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## 2017 Northeast Bankruptcy Conference

# The Critical Role of Financial Advisors in Unwinding Ponzi Schemes

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## 24<sup>th</sup> Annual ABI Northeast Conference

### The Critical Role of Financial Advisors in Unwinding Ponzi Schemes

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### Ponzi Schemes

- The term “Ponzi Scheme” comes from a 1920’s fraud where Charles Ponzi (1882-1949) bilked his clients out of \$20 million (worth more than \$240 million today).
- He promised clients a 50% profit within 45 days, or 100% profit within 90 days, by buying discounted postal reply coupons in other countries and redeeming them at face value in the United States.
- In reality, Ponzi was using money from new investors to pay early investors.



"I find that if I'm the first one in and the first one out, Ponzi schemes can be very lucrative."

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## Defining a Ponzi Scheme

- In the wake of some of the largest Ponzi schemes in history, the use of the term “Ponzi” to describe a fraudulent scheme has become more prevalent over the last decade
- In certain instances, often by the media, the term “Ponzi” has been used improperly to describe a situation that does not satisfy the legal requirements to be classified as a Ponzi scheme and is better characterized simply as a fraudulent scheme
- “Ponzi-like” has been used to describe a wide variety of frauds to make them sound more sophisticated by branding them as a Ponzi.

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## Defining a Ponzi Scheme

- In *SEC v. Management Solutions, Inc. (MSI)*, the district court conducted an extensive review of the various and sometimes conflicting definitions of a Ponzi scheme in different circuits.
- The court in *MSI* noted that all of the definitions tend to include that:  
“a Ponzi scheme is a fraudulent investment scheme in which ‘returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments.’”

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## Defining a Ponzi Scheme

- A pyramid scheme is similar to a Ponzi scheme, the difference being that investors in a pyramid scheme expect ‘to profit from their efforts at obtaining new people to invest in the business into which they have already invested their own money[,]’ rather than from the business itself.
- In certain instances, a scheme may allegedly constitute a Ponzi/pyramid scheme.

See *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 629-30 (Bankr. S.D. Ohio 2006) (“Canyon’s gold coin sales programs had all of the hallmarks of a classic Ponzi scheme.”).

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## Defining a Ponzi Scheme – the Ponzi Presumption

- Pursuant to 11 U.S.C. § 548 and similar state law statutes, a fiduciary may generally seek to avoid a transfer made with the actual intent to hinder, delay, or defraud creditors of the debtor.
- Proving that a transfer was made with actual intent is often a difficult and time-consuming task that involves establishing certain badges of fraud to demonstrate actual intent for each alleged fraudulent transfer.
- In cases involving transfers from a Ponzi scheme, however, some courts have relied on the Ponzi presumption to assume that transfers made in furtherance of the scheme were made with fraudulent intent in satisfaction of the proof requirements of a fraudulent transfer claim.

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## Defining a Ponzi Scheme – the Ponzi Presumption

- The Ponzi Presumption:
  - “There is a general rule – known as the ‘Ponzi scheme presumption’ – that such a scheme demonstrates ‘actual intent’ as a matter of law because ‘transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors.’”

- Bear Stearns Sec. Corp. v. Gredd (*In re Manhattan Inv. Fund, Ltd.*), 397 B.R. 1, 8 (S.D.N.Y. 2007)

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## Defining a Ponzi Scheme – the Ponzi Presumption

- Different courts consider various non-determinative factors to conclude whether a scheme qualifies as a Ponzi scheme. For example, courts have considered, among other factors, the following:
  1. the promise of large returns, returns with little to no risk, and/or consistent returns;
  2. the delivery of promised returns to earlier investors to attract new investors;
  3. the general insolvency of the investment scheme from the beginning;
  4. whether the perpetrator had any legitimate business operations;
  5. whether the perpetrator recruited agents and paid brokers high commissions to induce them to continue the scheme in some cases with a commission structure to discourage withdrawals;

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## Defining a Ponzi Scheme – the Ponzi Presumption

6. whether funds from investors were commingled, used for non-customer purposes, subject to excessively large fees and/or not invested in promised investments;
7. inconsistencies between statements issued by the perpetrator and actual bank statements and/or reports from the perpetrator of overstated investment returns in conjunction with understated losses;
8. whether all investors were encouraged to reinvest and extend their investments and later investors received lower returns than earlier investors; and
9. the secrecy, exclusivity, and/or complexity of the investment scheme . . . and the general stability of the investment scheme, among other factors.

See Kathy Bazoian Phelps and Hon. Steven Rhodes, *The Ponzi Scheme Book: A Legal Resource for Unraveling Ponzi Schemes*, § 2.03[1][b] (2012) (providing a compilation of factors that courts consider), and *MSI*, 2013 WL 4501088, at \*19.

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## Defining a Ponzi Scheme – the Badges of Fraud

- Modern badges of fraud:
  - (1) whether the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer;
  - (2) whether the debtor retained control of the asset;
  - (3) whether the transfer was to a family member;
  - (4) whether the transfer was prior to debtor incurring a substantial debt;
  - (5) whether the transfer was substantially all of debtor's assets;
  - (6) whether the debtor received consideration for the transfer;
  - (7) whether the transfer was disclosed or concealed;
  - (8) whether the debtor made the transfer before or after being threatened with suit by creditors; and
  - (9) whether the debtor absconded.

*Statute of 13 Elizabeth and the famous Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601) which involved the fraudulent transfer of sheep.*

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## Defining a Ponzi Scheme – the Ponzi Presumption

- Even in cases where a Ponzi scheme is clearly operant, it can be difficult to convince courts the presumption applies
  - “[T]he district judge appeared to believe that Sentinel had robbed Peter (Sentinel's FCM clients) to pay Paul (the Bank of New York) in the months before it filed for Chapter 11 bankruptcy. ... [I]t concluded that this behavior was not enough to show that Sentinel had actual intent to hinder, delay, or defraud its FCM clients. Rather, the opinion characterized Sentinel's behavior as a desperate “attempt to stay in business.”... Nonetheless, we disagree with the district court's legal conclusion that such motivation was insufficient to constitute actual intent to hinder, delay, or defraud Sentinel's FCM clients.”

See Grede v. Bank of New York Mellon, 441 B.R. 864, 883 (N.D.Ill. 2010) (no actual fraud where “Trustee failed to prove that Sentinel knew at the time of the transfers that their scheme would collapse, and the Ponzi presumption does not apply”) rev'd In re Sentinel Mgmt. Group, Inc., 728 F.3d 600, 667 (7th Cir. 2013)

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## Identifying the Ponzi Players

- When a Ponzi scheme is suspected, it is critical to identify the members of management and lower employees most relevant to the purported scheme.
  - CEO/CFO/CAO
  - Cash Management employees
  - Other employees who may have been involved in manipulating finances
  - Public accountants
- Additionally, third-parties often have intimate relationships with the Ponzi scheme and can offer details into their inner workings.
  - Identify top “promoters” of the Ponzi scheme
    - Madoff “Feeder Funds”
    - Other promoters

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## Identifying and Controlling Relevant Documents

- Investigation of Public Records
  - Any publicly available relevant filings
  - Social media
  - Pending litigation
- Secure Available Business Records
  - Locate, preserve and inventory business records on-and off-site
  - Obtain computer passwords from relevant personnel
  - Obtain website and email hosting information
  - Identify any P.O. Boxes
- Time is critical to avoid spoliation of key documents and records

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## Identifying and Controlling Relevant Documents

- Since parallel government investigations are common, it is critical to develop close working relationships with the relevant agencies
- In cases where actions have already been brought by the DOJ or SEC, it is likely that government entities will have already seized crucial documents and conducted interviews
  - Offering relevant legal or accounting expertise to the government may help convince agencies to share information with you more quickly or share information that may otherwise be impossible to obtain
    - More effective subpoena power

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## Getting Control of the Assets before they “Disappear”

- Corroborate company’s records with 3<sup>rd</sup> party documents (e.g., bank statements).
- Interview employees
  - When and where
  - Employee questionnaires
  - Personal property
- Follow the cash!
  - Sources and uses

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## Getting Control of the Assets before they “Disappear”

- Liquidation of Assets
  - Although most Ponzi schemes have little or no legitimate business operations, these schemes often accumulate assets that can be used to fund recoveries to creditors.
  - Asset types may vary widely, and often include personal property.
  - In many cases, deliberate efforts will have been made to shield assets.

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## Getting Control of the Assets before they “Disappear”

- Third Party Litigation
  - In some cases, it is possible to pursue recoveries against employed professionals or others with knowledge of the scheme who allowed it to continue.
  - In the bankruptcy context, fees awarded prior to the discovery of the Ponzi scheme may be reduced.
  - The *In Pari Delicto* doctrine may be used as a defense in bankruptcy (though it is often seen as inapplicable to receivers).

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## Getting Control of the Assets before they “Disappear”

- Chapter 5 Actions
  - In many Ponzi schemes, the largest pool of assets available to a fiduciary are from the recovery of funds paid to investors who profited as a result of their involvement in the scheme.
    - Given the nature of Ponzi schemes, allowing any participant to profit from their participation naturally comes at the expense of other investors.
    - Some circuits have disputed the idea of recovering assets from good-faith investors who may have already dissipated any profits.

See Securities Investor Protection Corp v. Bernard L. Madoff Investment Securities LLC, In re Bernard L. Madoff, Debtor, 531 B.R.439, (SDNY 2015)

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## Getting Control of the Assets before they “Disappear”

- Chapter 5 Actions - Preference
  - Generally available only through § 547(b) of the Bankruptcy code, although similar remedies exist in certain states.
  - These actions allow avoidance of transfers made on account of antecedent debt made within 90 days of a bankruptcy filing (1 year for insiders).
  - In the context of a Ponzi scheme, Ordinary Course and Contemporaneous Exchange defenses often fail.
    - However, Section 546(e) safe harbor defenses were particularly helpful for defendants in the Madoff and Lancelot schemes.
  - May be of limited usefulness depending on length of scheme.

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## Distribution of Recovered Assets

- Even prior to bringing the previously discussed Chapter 5 actions seeking recoveries from investors in the Ponzi scheme, it is critical to determine which investors benefited from their involvement
- The availability, level of detail, and complexity of the Ponzi scheme's records will complicate this issue.
- Two primary methods have been used by Bankruptcy Courts and Receivers
  - Last Statement Method
    - Status determined based on market value of securities reflected on last statement.
  - Net Equity Method
    - Status determined by amount of deposits less withdrawals.

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## Distribution of Recovered Assets

- Depending on the level of sophistication of the scheme and its victims, it can be challenging to accurately calculate victims' losses and receive relevant data from victims.
- Receivership vs. Bankruptcy
  - Receivers have wider authority to fashion distribution plans, with the consent of the district court.
  - Ponzi schemes in bankruptcy are subject to more complex oversight and assume more burdensome noticing requirements.

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## Distribution of Recovered Assets

- Proofs of Claim
  - In Ponzi schemes, scrutinizing victims' assertions of loss can be complex, due to the complicated nature of the schemes and frequent lack of access to records.
  - For this reason, it is crucial for the Trustee/Receiver to create an accurate register of participants and their transactions with the Ponzi entity, identify victim participants, and pursue available remedies against participants who profited from their involvement in the scheme.

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## Distribution of Recovered Assets

- The two most commonly applied methods of distributing assets to investors in a collapsed Ponzi scheme are the Rising Tide and Net Investment methodologies.
  - Rising Tide Method
    - Funds previously received by each victim are credited against the victim's pro rate share of the total amount invested.
    - Distributions continue as long as assets are available, continuingly increasing the shared recovery percentage of victims.

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## Distribution of Recovered Assets

- Net Investment Method
  - Difference between the total amount each victim contributed and the amount the victim received in withdrawals.
  - Distributions continue as long as assets are available, based on the amount the victim lost, rather than the percentage recovery the victim has receive.

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## Preferred district for filing?

- The notion of a preferred district for filing a Ponzi related bankruptcy depends on the party's role
  - Debtor?
  - Lender/Feeder Fund?
  - Victim?

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## Q&A

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