Nos. A12-1930, A12-2092

State of Minnesota

In Supreme Court

Patrick Finn, et al.,
Appellants (A12-2092),
Cross-Respondents (A12-1930),

v.

Alliance Bank,
Cross-Appellant (A12-1930),
Respondent (A12-2092),

Home Federal Bank,
Respondent (A12-2092),

KleinBank,
Respondent (A12-2092),

Merchants Bank N.A.,
Respondent (A12-2092),

M&I Marshall & Ilsley Bank,
Respondent (A12-2092),

American Bank of St. Paul, et al.,
Defendants.

BRIEF OF *AMICUS CURIAE* THE CLEARING HOUSE ASSOCIATION L.L.C. IN SUPPORT OF RESPONDENT BANKS

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The Clearing House Association L.L.C. ("The Clearing House"), respectfully submits this brief as *amicus curiae* in support of the position that payment of antecedent debt may not be avoided under the Minnesota Uniform Fraudulent Transfer Act (the "MUFTA") based upon a "Ponzi scheme presumption."[1]

INTEREST OF AMICUS CURIAE

The Clearing House—the United States' oldest banking association and payments company, owned by the world's largest commercial banks which collectively hold more than half of all U.S. deposits—has a substantial interest in this action because of the precedent that could be set for its member banks with regard to the standards for avoidance of loan repayments.

Members of The Clearing House make or participate in millions of loans. They expect those loans to be repaid pursuant to their terms. If scheduled loan repayments may be avoided as fraudulent based upon a non-evidentiary "Ponzi scheme presumption," that expectation will be crucially undermined. Imposing on a bank the risk that loan repayments may be avoided in circumstances that the bank cannot foresee would inflict unwarranted cost—on banks and on their customers—and undermine the stability of the rules by which the bank lending system operates.

The Clearing House, as *amicus*, urges this Court to reject the use of a "Ponzi scheme presumption" to avoid, as fraudulent, repayments of valid antecedent debt. There

[1] The Clearing House certifies that this brief was not authored in any part by counsel for any party to this appeal and that no other entity contributed monetarily toward its preparation.

is no legal basis for any such presumption, and employing it would undercut settled principles of contract law upon which the banking system is based.

INTRODUCTION

When a loan is extended by a bank, the bank becomes a creditor whose claim is defined by a contract. Unlike equity investors, who are not creditors but participate in upside equity value, lenders have no potential for upside equity value, and their right to repayment does not depend upon the solvency of the borrower. Instead, they have an enforceable contractual right to repayment of principal, and to interest for the use of the borrowed funds, regardless of the borrower's financial status or state of mind. Permitting avoidance of loan repayments as fraudulent based upon a presumption to be applied where the borrower has engaged in a particular type of fraud would upend these settled principles of contract law. There is no basis in Minnesota statutory or common law for disregarding valid contracts based on a "Ponzi scheme presumption."

Proponents of the use of such a presumption justify it as a means by which victims of a Ponzi scheme may be afforded equal treatment. But the objective of fraudulent conveyance laws is not equal treatment, and long-settled Minnesota case law rejects the use of fraudulent conveyance laws to achieve equal treatment by avoiding transfers that are only preferential. No Minnesota law supports the avoidance of the loan repayments at issue in this case.

ARGUMENT

LOAN REPAYMENTS PURSUANT TO CONTRACTUAL TERMS CANNOT BE AVOIDED AS FRAUDULENT

A lender is a creditor. Repayment of a loan pursuant to the terms of a valid agreement is not a fraudulent transfer, because repayment of an antecedent debt is an exchange for value. Minn. Stat. § 513.43(a). The net value of the borrower's assets available for creditors is not depleted, and the objectives of fraudulent conveyance law are not implicated, by such a repayment. Therefore, even were the borrower insolvent, and engaged in a Ponzi scheme, and even if repayment of the loan permitted the Ponzi scheme to continue, the repayment could not be avoided as fraudulent.

There exists no basis under Minnesota statutory or common law for avoidance of the repayment of valid debt. While employment of a "Ponzi scheme presumption" is often supported by reference to the statement of the Supreme Court of the United States in the bankruptcy case of the original Charles Ponzi that "equality is equity," that case involved avoidance of *preferences* under the federal Bankruptcy Code. *See Cunningham v. Brown*, 265 U.S. 1, 7 (1924). *Cunningham* is no precedent for avoidance of a loan repayment as *fraudulent*.

A. Fraudulent Conveyance and Preference Concepts Are Distinct

Avoidance of a transfer as fraudulent is entirely different from avoidance of a transfer as preferential, and a "Ponzi scheme presumption" cannot be employed to elide that difference. Indeed, the United States Supreme Court has cautioned that "[a]n attempt to prefer is not to be confounded with an attempt to defraud, nor a preferential transfer with

a fraudulent one." *Coder v. Arts*, 213 U.S. 223, 241 (1909) (internal quotation marks omitted); *see also Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 54 (2d Cir. 2005) ("'[A] conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another.'" (quoting *Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.*, 599 N.Y.S.2d 816, 191 A.D.2d 86, 90-91 (N.Y. App. Div. 1993))).

Fraudulent transfers reduce the corpus of assets available for payments to creditors, because they are transfers for less than equivalent value. *See, e.g.*, *Shields v. Goldestky (In re Butler)*, 552 N.W.2d 226, 232 (Minn. 1996) (the MUFTA is intended to "prevent debtors from putting property which is available for the payment of their debts beyond the reach of their creditors" (quoting *Kummet v. Thielen*, 210 Minn. 302, 306 (1941)); *see also Nordberg v. Sanchez (In re Chase & Sanborn Corp.)*, 813 F.2d 1177, 1181 (11th Cir. 1987) ("Fraudulent transfers are avoidable because they diminish the assets of the debtor to the detriment of *all creditors*." (emphasis added)).

By contrast, transfers *to creditors* made shortly before a bankruptcy filing are avoidable not because they reduce the value of the debtor's assets available for creditors, but to discourage creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy," and to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." *Union Bank v. Wolas*, 502 U.S. 151, 160-61 (1991) (quoting H.R. Rep. No. 95-595 at 177-78 (1977)).

By definition, a transfer *to a creditor* on account of a valid debt cannot be avoided as fraudulent.

> "[T]he preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because 'the basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them.'" *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634 (2d Cir. 1995) (quoting *Boston Trading Grp., Inc. v. Burnazos*, 835 F.2d 1504, 1509 (1st Cir. 1987)).

Consequently, under Minnesota law, as under other statutes based on the Uniform Fraudulent Transfer Act (the "UFTA"), a transfer to a creditor may not be avoided as either constructively or actually fraudulent if it was made on account of antecedent debt. *See* Minn. Stat. §§ 513.44(a)(2), 513.45(a) (each prohibiting avoidance of a transfer for reasonably equivalent value), 513.48(a) (providing a defense for transferees "who took in good faith and for a reasonably equivalent value"); *see also id.* § 513.43(a) (defining "value" to include the satisfaction of antecedent debt). Indeed, the Legislature has determined that avoidance of a payment on account of antecedent debt is appropriate *only* when a transfer is made to an insider with knowledge of the transferor's insolvency. *See* Minn. Stat. § 513.45(b).[2]

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[2] There is no contention that the repayments in this case were to insiders, or indeed were anything other than routine loan repayments to third-party lenders or participants not alleged to have been complicit:

> "Here, the record establishes that Alliance purchased a participation interest in a loan made by First United to a legitimate borrower and that the borrower repaid First United the loan principal, plus required interest and fees. Moreover, the receiver did not allege in the district court, nor does it argue on appeal, that First United's payments to Alliance depleted First

(...continued)

B. Intent and Insolvency Are Irrelevant Where a Payment Discharges Antecedent Debt

A "Ponzi scheme presumption" can play no role in avoidance of the repayment of valid debt.

As the Court of Appeals ruled, in this case a "Ponzi scheme presumption" is sought to be used to substitute for evidence of either fraudulent intent or insolvency. *Finn*, 838 N.W.2d at 598. But neither is relevant where a debtor has repaid a valid debt. Such a repayment does not deplete the transferor's assets, and therefore the intent and insolvency of the transferor are irrelevant. *See Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 375 (S.D.N.Y. 2003), *aff'd*, 99 F. App'x 274, 281 (2d Cir. 2004) ("[I]t is hornbook law that a conveyance cannot be fraudulent as to creditors if . . . [it] does not deplete or otherwise diminish the value of the assets of the debtor's estate remaining available to creditors." (internal quotation marks and alteration omitted)); *Imperial Elevator Co. v. Bennett*, 127 Minn. 256, 259, 149 N.W. 372, 374 (1914) ("the payment of or securing an honest debt by a debtor is not deemed fraudulent in law, though it operates as a

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(continued...)

> United's assets as envisioned by the court in [*Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)] or the drafters of the UFTA, or that the underlying loan that Alliance participated in was in any way oversold or nonexistent. Further, the receiver does not assert that Alliance lacked good faith when it entered into the loan-participation agreement with First United." *Finn v. Alliance Bank*, 838 N.W.2d 585, 602 (Minn. Ct. App. 2013) (footnote omitted).

Likewise, there is no contention that any participation here provided the participant with anything other than a share of a loan obligation due to First United. *See, e.g.*, *McVay v. W. Plains Serv. Corp.*, 823 F.2d 1395, 1399 (10th Cir. 1987) (holding that participations "lack any of the basic attributes" of equity and citing cases).

preference, and though it does in fact hinder and delay other creditors"); *Mackellar v. Pillsbury*, 48 Minn. 396, 398, 51 N.W. 222, 222 (1892) ("A mere preference by a debtor of one creditor to another is not fraudulent or void at common law, though the preference may have the incidental effect of hindering the latter from the collection of his debt.").

This Court has consistently held that the payment of a valid debt does not defraud other creditors. *See Magnusson v. Am. Allied Ins. Co.*, 282 Minn. 287, 293, 164 N.W.2d 867, 871 (1969) ("[T]he general rule, applied in the absence of statute, [is] that debtors are free to give a creditor preference if they choose to do so."); *Johnson v. O'Brien*, 275 Minn. 28, 31, 144 N.W.2d 720, 722 (1966) ("The fact that the grantor may have intended to give a preference to [certain holders of antecedent debt] is not evidence of an intent to hinder, delay, and defraud creditors[.]" (quoting *Neubauer v. Cloutier*, 265 Minn. 539, 547, 122 N.W.2d 623, 630 (1963))); *Farmers Co-Operative Ass'n of Bertha, Minn. v. Kotz*, 222 Minn. 153, 156, 23 N.W.2d 576, 578 (1946) ("[i]n the absence of legislation forbidding it, a debtor, even though insolvent at the time, may convey his property so as to give one creditor a preference over another" because a preference "does not constitute a 'purpose to hinder, delay or defraud creditors'" or "constitute fraud against general creditors"); *Kray v. Petersen*, 197 Minn. 364, 366, 267 N.W. 144, 145 (1936) ("The law applicable to the facts of the instant case is recognized in every decision, *viz.*, payment of an honest debt is not fraudulent under the general statutes against fraudulent conveyances, although it operates as a preference, the rule being that such preference by an insolvent

debtor can be avoided only under the bankruptcy law."); *Thompson v. Schiek*, 171 Minn. 284, 287, 213 N.W. 911, 912 (1927) (similar).

Other courts have also refused to avoid as fraudulent the repayment of valid antecedent debt because avoidance of such repayments "would tend to deflect fraudulent conveyance law from one of its basic functions (to see that an insolvent debtor's limited funds are used to pay *some* worthy creditor), while providing it with a new function (determining *which* creditor is the more worthy)." *Boston Trading*, 835 F.2d at 1511 (Breyer, J.).

> "To find a lack of 'good faith' where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a kind of 'preference'—concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless." *Id.* at 1512.

In *In re Sharp International Corp.*, *supra*, the Second Circuit adopted now-Justice Breyer's analysis, holding that a transfer on account of valid antecedent debt is not constructively or intentionally fraudulent, regardless of the mental state or intent of the parties at the time of repayment. In *Sharp*, a valid loan was repaid with proceeds that had been fraudulently obtained from other creditors—exactly as in a Ponzi scheme. However, because the payment discharged valid debt, it could not be avoided as a constructive fraudulent transfer. 403 F.3d at 54-55. Nor could it be avoided as an intentional fraudulent transfer:

> "[T]he intentional fraudulent conveyance claims fail[] for the independent reason that Sharp inadequately alleges fraud with respect to the transaction that Sharp seeks to void, *i.e.*, [borrower's] $12.25 million payment to

> [lender]. *See Boston Trading*, 835 F.2d at 1510 ('Fraudulent conveyance law is basically concerned with transfers that hinder, delay or defraud creditors; it is not ordinarily concerned with how such debts were created.') (emphasis omitted).
>
> "The fraud alleged in the complaint relates to the manner in which [borrower] obtained new funding from [other creditors], not [borrower's] subsequent payment of part of the proceeds to [lender]. The $12.25 million payment was at most a preference between creditors and did not 'hinder, delay, or defraud either present or future creditors.' [N.Y. Debtor & Creditor Law] § 276; *cf. HBE Leasing I*, 48 F.3d at 640 (actual intent adequately alleged where the payment in question 'effectively transferred substantial assets from the corporation to [insiders]' with the potential intent of defrauding future judgment creditors)." *Id.* at 56-57.

This reasoning is consistent with prior rulings of this Court and other courts that refuse to avoid as fraudulent the payment of valid debt. *See Johnson*, 275 Minn. at 31-32, 144 N.W.2d at 722 (a conveyance in exchange for fair consideration was a preference and could not be avoided as fraudulent, even though the recipient "was aware of [the transferors'] intent to defraud their creditors"); *HBE Leasing*, 48 F.3d at 634 ("[T]he preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because 'the basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them.'" (quoting *Boston Trading*, 835 F.2d at 1509)); *Scholes v. Lehmann*, 56 F.3d 750, 753 (7th Cir. 1995) ("It is apparent from the wording of the [UFTA], as well as from its purpose, that if a transfer is made for commensurate consideration—if it is 'fair' in the sense of being one side of an equal exchange—it is not voidable. For creditors are not disturbed, delayed,

hindered, or defrauded if all that happens is the exchange of an existing asset of the debtor for a different asset of equal value.").

This logic, and the legal principles upon which it depends, are not altered in Ponzi scheme cases. *See, e.g.*, *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 491 (D. Conn. 2002) (transfers to creditors of a Ponzi scheme who had a contractual right to both principal and profits could not be avoided as fraudulent because "the Debtor received a dollar-for-dollar forgiveness of a contractual debt" in exchange); *Lustig v. Weisz & Assocs., Inc. (In re Unified Commercial Capital, Inc.)*, No. 01-MBK-6004L, 2002 WL 32500567, at *8 (W.D.N.Y. June 21, 2002) (rejecting trustee's effort to claw back profits from "an innocent investor, who has received a bargained-for, contractual interest payment, at a commercially reasonable rate"); *cf. Jobin v. Matthews (In re M&L Bus. Mach. Co.)*, 184 B.R. 136, 141 (D. Col. 1995) (permitting avoidance of transfers within the 90-day pre-petition period *as preferential* to "equalize distribution to creditors" of a Ponzi scheme).

C. No Presumption Can Substitute for a Preference Remedy That Does Not Exist Under Minnesota Law

Presumably because no remedy exists under Minnesota statutory or common law to permit avoidance of a loan repayment that extinguishes antecedent debt owed to a third party, Appellants ask this Court to employ a "Ponzi scheme presumption" as a basis for avoidance of such repayments. But there is no logical or legal basis for their proposal. If a creditor holding a valid contractual debt sued for repayment, the debtor could hardly defend on the grounds that it was insolvent and engaging in a fraud. For the same reason,

a presumption of insolvency and fraudulent intent—even if it were valid, which it is not—has no relevance to repayment of valid antecedent debt, which is a transfer *to a creditor*, *for value*.

The court below properly refused to employ a "Ponzi scheme presumption" as evidence that repayment of a loan according to its terms did not constitute satisfaction of antecedent debt or receipt of reasonably equivalent value. *See Finn*, 838 N.W.2d at 603. The court erred, however, when it held that a "Ponzi scheme presumption" could be employed as evidence of actual intent to defraud on the part of the borrower, *see id.* at 598-99, as evidence of insolvency, *see id.* at 601, and that repayments to the banks put "*property that was otherwise available for the payment of its debts beyond the reach of its creditors*," *id.* at 600 (emphasis added).[3] The court failed to offer any foundation, or explanation, for using a presumption as a substitute for evidence, but more importantly in this case, the court failed to recognize that transfers to the banks were transfers of equivalent value made *to creditors* that by definition did not put property *beyond the reach* of creditors, and insolvency and intent are therefore irrelevant.

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[3] Confusingly, the Court of Appeals suggests that "*mere* preferences, that is, transfers made without fraudulent intent" are immune from avoidance, while preferential transfers made "with the intent to actually defraud a creditor" are voidable as fraudulent. *Finn*, 838 N.W.2d at 600. But the cited cases hold only that a transfer may be preferential to the extent that antecedent debt is repaid, and fraudulent to the extent that more than equivalent value is transferred. *See, e.g.*, *Crookston State Bank v. Lee*, 124 Minn. 112, 113, 144 N.W. 433, 434 (1913) ("a transfer which works a preference may [] at the same time be actually fraudulent as to creditors," to the extent it was in excess of reasonably equivalent value (citing *First Nat'l Bank of Northfield v. Anderson*, 101 Minn. 107, 109, 111 N.W. 947, 947-48 (1907) (discussing property valued at $15,580 exchanged in satisfaction of an $8000 mortgage))).

Appellants similarly err, inviting this Court to conflate the distinct legal principles governing debt obligations and equity interests: "When a transfer is made in furtherance of a Ponzi scheme, there simply are no 'legitimate' funds in excess of the principal invested to include in the transfer, *no matter whether the transferee holds equity, debt, or some other contractual right to payment*." (Appellants' Br. at 37 (emphasis added).) This Court should not accept the invitation. Repayment of debt pursuant to the terms of a valid contract cannot be fraudulent, even if the borrower is insolvent. In stark contrast, where the transferor is insolvent, payment on account of equity is by definition fraudulent because the equity of an insolvent entity has no value.

Consequently, while there is no basis for substituting a "Ponzi scheme presumption" for evidence of insolvency or fraudulent intent, as a matter of law no such presumption can play a role with regard to avoidance of a payment of valid antecedent debt. *See, e.g.*, *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp., LLC)*, 362 B.R. 624, 638 (Bankr. S.D.N.Y. 2007) (contrasting payments based on equity with "the lawful and disclosed payment of a valid contractual antecedent debt").

CONCLUSION

For the reasons stated above, The Clearing House respectfully contends that this Court should rule that no "Ponzi scheme presumption" can be employed under Minnesota law to avoid as fraudulent transfers made on account of valid antecedent debt.

Dated: February 3, 2014

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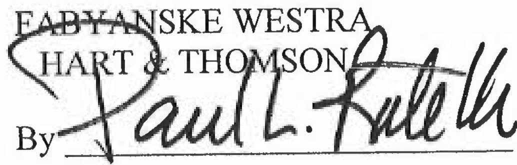

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