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Discerning Derivative Claims - From Madoff to TelexFree

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DISCERNING DERIVATIVE CLAIMS: FROM *MADOFF* TO *TELEXFREE*

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GENERAL OVERVIEW OF PONZI SCHEMES

- "Ponzi" Schemes take their name from Charles Ponzi, who orchestrated not the first, but the most well-known scheme in 1920
- There is no exact definition for a Ponzi Scheme
    - Courts look "for a general patter, rather than specific requirements." *See Manhattan Inv. Fund, Ltd. V. Gredd (In re Manhattan Inv. Fund, Ltd.)*, 397 B.R. 1, 12 (S.D.N.Y 2007) (stating there is no precise Ponzi scheme definition).
- Black's Law Dictionary defines 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. Money from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other than the continual [deposit] of new funds.

PONZI SCHEMES (CONTINUED)

- Generally, the form of a Ponzi scheme consists of a set of investments whereby initial investors are paid by the payments invested by subsequent investors.
- The requirement that these schemes require ever-increasing funds to keep the earlier-in-time investors paid makes the schemes ultimately untenable, leading to a collapse of the entire structure and numerous claimants left underpaid or entirely unpaid.
- In recent years, the most infamous Ponzi scheme was orchestrated by Bernie Madoff.
  - Madoff orchestrated a scheme that brought in nearly 5,000 investors and more than $64 billion.

PONZI SCHEMES AND BANKRUPTCY

- Because the large size of claimants to a Ponzi scheme case and the need to consolidate all potential claims in a single jurisdiction, Ponzi schemes are routinely administered through the bankruptcy courts, where the Bankruptcy Code provides a structured system to allocate funds, determine priority of payments, and provide all creditors with a (relatively) level playing field for determining how payments will be disbursed.
- Critically, the Bankruptcy forum also allows for both preference and fraudulent transfer claw-backs to allow the trustee to try and retrieve the largest amount of money for distribution as possible.
- Often, the trustee will utilize these powers to claw back the payments made to early-in-time investors, who typically receive more in return than later-in-time investors in the scheme.

THE AUTOMATIC STAY AND ITS EFFECT ON PONZI SCHEME CLAIMANTS

- 11 U.S.C. § 362 imposes the "automatic stay" when a bankruptcy case is initiated. This stay prevents all further credit-collection activity.
- Under subsection (a)(1), the "continuation or commencement" of most kinds of lawsuits against the Debtor – here the Ponzi Scheme organization – is frozen, requiring all litigants to come to the same forum to resolve their disputes.
- The stay allows for clarity by preventing the "race to the courthouse" that would otherwise ensue. Because Ponzi scheme investors can be located across the nation, or the globe, the bankruptcy stay facilitates a uniform process in a single court to try and resolve all issues related to the fraud.

THE APPLICABILITY OF "FRAUDULENT TRANSFER" PRINCIPLES TO PONZI SCHEMES

- One major complication with Ponzi scheme cases is the inherent logical gap that occurs in litigating transfers to "net winners" of the scheme (early investors who are actually paid) to distribute to "net losers" (later-in-time investors who get little or nothing) as "fraudulent transfers."
- This analysis has traditionally been viewed under a constructive trust theory, which has led to logical problems.
- A "fraudulent transfer" requires a transfer of "an interest of the debtor in property" under section Bankruptcy Code section 548(a)(1)(B)(ii)(II). However, Ponzi scheme transfers do not clearly fit that definition.

THE APPLICABILITY OF "FRAUDULENT TRANSFER" PRINCIPLES TO PONZI SCHEMES (CONTINUED)

- If Investor 1 invests $100 and received $150 in return (the extra $50 coming from Investor 2's $100 investment), the transferred funds were never technically property of the Debtor. Those funds are viewed to be held in a constructive trust for the benefit of Investor 2.
- Thus, the transfer of the $50 to Investor 1 was really a transfer of an equitable interest in the $50 of Investor 2, and not a transfer of $50 of the Debtor's money. So technically, a fraudulent transfer claim could not be asserted, since the transfer of the $50 was not made for any value to the Debtor, and thus, Investor 1 cannot be a "purchaser for value" to take the equitable interest free and clear.
- This makes Investor 1 the constructive trustee for Investor 2. And Investor 2 has an unjust enrichment claim against Investor 1.
- Thus, the bankruptcy trustee should not have a right to the claim of Investor 2 against Investor 1, since that is an equitable trust claim held by the Investor, and not the Debtor.

HOW COURTS HAVE GOTTEN AROUND THE CONSTRUCTIVE TRUST PROBLEM

- *Jus Tertii* – "a right of a third party (as to property in another's possession)"
  - Under this concept, the recipient of property of a third-party by an intermediary is estopped from asserting that the third-party, a non-party to the dispute between the possessor and the intermediary, contains superior rights (Trustee sues Investor 1, Investor 1 says the property is Investor 2's and, thus, not recoverable by Trustee, but Investor 2 is not a party to the dispute between Trustee and Investor 1). This transforms Investor 2's unjust enrichment claim into a fraudulent transfer claim for the trustee.
- Tracing
  - When the debtor commingles all the funds received from the various investors to the point where tracing of the funds – a necessary component of constructive trust recoupment – the funds are treated as the Debtor's funds, because no individual investor can successfully transfer his or her money in the large, commingled account. This provides the trustee with a direct interest in the funds and allows for a fraudulent transfer claim.

SIPA AS ANOTHER AVENUE FOR PONZI RESTITUTION

- In Ponzi schemes involving securities, as the Madoff case involved, Congress enacted the Securities Investors Protection Act ("SIPA").
- SIPA treats all investments paid into the scheme as "customer property" and only allows for distributions to "customers" – *i.e.* investors into the scheme.
- Critically, SIPA directly dictates that "[f]or purposes of [fraudulent transfer] recover[ies], the property so transferred shall be deemed to have been the property of the debtor . . . ."
  - This language clearly avoids the equitable hoops required under traditional bankruptcy code fraudulent transfer litigation.

ANCILLARY LITIGATION AND SECTION 105(A)

- All bankruptcy practitioners are very familiar with Section 105(a) of the Bankruptcy Code.
  - This provision reads: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process."
- This section of the Bankruptcy Code provides the Courts with an equity safety-valve that allows bankruptcy courts to grant orders consistent with equitable principles, so long as the orders bear a rational relationship to some other provision in the Bankruptcy Code.
- Often, this section is utilized to extend the automatic stay to ancillary litigation between Ponzi scheme claimants to ensure that all claims are adjudicated together.

MADOFF AND THE STAY OF ANCILLARY PROCEEDINGS

- *Marshall v. Picard (In re Bernard L. Madoff Inv. Sec. LLC)*, 740 F.3d 81 (2d Cir. 2014) ("***Madoff II***").
- *Madoff II*, issued by the Second Circuit in January of 2014, addressed the impact of a permanent injunction entered in the liquidation case of Bernard L. Madoff Investment Securities LLC ("BLMIS") instituted by the Securities Investment Protection Corporation and referred to the United States Bankruptcy Court for the Southern District of New York.
- This injunction enjoined state law tort actions that two of BLMIS's defrauded investors were attempting to assert against the estate of Jeffry M. Picower, one of Madoff's allaged co-conspirators and other related defendants (the "Picower Defendants"). In the liquidation action, governed by SIPA, a trustee was appointed for the expeditious and orderly liquidation of BLMIS. In the SIPA litigation, the trustee commenced an adversary proceeding against the Picower Defendants asserting claims of fraudulent transfers, avoidable preferences, and turnover under state law and the Bankruptcy Code.
- While this adversary proceeding was ongoing, the investors filed a putative class action in the United States District Court for the Southern District of Florida asserting claims of civil conspiracy, conversion, and conspiracy to violate the Florida Civil Remedies for Criminal Practices Act. The SIPA trustee was made aware of this lawsuit and sought and obtained a preliminary injunction enjoining the Florida litigation on May 3, 2010. Ultimately, the SIPA trustee settled the adversary proceeding and also obtained a permanent injunction enjoining any action "that is duplicative or derivative of the claims brought by the Trustee." The Florida plaintiffs appealed the entry of the permanent injunction to the United States District Court for the Southern District of New York, which affirmed, and subsequently to the United States Court of Appeals for the Second Circuit.
- On appeal, the Second Circuit determined that the claims that were being sought in the Florida litigation were "derivative" of those claims settled by the SIPA trustee and that the claims of conspiracy asserted by the Florida litigants were an attempt to "plead around" the injunction entered in New York.

MADOFF AND THE STAY OF ANCILLARY PROCEEDINGS

- *Picard v. Fairfield Greenwich Ltd.,* 762 F.3d 199 (2d Cir. 2014) *("__Madoff III__")*
- *Madoff III* is, in a sense, an inverse of *Madoff II*. In *Madoff III*, the SIPA trustee was seeking to intervene in three lawsuits, none of which directly involved the property of the BLMIS estate as a party, to stay those proceedings. Rather than directly addressing claims held by the BLMIS estate, the three lawsuits into which the trustee sought to intervene were brought by investors in "feeder funds"—funds that channeled investments into the ponzi scheme.
- In contrast to *Madoff II*, where the claims being asserted were duplicative of those settled by the trustee, the claims in the *Madoff III* cases only impacted the BLMIS estate by potentially diverting money that could be collected by the estate, were it to assert actions against the feeder funds itself.
- The trustee attempted to assert that the claims against the feeder funds were stayed by the automatic stay and were, in substance, fraudulent transfer claims which were the sole property of the BLMIS estate. The trustee further argued that the claims against the feeder funds were, again, an attempt to "plead around" the automatic stay and designation as fraudulent transfer claims.
- The Second Circuit rejected the trustee's arguments, holding that the claims asserted by the clients of the feeder funds were distinct from—and therefore not derivative of—the claims of the BLMIS estate. This was so, first and foremost, because the feeder funds owed direct fiduciary duties to their clients that were implicated by the complaints in those cases. The duties owed to the estate and those owed to the feeder fund clients were distinct and, therefore, not derivative.
- Even though the estate could be tangentially impacted by the settlement of these cases because there will be less target money for claims asserted by the estate against the feeder funds, this contingent impact on the estate was insufficient to allow the trustee to stay the litigation against the feeder funds, as it had done in *Madoff II*.

TELEXFREE – BRINGING *MADOFF*'S SIPA CLAIMS INTO THE PURE BANKRUPTCY CONTEXT

- *In re TelexFree, LLC*, No. 18-2001, 941 F.3d 576 (1st Cir. 2019)
- The appeal before the First Circuit in *TelexFree* was from bankruptcy court orders adopted by the United States District Court for the District of Massachusetts arising out of the bankruptcies of TelexFree, LLC; TelexFree, Inc.; and TelexFree Financial, Inc. (collectively, "TelexFree"), who orchestrated one of the largest Ponzi/pyramid schemes in U.S. history.
- Designed to look like a legitimate business, TelexFree was a combination of a Ponzi scheme and a pyramid scheme. Reduced to its essentials, new participants paid previous investors. To generate recoveries for distribution to all net losers, the *TelexFree* trustee brought fraudulent transfer and preference suits against net winners under Sections 547 and 548.
- The dispute in the *TelexFree* case was over who would be allowed to seek to recover payments made by new participants in the scheme to the existing participants who recruited them (the "Contested Funds"). The trustee was attempting to recoup these Contested Funds through avoidance actions, while victims represented by the Plaintiffs' Interim Executive Committee ("PIEC") were asserting unjust enrichment claims to recover the same sums.
- Critically, the trustee originally allowed the PIEC litigation to move forward without issue, as the claims asserted in those cases were against the financial institutions, lawyers, and leaders of the Telexfree scheme. However, when the PIEC litigants asserted claims directly seeking to obtain the Contested Funds from the "net winners"—the same funds sought from the trustee—the trustee sought to intervene, arguing that such claims were derivative of the estate's fraudulent transfer claims.

TELEXFREE – BRINGING *MADOFF*'S SIPA CLAIMS INTO THE PURE BANKRUPTCY CONTEXT

- In its opinion, the First Circuit upheld the lower courts' analysis that the PIEC's unjust enrichment claims were barred by the automatic stay under 11 U.S.C. § 362(a)(3) based on the following findings: (1) that the trustee has standing to bring the avoidance actions because the Contested Funds were "interests of the debtor in property" under 11 U.S.C. §§ 547 and 548; (2) that these avoidance actions were themselves "property of the estate" under 11 U.S.C. § 541; and (3) that the unjust enrichment claims were acts to "obtain" or "control" property of the estate (i.e., the avoidance actions) -- and thus barred by 11 U.S.C. § 362(a) -- because they are "derivative" of the avoidance actions under the analyses set forth in the Second Circuit's *Madoff* cases. The net effect of these rulings was to permit the trustee to pursue the Contested Funds and to stop PIEC's efforts to pursue those funds.
- On appeal, the First Circuit addressed "only arguments that the appellant makes as to why the bankruptcy court erred in ruling that their unjust enrichment claims are stayed pursuant to § 362(a)(3). Those arguments . . . are: (1) that the avoidance action claims are not "property of the estate" within the meaning of that stay provision because the bankruptcy court's 'standing' finding is flawed; and (2) that, in any event, the unjust enrichment claims do not seek to 'obtain' or 'control' the 'property of the estate' within the meaning of that stay provision because those claims are not 'derivative' of the avoidance action claims under the derivative analyses the Second Circuit employed in the Madoff cases."

TELEXFREE – BRINGING *MADOFF*'S SIPA CLAIMS INTO THE PURE BANKRUPTCY CONTEXT

- As to the first argument regarding the alleged lack of standing by the Trustee to sue net winners, the court soundly rejected the theory, stating:

> We affirm the district court's finding that TelexFree had a property interest in the Contested Funds for the purposes of Darr's Avoidance Actions under both §§ 547 and 548, and therefore that Darr has standing to bring his claims. The bankruptcy court carefully evaluated the substance of the TelexFree scheme when it approved the trustee's net equity formula. The formula recognizes that membership fees paid directly to TelexFree -- in which TelexFree indisputably would have had a property interest -- are functionally the same as membership fees that were paid to recruiting participants as part of a triangular transaction. Where membership fees were paid directly to TelexFree, recruiting participants were compensated with credits which, according to the terms of the contract, they could redeem for cash at a later point using money generated largely from membership fees. In the triangular model, new participants gave their membership fees in cash directly to already-recruited participants.
>
> In both situations, participants engaged in a system designed and implemented by TelexFree. New participants knew, or should have known, that the recruiting participant was acting at TelexFree's behest and that the recruiting participant had no authority to let a new participant into the TelexFree scheme unilaterally. On joining the scheme, the new participant received an invoice and user account from TelexFree. Membership in the scheme was governed by a contract that TelexFree wrote. The new participants would have never paid the recruiting participants but for TelexFree's promise that they could join the scheme.

TELEXFREE – BRINGING *MADOFF*'S SIPA CLAIMS INTO THE PURE BANKRUPTCY CONTEXT

- The court also rejected two arguments set forth by PIEC for why the Trustee lacked standing. First, the court rejected the contention that the Trustee could not sue, because the contracts with the company were fraudulent and void *ab initio*. According to the court, the transactions were, "at most," voidable, but not void.
- Second, PIEC took the position that the doctrine of *in pari delicto* barred the Trustee's suits. Again, the First Circuit held otherwise, saying *in pari delicto* "does not defeat [the Trustee's] standing to bring avoidance actions."
- Finally, the court held that the claims brought by PIEC were derivative of the Trustee's claims and thus were barred by the automatic stay:

> This brings us to the issue of whether PIEC's unjust enrichment claims are derivative of Darr's Avoidance Actions and thus an impermissible attempt to obtain possession of or exercise control over Darr's Avoidance Actions in violation of 11 U.S.C. § 362(a)(3). The bankruptcy court ruled the unjust enrichment claims brought by PIEC are derivative of the trustee's Avoidance Actions because they seek to accomplish the same thing as the trustee's actions and to go about it in the same way. That is, PIEC has admitted that the proposed classes' efforts to prove unjust enrichment will not focus on any supposed wrongdoing by individual Net Winners. Rather, PIEC seeks to prove its unjust enrichment case through the overall fraudulent scheme created by TelexFree. That is what the trustee seeks to do. *Id.*