Administrating Ponzi Schemes

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Getting Started

Initial Steps

- Conflict Check
- Investigation
  - Public Records
  - Social Media
  - Pending Litigation
- Assembling a Team
  - Select outside professions
  - Clear calendars of key staff members and professionals
  - Strategize as a team
Getting Started

- Secure the Assets
  - Locate, preserve and inventory business records
  - Obtain computer passwords
  - Obtain website and email hosting information
  - Identify any P.O. Boxes
- Corroborate company’s records with 3rd party documents (e.g., bank statements).
- Interview employees
  - When and where
  - Employee questionnaires
  - Personal property
- Follow the cash!
  - Sources and uses
Is the Company Really 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.
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.’”
Is the Company Really 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.

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Is the Company Really a Ponzi Scheme?

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;
Is the Company Really a Ponzi Scheme?

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.

Why a Ponzi Scheme Determination Matters

- 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.
Why a Ponzi Scheme Determination Matters

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)
Sources of Recovery

- 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.
Sources of Recovery

- 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).
Sources of Recovery

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.
Sources of Recovery

Prior to seeking recoveries from investors in the Ponzi scheme it is necessary to determine which investors benefited from their involvement

- 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.
Chapter 5 Actions (continued)

Preferences

- 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.
- May be of limited usefulness depending on length of scheme.
Interaction/Cooperation with Government Authorities

- In cases where actions have already been brought by the DOJ or SEC, it is likely that government entities will have already seized assets.  
  - In this situations, a close working relationship with the relevant authorities is crucial.

- Where complex technical or accounting challenges make the true financial picture opaque, a trustee or receiver can provide valuable resources to a government investigation, and vice versa.  
  - Benefits to a fiduciary include access to witnesses or principals, and potential greater recoveries for creditors.  
  - Disposition of criminal cases may be necessary prior to asset distribution depending on the source.
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**
  - Funds previously received by each victim are credited against the victim’s pro rate share of the total amount invested.

- **Net Investment**
  - Difference between the total amount each victim contributed and the amount the victim received in withdrawals.
Bankruptcy v. Receivership

- Who is making the decision?
- Benefits of Bankruptcy
  - Ch. 5 actions
- Benefits of Receivership
  - Often less expensive
  - Potential relief from *in pari delicto* defense
- Trustee and Receiver Liability
  - See “Fiduciaries Gone Wild?” Hayes, Sewell and Bodenstein– National Association of Bankruptcy Trustees, February 28, 2015

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Resources

■ The Ponzi Book: A Legal Resource For Unraveling Ponzi Schemes
  □ Kathy Bazoian Phelps
  □ Hon. Steven Rhodes

■ Fraud and Forensics: Piercing Through the Deception in a Commercial Fraud Case
  □ Kathy Bazoian Phelps, et al.

■ Receivership Sourcebook
  □ Phillip S. Stenger