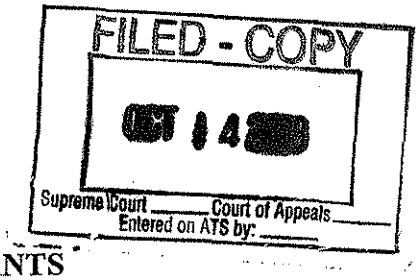
10-14-2008

Christian v. Mason Appellant's Reply Brief Dckt. 35331

IN THE SUPREME COURT OF THE
STATE OF IDAHO

JERRY CHRISTIAN and JOY CHRISTIAN, husband and wife, Plaintiffs/Appellants, vs. DAVID MASON, Defendant/Respondent.	)	**Supreme Court Case No. 35331**



REPLY BRIEF OF APPELLANTS

On Appeal from the District Court of the Seventh Judicial
District of the State of Idaho, in and for the County of Bonneville

The Honorable Jon J. Shindurling, District Judge, Presiding

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I. Introduction.

The issue in this case is whether appellants the Christians had a right to pursue a fraudulent transfer claim against respondent Mason to recover funds transferred to Mason by Robert McClung, in excess of the amounts provided by Mason to McClung during McClung's operation of a Ponzi scheme. The undisputed facts establish that fraudulent transfers occurred. The district court ruled that the fraudulent transfer claim was preempted by federal bankruptcy law, and dismissed the Christians' complaint. In their opening brief, the Christians established that once the trustee's ability to commence an avoidance action expired, other creditors such as the Christians were free to pursue their own fraudulent transfer claims against third party transferees such as Mason, and the district court erred. Mason argues that the trustee had the right to act until the expiration of the UFTA statute of limitations, such that the trustee owned the fraudulent transfer claim against Mason until it was expired as to all creditors. As explained below, this ignores the restriction on the trustee's ability to act under 11 U.S.C. § 546(a). The cases Mason cites actually support the Christians. Mason also repeats his arguments from below that the money he received from McClung actually belonged to his father, and that last amounts he received were "return of principal" and not fraudulent transfers. Again, the cases Mason cites actually support the Christians, and Mason admits the material facts establishing that he is liable under the UFTA. Summary judgment should have been granted to the Christians, not Mason.

II. Argument and authority.

A. Mason's argument that the bankruptcy trustee had the right to pursue a fraudulent transfer claim during the entire limitation period under the UFTA ignores the restriction on the trustee's ability to act contained in 11 U.S.C. § 546(a).

Mason does not dispute the district court's finding that he received $32,873.12 more from McClung than he gave to McClung. It is also undisputed that Mason received that excess amount in the three payments he received from McClung within four years of the date the Christians filed suit against Mason to avoid McClung's fraudulent transfer.[1]

Mason's main argument is essentially that the trustee in bankruptcy had the same four-year limitations period under the UFTA in which to file an action to avoid McClung's fraudulent transfers, and that as a result no creditor other than the trustee could ever pursue a fraudulent transfer claim against McClung's transferees. Mason cites no authority directly in support of this assertion. He omits any discussion of 11 U.S.C. § 546(a), which (at the time of McClung's bankruptcy filing) required the trustee to bring an action to avoid a transfer by McClung, whether under state law or under federal law, no later than either two years after McClung's April 16, 2003 bankruptcy petition (i.e., April 16, 2005), or one year after the first appointment of a trustee in the bankruptcy on April 17, 2003 (i.e., April 17, 2004). Christians did not file suit until well over a year after the trustee's ability to act had been lost pursuant to 11 U.S.C. § 546(a).

Mason confuses the statute of limitations under the UFTA – four years from the date of the transfer – with the time limit imposed by 11 U.S.C. § 546(a) for a trustee in bankruptcy to commence an avoidance action under 11 U.S.C. § 544 following the commencement of a bankruptcy proceeding. The fact that § 544 permits the trustee to proceed under state law does nothing to change the requirement under § 546(a) that the trustee act within its time limits. This is so because the Trustee's standing to act at all is a creature of federal law, made possible by 11 U.S.C. § 544. E.g., In re Hammer, 2007 Bankr. LEXIS 3359, *4-*5 (W.D. Wa.) ("Section 546(a) limits the time in which a trustee can assert an avoidance action, including an avoidance action under section 544(b). Although a trustee's claim may arise under a state fraudulent conveyance statute, as in the instant case, the trustee's standing to assert that claim only arises by virtue of section 544(b) on the petition date. When the petition is filed, the trustee is authorized to evaluate potential fraudulent transfers and, within the limits of section 546(a), bring a cause of action for avoidance.").

Thus, the trustee's ability to pursue an avoidance claim may be lost either because: (a) the four year statute of limitations under the UFTA expires before the bankruptcy petition is filed or the trustee is appointed; or (b) the time for the trustee to act under § 546(a) has passed, even though the UFTA limitations period has not yet expired. In the latter case (as here), individual creditors are then free to pursue UFTA claims against third party transferees, for transfers occurring within the UFTA statute of limitations. Klingman v. Levinson, 158 B.R.

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[1] As previously noted, Christians filed suit against Mason on July 20, 2006. CR 4. Mason received the excess amounts from McClung in payments dated July 22, 2002, July 29, 2002, and October 2, 2002. CR 27, 49, 66, 68, 86.

109 (N.D. Ill. 1993); In re Integrated Agri, Inc., 313 B.R. 419, 427-428 (C.D. Ill. 2004) ("The landscape changes, however, once it is determined that the Trustee's claim is no longer viable. A creditor regains standing to pursue a state law fraudulent conveyance action, in its own name and for its own benefit, once the statute of limitations expires on the bankruptcy trustee's right to bring the claim. . . . At that point, the bankruptcy court ordinarily would have no jurisdiction to hear the creditor's suit to recover from a third party transferee and the suit must be filed or revived in a non-bankruptcy forum.")[2]; 4 Collier on Bankruptcy, § 546.02(1)(b) (15th ed. 1989) ("If the state law limitations period governing a fraudulent transfer action has not expired at the commencement of a bankruptcy case, the trustee may bring the action pursuant to section 544(b), provided that it is commenced within the section 546(a) limitations period."); In re Ahead By a Length, Inc., 100 B.R. 157, 164 (Bankr. S.D.N.Y. 1989) (holding that to sue successfully under § 544(b), "the trustee must have commenced suit within two years of her appointment ... on a cause of action which was viable under applicable law on the date that the bankruptcy petition was filed").[3]

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[2] This is exactly what happened here; after the trustee in McClung's bankruptcy failed to act within the time allowed by 11 U.S.C. § 546(a), the Christians sued Mason in state court under Idaho's version of the UFTA.

[3] These decisions also make clear that the automatic stay under 11 U.S.C. § 362 is not relevant; once the trustee has failed to act within the allotted time under § 546(a), a creditor's suit against a *third party transferee* (not against the debtor) does not relate to property of the bankruptcy estate, and the automatic stay does not apply. It is the *claim*, while it remains viable under § 546(a), which belongs to the bankruptcy estate; the fraudulently transferred property does not become property of the bankruptcy estate until (and if) it is recovered by the trustee. See 11 U.S.C. § 541(a)(3) (providing that an "interest in property that the trustee *recovers*" becomes property of the estate). Thus, once the trustee's claim is extinguished by the passage of the time allowed under § 546(a), a creditor's claim against a third party to recover fraudulently transferred property is not affected by the bankruptcy.

There is no authority for the proposition that the state UFTA statute of limitations extends the trustee's time to commence an avoidance action beyond that allowed under § 546(a) – a result which would effectively have state law preempting federal law in the bankruptcy arena. Rather, as the Christians discussed at length in their opening brief, the authority is directly to the contrary.

Mason completely ignores 11 U.S.C. § 546(a), and he mischaracterizes Klingman v. Levinson, 158 B.R. 109 (N.D. Ill. 1993), as holding that the trustee's right to act expires only when the bankruptcy closes. In fact, § 546(a) clearly provides that the trustee's right expires at the *earlier* of (a) two years from the petition or one year from the appointment of a trustee; or (b) closure of the bankruptcy proceeding. The district court in Klingman recognized as much and stated that (as to the version of § 546(a) then in effect): "The trustee's right to bring an action to recover a fraudulent conveyance is subject to the time limitations of 11 U.S.C. § 546(a), which limits the trustee to the earlier of two years after his appointment or the time the case is closed or dismissed." 158 B.R. at 113 n. 3. Mason's characterization is wrong. Notably, he does not discuss any of the other authority on point referenced by the Christians.

The decisions cited by Mason do support his argument. The cases he cites for the proposition that "a trustee can pursue fraudulent conveyances under state law" (Respondents' Brief, p. 4) do *not* hold that state law preempts or extends the time limits for action by the trustee contained in 11 U.S.C. § 546(a). They state no more than the fact that a trustee may avoid fraudulent transfers either under the bankruptcy code (11 U.S.C. § 548) or under state law (as provided in 11 U.S.C. § 544(b)). See Donnell v. Kowell, 533 F.3d 762, 775 n. 7 (9th Cir. 2008);

In re United Energy Corp., 944 F.2d 589, 593 (9th Cir. 1991). The court in In re Slatkin, 243 Fed. Appx. 255, 258 (9th Cir. 2007) actually recognized that § 546(a) only "provides a trustee with *up to two years* in which to commence an action against a fraudulent transfer." Mason's argument is contrary to both 11 U.S.C. § 546(a) and the cases he relies upon.

Similarly, Mason's assertion that the bankruptcy trustee "has the ability to use different causes of action which in turn allows for different statutes of limitation," such that the trustee "also has the ability to use Idaho's longer statute of limitation" is not supported by decisions he cites for that proposition. See Respondent's Brief, p. 6. In re Avi, Inc., 389 B.R. 721 (9th Cir. BAP 2008) involved only the question of whether a trustee could avoid a subsequent transfer without first avoiding the initial fraudulent transfer by the debtor. It contains no discussion of the application of § 546(a). It is inapposite. In Heaper v. Brown, 214 B.R. 576 (8th Cir. BAP 1997), the court held only that Missouri's newly-enacted version of the UFTA did not apply retrospectively. It did not discuss the application of 11 U.S.C. § 546, probably because the trustee filed a complaint to avoid a fraudulent transfer of the debtor the same year as the debtor filed for bankruptcy protection, i.e., within the time required by § 546(a). Heaper is inapposite. Again, Mason's argument misses the distinction between the limitations period for a *claim* under the UFTA, and the restriction on the *trustee's* ability to commence an action to assert such a claim, contained in 11 U.S.C. § 546(a).[4]

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[4] Mason's argument that there is no evidence the trustee "abandoned" its right to assert a fraudulent transfer claim (Respondent's Brief, p. 6) again misses the point – the trustee had to act within the time provided in 11 U.S.C. § 546(a), or it would no longer have a viable claim. Its failure to act within the required time is the equivalent of an affirmative abandonment.

Following the lapse of time allowed under 11 U.S.C. § 546(a) for the bankruptcy trustee to commence an action to avoid McClung's fraudulent transfers – whether under federal law or under Idaho's version of the UFTA – individual creditors, including the Christians, became free to pursue UFTA claims against excess transferees such as Mason. Klingman, supra; In re Integrated Agri, Inc., supra. The district court's decision to the contrary was error.[5]

B. This Court may direct entry of summary judgment to the Christians, where the parties cross-moved for summary judgment below and the material facts are undisputed.

Mason initially asserts that the district court's ruling constitutes an unreviewable denial of Christians' motion for summary judgment. In fact, this court has vacated summary judgment for one party and directed entry of summary judgment for the other, where the material facts were undisputed and judgment as a matter of law was appropriate. E.g., Hieb v. Mitchell, 117 Idaho 1075, 1079 (1990); Pocatello R.R. Fed. Credit Union v. Dairyland Ins. Co., 129 Idaho 444, 447 (1996); Sublimity Ins. Co. v. Shaw, 127 Idaho 707, 709 (1995). This is such a case. The material facts are undisputed: Mason admitted in his complaint that McClung operated a Ponzi scheme in which he was a participant, and has admitted through course of the proceedings below and again in this court that he was an initial transferee from McClung in the amount of

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[5] Mason also apparently asserts that because Jerry Christian participated in the unsecured creditor's committee in McClung's bankruptcy, he was required to force the trustee to act within the time required by 11 U.S.C. § 546(a). There is no authority for this proposition. Likewise, Mason's assertion that the Christians "took intentional steps to appropriate the cause of action for themselves" is baseless; the Christians did not pursue their fraudulent transfer claim against Mason until a year after the trustee had lost the ability to do so and any creditor of McClung was free to pursue the funds fraudulently transferred to Mason. The equities do not favor Mason keeping other investors' money. As the Ninth Circuit panel stated in the decision mainly relied upon by Mason: "We see nothing inequitable in the effort to mitigate the losses suffered by other innocent investors." Donnell, 533 F.3d at 776.

$32,873.12 in excess of the principal amount he provided to McClung. He has admitted below and here that all of the excess transfers to him occurred within the four year limitation period under the UFTA. He has admitted that the Christians are judgment creditors of McClung in an amount far exceeding the amount of the excess transfers to him. Under these undisputed material facts, Christians are entitled to summary judgment.

C. Mason has admitted that he is the first transferee of excess funds from McClung, and whether the funds were subsequently transferred to his father is irrelevant for purposes of Mason's liability under the UFTA.

Literally in the first two sentences of his argument that the excess funds at issue belong to his father, Mason admits that he is nevertheless liable to Christians for McClung's transfer of the money to him. He first acknowledges that "Idaho law allows recovery against 'the first transferee of the asset'. . ." under I.C. § 55-917(2)(a), and in the next sentence admits that "Mason was the payee on the checks" from McClung. Respondent's Brief, p. 10. I.C. § 55-917(2)(a) provides that where a transfer is avoidable, judgment may be entered against "The first transferee of the asset *or* the person for whose benefit the transfer was made" (emphasis added). This means that the Christians had the option, but were not required, to seek judgment against Mason's father. On its face § 917(2)(a) allows them to obtain judgment against the initial transferee, which Mason admits is him.

The Christians also set forth in their opening brief the undisputed facts establishing that Mason was the transferee from McClung. Whether Mason owed the money to

his father is irrelevant. Because Mason was the first transferee of the funds from McClung, the Christians are entitled to judgment against him.

D. All amounts that Mason received from McClung in excess of what he "invested" in the Ponzi scheme are recoverable fraudulent transfers, as there are no "earnings" in a Ponzi scheme to trace or account for, and there is no reasonably equivalent value given for the excess transfers.

Mason repeats his argument from below that the first amounts he received from McClung were "earnings," and last amounts transferred to him during the limitation period were a "return of principal" and therefore not fraudulent transfers. This argument is unsupported by authority. The decisions Mason cites recognize that the opposite is true -- that because a Ponzi scheme by definition does not produce real "earnings" but is merely a shell game in which different victims' funds are passed around by the perpetrator of the scheme, *any* amounts received back by a victim up to his initial outlay are restitution, and once the victim has received back that initial outlay, any amount he receives from the perpetrator thereafter is a fraudulent transfer. Because there are no actual "earnings," Mason's argument that the first transfers from McClung were not return of principal but were payment of earnings is factually unsupported and incorrect.

The decision Mason mainly relies upon actually supports the Christians. In Donnell v. Kowell, 533 F.3d 762 (9th Cir. 2008), a Ninth Circuit panel recently explained exactly the point set forth above. The panel expressly rejected essentially the same argument Mason attempts here. Its reasoning is instructive and directly persuasive, thus it is quoted here at length.

First, the panel acknowledged that payments back to a Ponzi scheme victim up to the amount of the victim's outlay to the perpetrator are not "return of principal," but are restitution to the victim:

> Payments of amounts up to the value of the initial investment are not, however, considered a "return of principal," because the initial payment is not considered a true investment. Rather, investors are permitted to retain these amounts because they have claims for restitution or rescission against the debtor that operated the scheme up to the amount of the initial investment. Payments up to the amount of the initial investment are considered to be exchanged for "reasonably equivalent value," and thus not fraudulent, because they proportionally reduce the investors' rights to restitution. *United Energy,* 944 F.2d at 595. If investors receive more than they invested, "[p]ayments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity."

533 F.3d at 772. Thus, the panel held, the trustee in the case before it could "presume that *the earliest payments received by the investor are payments against the investor's claim for restitution. Transfers in excess of that amount, made within the statute of limitations, are avoidable as fraudulent conveyances.*" Id. at 774 (emphasis added). The panel then reiterated that purported payments of "profits" from Ponzi scheme operators are merely payments of restitution to a victim of the scheme, up to the amount of the victim's initial outlay, and explained that payments beyond this amount are *not* a reasonably equivalent exchange for the victim's initial outlay:

> Payouts of "profits" made by Ponzi scheme operators are not payments of return on investment from an actual business venture. Rather, they are payments that deplete the assets of the scheme operator for the purpose of creating the appearance of a profitable business venture. . . . The appearance of a profitable business

> venture is used to convince early investors to "roll over" their investment instead of withdrawing it, and to convince new investors that the promised returns are guaranteed. . . . Up to the amount that "profit" payments return the innocent investor's initial outlay, these payments are settlements against the defrauded investor's restitution claim. Up to this amount, therefore, there is an exchange of "reasonably equivalent value" for the defrauded investor's outlay. Amounts above this, however, are merely used to keep the fraud going by giving the false impression that the scheme is a profitable, legitimate business. These amounts are not a "reasonably equivalent" exchange for the defrauded investor's initial outlay.
>
> In this case, Kowell never actually possessed an interest in a company purchasing account receivables from Malaysian glove manufacturers. The investment strategy promised by Wallenbrock's officers was a lie to induce Kowell and investors like him to fund Wallenbrock. What Wallenbrock did was return to Kowell *his own money, plus money from subsequent* "investors," to persuade Kowell to continue to invest and to secure testimonial evidence from people like Kowell to induce others to invest. Although Kowell was putting real money into Wallenbrock, and was getting what looked like real profits in return, in fact he never received "reasonably equivalent value" for his investment, just cash that was moved around in an elaborate shell game.

Id. at 777-778 (emphasis added; citations omitted).

The Ninth Circuit panel's analysis applies here. Mason's attempted characterization of the first payments to him as "earnings" is based on fiction, not fact. What McClung returned to Mason initially was his own money, and what he returned to Mason after that was other investors' money "moved around in an elaborate shell game," i.e., a fraudulent transfer. Mason has long since admitted in response to the Christians' Complaint that McClung carried on a Ponzi scheme, and that the "gains" paid to victims were "fictitious." CR 5-6 (Complaint); CR 22 (Answer). Those payments of fictitious "earnings" to Mason totaling were

essentially payments toward his restitutions claim against McClung. Once Mason received that total back from McClung he was fully compensated, and any additional amounts he received were fraudulent transfers. Mason does not dispute that the amounts paid to him within the UFTA limitations period include all amounts exceeding what he paid to McClung.

E. Mason is not entitled to a fee award.

Mason requests an award of attorney's fees. He does not cite a statute or rule in support of the request. The decision he cites deals with a fee award under I.C. § 12-121, which allows for an award of fees in response to a frivolous action. He relies on the portion of the decision referring to appeals which merely ask this court to second guess the district court's view of conflicting evidence. It has no application here, where the material facts are undisputed, the Christians' appeal deals largely with the district court's decision on a matter of law regarding the effect of McClung's bankruptcy on this case, and its decision is contrary to both the Bankruptcy Code and the weight of case law on the subject. A fee award is not appropriate in this case.

III. Conclusion.

The material facts are undisputed, and under those facts the Christian are entitled to judgment as a matter of law. The district court's decision should be reversed with direction to enter summary judgment in the Christians' favor.

Dated this 14th day of October, 2008.

MARCUS, CHRISTIAN & HARDEE, LLC

By _____
Michael Christian
Attorneys for Plaintiff/Respondent

CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of October, 2008, I caused to be served a true and correct copy of the foregoing **REPLY BRIEF OF APPELLANTS** in the above-referenced matter by the method indicated below, and addressed to the following:

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