

Commercial Fraud Task Force Committee

The ABI Commercial Fraud Task Force Committee facilitates information sharing, training, and education between ABI members and the public-private sector to combat commercial bankruptcy fraud.



Ponzi Schemes in Bankruptcy

Written by: Patrick M. O’Keefe

O’Keefe & Associates; Bloomfield Hills, Mich.
pokeefe@okeefeandassociates.com

Russell D. Long

O’Keefe & Associates; Bloomfield Hills, Mich.
rlong@okeefeandassociates.com

Michael S. McElwee

Varnum, Riddering, Schmidt & Howlett, LLP; Grand Rapids, Mich.
msmcElwee@varnumlaw.com

Ponzi schemes are named after confidence man Charles Ponzi, who invented a scheme to profit from foreign exchange arbitrage through the purchase and redemption of postal coupons after World War I. Ponzi attracted financial backing for his scheme by offering investors enormous returns. As he paid early investors the high returns they were promised, word spread and Ponzi began collecting cash from investors at a frenzied pace. However the postal coupon scheme did not generate enough profit to pay the returns Ponzi promised, and in fact he went deeper into debt with each transaction. He was only able to sustain the scheme by paying returns to earlier investors with cash received from later investors. When authorities began to investigate Ponzi’s business, investors became spooked, new investment funds dried up and the scheme quickly collapsed, leaving Ponzi unable to repay any of the remaining investors.

The purpose of this article is to explore the characteristics of Ponzi schemes, the significance of Ponzi schemes in bankruptcy cases and the evidence required to prove the existence of a Ponzi scheme. Not all failed businesses are the result of illegitimate activity. However, if a failed business is a Ponzi scheme, the likelihood of a successful recovery action in bankruptcy is vastly improved. Over the past three years, we have had the opportunity to investigate several Ponzi schemes. In each instance we were asked to establish both that the debtor was indeed operating a Ponzi scheme, and the first date upon which the debtor's operations became a Ponzi scheme. This can be easy to do in instances where the debtor's operation is launched as a criminal Ponzi enterprise from the beginning. It is more difficult, however, when the debtor initially operates a legitimate business but for reasons of financial hardship, the business gradually morphs into a criminal enterprise. The bankruptcy trustee, once appointed, quickly encounters two things; a large body of jilted unsecured creditors clamoring for their money back, and few, if any, existing assets with which to pay them. If the jilted creditors are to be paid, the source of payment will

almost always be the lucky investors who actually made money in the scheme. That is, the trustee must sue the “winners” to pay the “losers.”

The remedies available to a trustee for this purpose are uniquely powerful ones. But they arise only if the trustee can show, as a threshold matter, that the debtor was in fact an operating Ponzi scheme. Whether the debtor was doing so is thus a singularly important issue. A brief description of some of the remedies available to a trustee who succeeds in carrying this initial burden will suffice to show just how important the issue is.

First, any distribution to an “investor” above the investor’s initial undertaking (*i.e.*, any distribution in excess of principal) constitutes a fraudulent transfer as a matter of law. All interest or other “Ponzi Profit” payments to investors are therefore at risk, regardless of the relative guilt or innocence of the individual investors.

Second, the debtor in a Ponzi scheme case is presumed to have acted with fraudulent intent. Thus, any and all payments by the debtor to investors, even refunds of invested principal, are recoverable by the trustee unless the defendant can prove both (1) good faith and (2) an exchange of reasonable equivalent value. The burden is on the investor, not on the trustee, to do this. Since Ponzi schemes often involve unorthodox transactions (for example, post-dated checks), good faith is typically difficult, if not impossible, for the investor to establish. Thus, even the investor’s principal is at risk.

Third, with respect to preferential transfers, the cases generally hold that there is no ordinary course of business defense in a Ponzi scheme case, there being “nothing ordinary” about a Ponzi operation. Since Ponzi operators tend to pay the greatest number of payments—and the highest payment amounts—immediately before the operation collapses (which often corresponds more or less to the 90-day preference period), a great proportion of the dollars distributed by the Ponzi operator are recoverable as preferences.

Of course the underlying dynamic driving any Ponzi scheme is greed. Investors suspend good judgment and overlook basic due diligence in their eagerness to get in on the action. In the Ponzi schemes we investigated, investors received profits for short-term investments and did not bother to annualize their returns. Consequently, investors were desensitized to the ridiculousness of their yields. A 6 percent return over 45 days looks like 6 percent, not the approximate 50 percent annualized return.

The key to a good Ponzi scheme is to make sure early investors get their money back since the best way to prolong a Ponzi scheme is through repeat investors. Effective operators overcome skepticism by having cash available to retire a nervous investor’s obligation. An investor who promptly receives his money back is often embarrassed for having doubted the business acumen of the operator, and may overcome this humility by investing more heavily, and telling his friends about the great opportunity. The aftermath of a Ponzi scheme is a little like the remains of a nuclear explosion. After the mushroom cloud dissipates few, if any, assets exist. The short-term winners in a Ponzi scheme are the investors that get out before the scheme blows up and the promoters who raise investors’ funds for a piece of the action or a commission but put none of their own capital at risk.

The key for a trustee, then, as indicated, is to establish that the debtor's operation was indeed a Ponzi scheme. The purpose of this article is to address this issue. What proof will suffice to establish this critical point?

This is relatively easy to prove in instances where the debtor's operation is launched as a "pure" Ponzi enterprise from the beginning. This point was well explained in *Merrill v Abbott (In re Independent Clearing House Co.)*, 77 Bankr. 843 (D.C. Utah, 1987):

The evidence before the Bankruptcy Court ... showed that the Debtors conducted no business operations, never generated any profits or earnings, paid all monthly disbursements to [investors] solely from [investors'] investments, were insolvent from the moment the first investment contract was executed, became more insolvent with each successive contract, and ran their business as a Ponzi scheme ... Thus, it was undisputed that the Debtors' business was "conducted as a Ponzi scheme...." 77 Bankr. at 859.

The court held that a transfer need not be made with intent to hinder, delay or defraud a specific transferee to constitute "international fraud." Rather, "the trustee need only show that the transfers were made with the intent to hinder, delay or defraud an entity to which the debtor was *or became* indebted on or *after the date that such transfer occurred.*" 77 Bankr. 860 (emphasis in original).

Since Ponzi schemes must, as a matter of scientific necessity, eventually collapse and leave some creditors unpaid, one can therefore always infer the necessary intent:

Indeed no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that the investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent within the eyes of the law. 77 Bankr. at 860.

Ponzi schemes generally have the following characteristics:

(1) *Capital Providers.* A Ponzi scheme thrives on funds provided by third-party investors. These could be individuals or financial institutions providing cash in the form of either debt or equity. Generally, the distinction between "debt" and "equity" is of little importance because any infusion of capital gives rise to an equitable obligation by the debtor to return it. The

return of funds by the debtor to the investor is therefore arguably the satisfaction of a debt, either expressed or implied. Distinction between debt or equity capital is also unnecessary since the profitable business activity required to service both forms of capital is absent in a Ponzi scheme.

(2) *Existence of Fraud.* Ponzi operators invariably make false representations to their "investors," and do so knowingly. That is, the Ponzi operator will pitch the business as if it were legitimate, while knowing that new loan proceeds will be used to repay earlier lenders, not to invest in the enterprise "pitched" to the investor. Often, the only business being conducted is the raising of investor funds. Intent is often difficult to prove directly. This requires a careful cataloging of the number of investors, the amount and timing of their investments, the legitimate profits (if any) generated from the debtor's business activities, and the tracing of payments from payment sources. Proving that the debtor knew some existing or future creditor would go unpaid is much more difficult, however, when the debtor initially operates a legitimate business, encounters financial hardship and reacts not by closing or changing the business, but by borrowing money to keep the business afloat. If the debtor does so knowing or suspecting that the business is not healthy enough to retire new debt when it comes due, but represents otherwise to the new lender, he has engaged in the same basic deception that "pure" Ponzi operators use from the beginning. If, when the new debt comes due, the debtor pays it with a yet another new loan, and does the same thing again when the new loan matures, he has become as much a Ponzi operator as Charles Ponzi himself. This evidence generally is sufficient to enable the trier of fact to infer that the Ponzi operator formed the requisite criminal intent.

(3) *High Rates of Return.* A Ponzi operator's pitch to investors will typically not withstand even the most perfunctory due diligence by the investor. The key for the Ponzi operator is therefore to get people to invest without asking too many questions. To accomplish this, the Ponzi operator will typically do two things. First, offer extremely high rates of return. And second, actually pay such returns to earlier investors. This creates a level of temptation (the so-called "greed factor") that is exploited to assure a steady stream of new investors. A Ponzi operation will therefore usually involve extremely high rates of return over short periods of time and at least an initial pool of lucky investors who actually rake in these high returns. The payment of extremely high returns to nontraditional lenders is particularly probative. It shows that the debtor knows, or at least suspects, that he would not qualify for bank financing. A willingness to overpay for credit shows desperation for new loan funds. We have investigated Ponzi schemes where rates of return ranged as high as 2,500% per annum. No business can sustain even anything close to that cost of capital. Any debtor who would agree to pay it can be presumed to understand that there is no hope of long term survival.

(4) *Increasing Insolvency.* A Ponzi scheme, by its very nature, becomes increasingly insolvent with each business transaction. It does so by the very "Ponzi" nature of the operation, which involves at its core the payment of previous loan obligations with the proceeds of later ones. The Ponzi scheme's ability to repay debts is solely contingent on raising new funds, which has the effect of deepening the insolvency. Since both past and current obligations entail carrying costs (primarily interest), the enterprise takes on more water with each transaction. If this "increasing insolvency" can be established, the debtor's intent to "hinder delay or defraud" its creditors is presumed. The most difficult part of a fraud case—proving that the debtor acted with the requisite intent—is therefore presumptively established. The importance of this to the trustee's

collection efforts cannot be over emphasized. The touchstone for all Ponzi operations is the concept of “increasing insolvency.” The trustee must show that, with each new loan transaction, the debtor became more insolvent. To show this, the trustee might create a chart that plots the debtor’s cash receipts and its gross recurring obligations. When each new loan is incorporated into the chart, it will often cause a wider and wider separation between income and expenses. If that separation continues to increase, and the trustee can show that the business is not able through operations to narrow the gap, the first and most basic element of a Ponzi scheme will have been established.

Not all hopeless businesses, however, are criminal enterprises. The trustee must also show knowledge on the debtor’s part that the business was becoming increasingly insolvent and that the business could not sustain the new debt it incurred or was likely to incur in the future. That is, intent will be presumed only if the trustee can establish knowledge on the debtor’s part that its increasing insolvency was irreversible, or that its debt could not be retired from cash generated by operations.

Possibly the best way to show this is by tracing new loan proceeds to the retirement of pre-existing debt (that is, robbing from Peter to pay Paul), rather than using the funds to invest in capital and equipment. If the debtor seeks new loans at the time pre-existing debt matures, uses the new loan proceeds to pay old debt and becomes increasingly insolvent in the process of doing so, the trier of fact can infer the requisite knowledge and intent. The facts, taken together, reveal (1) knowledge on the debtor’s part that its operations are not self-sustaining, and (2) a plan by the debtor to stay afloat with borrowed funds. While such a debtor can, unlike a “pure” Ponzi operator, fall back on the “hope springs eternal” defense, a strong and well organized set of proofs by the trustee will often overwhelm this defense.

The key to establishing the existence of a Ponzi scheme is to demonstrate that the only source of repayment to investors is funds from other investors. Since no business activity exists, an analysis of the cash transferred in and out of the entity should be sufficient to show the sources and uses of funds. If there is business activity, it is important to understand the level of such activity and document the volume and the inadequate profitability available to service the debt load. There are trailing pieces of evidence that can support your conclusions on the scheme such as computing and documenting the costs of capital and comparing it to the profit margins of any business activity. Such analysis highlights the ridiculousness of the proposition since Ponzi scheme businesses cannot sustain the level of profitability required to service the costs of invested capital. Rarely in Ponzi schemes is money invested in machinery, equipment, goods, services or even in alternative investment vehicles like stocks and bonds. Typically, the only disbursement activity in the checking account relates to payments to capital providers in the forms of interest or principal reductions on maturing obligations. Capital provider A’s money is distributed to capital provider B. The cash coming into the entity is from capital providers, not customers.

Other evidence that might bear on this issue includes:

- (a) Material misrepresentations by the debtor to lenders about income, expenses, and prospects.

- (b) False or misleading projections.
- (c) Increased reliance on nontraditional lenders.
- (d) Willingness to offer and pay above interest rates.
- (e) Failure to reveal losses, or lost opportunities, to lenders.
- (f) Cooked books.
- (g) Bleak audit reports.
- (h) Neglect of the business to raise funds.
- (i) Foolish spending to give the appearance of success.
- (j) Preferential treatment of select lenders.

The evidence required to support a Ponzi scheme analysis is collected through the following steps:

1. Follow the money. How are capital providers being paid?
2. Analyze the business activity
 - a. Are there sales?
 - b. Are funds generated into the company from customers or investors?
 - c. Is the business profitable?
 - d. Does the business justify the amount of capital and its cost?
 - e. Is there a lot of activity in repaying investors? Perhaps more so than sales activity?
3. Determine whether the investors' returns are exorbitant. Most legitimate businesses cannot sustain levels of profitability required to service and retire Ponzi scheme capital.

The analysis and documentation resulting from these steps will drive and support your conclusions regarding the nature of the debtor's operations and assist the trustee's efforts in recovering actions.