 N.Y.L.J. 86 (2012). [↑](#footnote-ref-18)
19. *Id.* [↑](#footnote-ref-19)
20. *Id.* [↑](#footnote-ref-20)