Cunningham v. Brown

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Cunningham v. Brown

Case: Cunningham v. Brown (1924)

Subject Category: Pyramid

Agency Involved: Bankruptcy Trustee Suit

Court: U.S. Supreme Court

First Circuit Court of Appeals

D. Massachusetts

Case Synopsis: The Supreme Court was asked to decide if the victims of Charles Ponzi who received payment on their loans just before he was declared insolvent should be forced to disgorge their gains and take a position as an unsecured creditor to his bankrupt estate.

Legal Issue: Should victims of a Ponzi scheme who were paid in advance of a bankruptcy filing have to return the funds received?

Court Ruling: The Supreme Court held that the participants in Charles Ponzi's famous scheme who cashed out just before the schemes collapse had to repay the money received and join others similarly situated as general creditors of his estate. Ponzi solicited participants in his scheme by offering a 150%

return on investment after 45 days of investment. When word got out that the scheme was untenable and after taking in over $9 million in funds, there was a run on the remaining funds of the scheme. Several parties were paid the amounts due to them under Ponzi's terms just before its collapse. Money in Ponzi's accounts consisted of comingled funds of all of his creditors. The Court held that because the participants were unable to directly identify the money that they held a claim to, those who received payment did so unlawfully, and the bankruptcy trustee could demand payment back into the estate for dispersment to the general creditors.

Practical Importance to Business of MLM/Direct Sales/Direct Selling/Network Marketing/Party Plan/Multilevel Marketing:

Cunningham v. Brown , 265 U.S. 1 (1924) : The Supreme Court held that the participants in Charles Ponzi's famous scheme who cashed out just before the schemes collapse had to repay the money received and join others similarly situated as general creditors of his estate. Ponzi solicited participants in his scheme by offering a 150% return on investment after 45 days of investment. When word got out that the scheme was untenable and after taking in over $9 million in funds, there was a run on the remaining funds of the scheme. Several parties were paid the amounts due to them under Ponzi's terms just before its collapse. Money in Ponzi's accounts consisted of comingled funds of all of his creditors. The Court held that because the participants were unable to directly identify the money that they held a claim to, those who received payment did so unlawfully, and the bankruptcy trustee could demand payment back into the estate for dispersement to the general creditors.

CUNNINGHAM v. BROWN

265 U.S. 1 (1924)

CUNNINGHAM, TRUSTEE OF PONZI,

v.

BROWN ET AL.

No. 213.

Supreme Court of United States.

Argued March 12, 1924.

Decided April 28, 1924.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

Mr. Edward F. McClennen, with whom *Mr. William R. Sears* and *Mr. Clarence M. Gordon* were on the brief, for petitioner.

Mr. John H. Devine, with whom *Mr. Walter A. Buie, Mr. Edward A. Counihan, Jr.,* and *Mr. Joseph P. Dexter* were on the brief, for Crockford, Murphy and Holbrook, respondents.

Mr. Louis Goldberg for Brown, respondent.

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MR. CHIEF JUSTICE TAFT delivered the opinion of the Court.

These were six suits in equity brought by the trustees in bankruptcy of Charles Ponzi to recover of the defendants sums paid them by the bankrupt within four months prior to the filing of the petition in bankruptcy, on the ground that they were unlawful preferences. All the trustees have died or resigned pending the litigation, and Cunningham, having been substituted for the last survivor, is now the sole trustee. The actions were tried together in the District Court, and were argued together in the Circuit Court of Appeals, and all the bills were dismissed in both courts. The facts and defenses are the same in all the cases, except that, in that of Benjamin Brown, there was an additional defense that he was a minor when the transactions occurred. We have brought the cases into this Court by writ of certiorari.

The litigation grows out of the remarkable criminal financial career of Charles Ponzi. In December, 1919, with a capital of $150, he began the business of borrowing money on his promissory notes. He did not profess to receive money for investment for account of the lender. He borrowed the money on his credit only. He spread the false tale that on his own account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100 per cent. profit, and that this was made possible by the excessive differences in the rates of exchange following the war. He was willing, he said, to give others the opportunity to share with him this profit. By a written promise in ninety days to pay them $150 for every $100 loaned, he induced thousands to lend him. He stimulated their avidity by

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paying his ninety-day notes in full at the end of forty-five days, and by circulating the notice that he would pay any unmatured note presented in less than forty-five days at 100% of the loan. Within eight months he took in $9,582,000 for which he issued his notes for $14,374,000. He paid his agents a commission of 10 per cent. With the 50 per cent. promised to lenders, every loan paid in full with the profit would cost him 60 per cent. He was always insolvent and became daily more so, the more his business succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes.

The defendants made payments to Ponzi as follows:

Benjamin Brown, July 20th $600

Benjamin Brown, July 24th 600

H.W. Crockford, July 24th 1,000

Patrick W. Horan, July 24th 1,600

Frank W. Murphy, July 22nd 600

Thomas Powers, July 24th 500

H.P. Holbrook, July 22nd 1,000

By July 1st, Ponzi was taking in about one million dollars a week. Because of an investigation by public authority, Ponzi ceased selling notes on July 26th, but offered and continued to pay all unmatured notes for the amount originally paid in, and all matured notes which had run forty-five days, in full. The report of the investigation caused a run on Ponzi's Boston office by investors seeking payment and this developed into a wild scramble when, on August 2nd, a Boston newspaper, most widely circulated, declared Ponzi to be hopelessly insolvent, with a full description of the situation written by one of his recent employees. To meet this emergency, Ponzi concentrated all his available money from other banks in Boston and New England in the Hanover Trust Company, a banking concern in Boston, which had been his chief depository. There was no evidence of any general

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attempt by holders of unmatured notes to secure payment prior to the run which set in after the investigation July 26th.

The money of the defendants was paid by them between July 20th and July 24th and was deposited in the Hanover Trust Company. At the opening of business July 19th, the balance of Ponzi's deposit accounts at the Hanover Trust Company was $334,000. At the close of business July 24th it was $871,000. This sum was exhausted by withdrawals of July 26th of $572,000, of July 27th of $288,000, and of July 28th of $905,000, or a total of more than $1,765,000. In spite of this, the account continued to show a credit balance because new deposits from other banks were made by Ponzi. It was finally ended by an overdraft on August 9th of $331,000. The petition in bankruptcy was then filed. The total withdrawals from July 19th to August 10th were $6,692,000. The claims which have been filed against the bankrupt estate are for the money lent and not for the 150 per cent. promised.

Both courts held that the defendants had rescinded their contracts of loan for fraud and that they were entitled to a return of their money, that other dupes of Ponzi who filed claims in bankruptcy must be held not to have rescinded, but to have remained creditors, so that what the latter had paid in was the property of Ponzi, that the presumption was that a wrongdoing trustee first withdrew his own money from a fund mingled with that of his *cestui que trustent,* and therefore that the respective deposits of the defendants were still in the bank and available for return to them in rescission, and that payments to them of these amounts were not preferences but merely the return of their own money.

We do not agree with the courts below. The outstanding facts are not really in dispute. It is only in the interpretation of those facts that our difference of view arises.

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In the first place, we do not agree that the action of the defendants constituted a rescission for fraud and a restoration of the money lent on that ground. As early as April, his secretary testifies, Ponzi adopted the practice of permitting any who did not wish to leave his money for forty-five days to receive it back in full without interest, and this was announced from time to time. Two of the defendants expressly testified to this. It was reiterated in the public press in July and by the investigating public authorities. There is no evidence that these defendants were consciously rescinding a contract for fraud. Certainly Ponzi was not returning their money on any admission of fraud. The lenders merely took advantage of his agreement to pay his unmatured notes at par of the actual loan. Such notes were paid under his agreement exactly as his notes which were matured were paid at par and 50 per cent. The real transaction between him and those who were seeking him is shown by the fact that there were five hundred to whom he gave checks in compliance with his promise and who were defeated merely because there were no more funds.

The District Court found that when these defendants were paid on and after August 2nd, they had reason to believe that Ponzi was insolvent. The statute, § 60b of the Bankruptcy Act, as amended June 25, 1910, c. 412, 36 Stat. 838, 842, requires that, in order that a preference should be avoided, its beneficiary must have reasonable cause to believe that the payment to him will effect a preference, that is that the effect of the payment will be to enable him to obtain a greater percentage of his debt than others of the creditors of the insolvent of the same class. The requirement is fully satisfied by the evidence in this case, no matter where the burden of proof. On the morning of August 2nd, when news of Ponzi's insolvency was broadly announced, there was a scramble and

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a race. The neighborhood of the Hanover Bank was crowded with people trying to get their money and for eight days they struggled. Why? Because they feared that they would be left only with claims against the insolvent debtor. In other words, they were seeking a preference by their diligence. Thus they came into the teeth of the Bankrupt Act and their preferences in payment are avoided by it.

But even if we assume that the payment of these unmatured notes was not according to the contract with Ponzi and that what the defendants here did was a rescission for fraud, we do not find them in any better case. They had one of two remedies to make them whole. They could have followed the money wherever they could trace it and have asserted possession of it on the ground that there was a resulting trust in their favor, or they could have established a lien for what was due them in any particular fund of which he had made it a part. These things they could do without violating any statutory rule against preference in bankruptcy, because they then would have been endeavoring to get their own money, and not money in the estate of the bankrupt. But to succeed they must trace the money and therein they have failed. It is clear that all the money deposited by these defendants was withdrawn from deposit some days before they applied for and received payment of their unmatured notes. It is true that by the payment into the account of money coming from other banks and directly from other dupes the bank account as such was prevented from being exhausted; but it is impossible to trace into the Hanover deposit of Ponzi after August 1st, from which defendants' checks were paid, the money which they paid him into that account before July 26th. There was, therefore, no money coming from them upon which a constructive trust, or an equitable lien could be fastened. *Schuyler* v. *Littlefield,*232 U.S. 707; *In re*

Mulligan, 116 Fed. 715; *In re Matthews' Sons,* 238 Fed. 785; *In re Stenning* (1895), 2 Ch. 433. In such a case, the defrauded lender becomes merely a creditor to the extent of his loss and a payment to him by the bankrupt within the prescribed period of four months is a preference. *Clarke* v. *Rogers,*228 U.S. 534; *In re Dorr,* 196 Fed. 292; *In re Kearney,* 167 Fed. 995.

Lord Chancellor Eldon, in *Clayton's Case* (1816 Ch.), 1 Merivale, 572, held that, in a fund in which were mingled the moneys of several defrauded claimants insufficient to satisfy them all, the first withdrawals were to be charged against the first deposits and the claimants were entitled to be paid in the inverse order in which their moneys went into the account. Ponzi's withdrawals from his account with the Hanover Trust Company on July 26, 27 and 28, were made before defendants had indicated any purpose to rescind. Ponzi then had a defeasible title to the money he had received from them and could legally withdraw it. By the end of July 28th, he had done so and had exhausted all that was traceable to their deposits. The rule in *Clayton's Case* has no application.

The courts below relied on the rule established by the English Court of Appeals in *Knatchbull* v. *Hallett,* L.R. 13 Ch. D. 696, in which it was decided by Sir George Jessel, Master of the Rolls, and one of his colleagues, that where a fund was composed partly of a defrauded claimant's money and partly of that of the wrongdoer, it would be presumed that in the fluctuations of the fund it was the wrongdoer's purpose to draw out the money he could legally and honestly use rather than that of the claimant, and that the claimant might identify what remained as his *res* and assert his right to it by way of an equitable lien on the whole fund, or a proper *pro rata* share of it. *National Bank* v. *Insurance Co.,*104 U.S. 54, 68; *Hewitt* v. *Hayes,* 205 Mass. 356. To make the rule applicable here, we must infer that in the deposit and withdrawal

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of more than three millions of dollars between the deposits of the defendants prior to July 28th, and the payment of their checks after August 2nd, Ponzi kept the money of defendants on deposit intact and paid out only his subsequent deposits. Considering the fact that all this money was the result of fraud upon all his dupes, it would be running the fiction of *Knatchbull* v. *Hallett* into the ground to apply it here. The rule is useful to work out equity between a wrongdoer and a victim; but when the fund with which the wrongdoer is dealing is wholl made up of the fruits of the frauds perpetrated against a myriad of victims, the case is different. To say that, as between equally innocent victims, the wrongdoer, having defeasible title to the whole fund, must be presumed to have distinguished in advance between the money of those who were about to rescind and those who were not, would be carrying the fiction to a fantastic conclusion.

After August 2nd, the victims of Ponzi were not to be divided into two classes, those who rescinded for fraud and those who were relying on his contract to pay them. They were all of one class, actuated by the same purpose to save themselves from the effect of Ponzi's insolvency. Whether they sought to rescind, or sought to get their money as by the terms of the contract, they were, in their inability to identify their payments, creditors and nothing more. It is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt law. Those who were successful in the race of diligence violated not only its spirit but its letter and secured an unlawful preference.

We do not see that a minor whose money could not be identified is in a better situation than that of the other defendants. Like them, on August 2nd, he was only a creditor of Ponzi, and was moved to avoid insolvency by a preference just as they were. A minor is not exempt

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from the defeat of an unlawful preference by § 60b of the Bankruptcy Act as amended.

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