# The Application of Federal Common Law to Overcome Conflicting State Laws in the Supplemental Disgorgement Proceedings of an SEC Appointed Receiver

*Gauhar Naseem*[†]



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[†] This paper stems from work the author was involved in as a summer intern with the law firm of DurretteBradshaw, P.L.C. located in Richmond, Virginia. I would like to acknowledge and thank Mr. Douglas Scott, who conducted the research on choice-of-law, and Mr. John Smith for their general guidance and support during my employ with the great people at DurretteBradshaw. I would also like to thank Professor Michael Collins, without whose direction this article could not have been produced, and Professor John Paul Jones, for devoting his limited and valuable time during the editing process. Additionally, credit is due to Emily Heanselman who assisted me in the research on the law of Ponzi schemes. As always, my success is due to the love and devotion of my parents, who never stopped believing in me. I would also like to thank Eugene Pickel, who taught me how to believe in myself. Most importantly, I would like to thank my wife, Mona, without whom I would still be wandering aimlessly.

## INTRODUCTION

In spite of the *Erie* doctrine, federal common law is still applied to decide conflicting state laws in diversity actions where a federal law, interest, or function is implicated.[1] A federal court's authority to substantively implement a federal common law rule over state law is most clear when the party to the action is a federal entity: an agency of the U.S. Government deriving its authority from the Constitution or some source of federal law.[2] Analyzing a federal court's authority to apply common law becomes more difficult where parties to a diversity lawsuit are private citizens seeking to have federal common law adopted to displace state law. While the application of federal common law in private diversity actions has been held to be proper by the Supreme Court in certain cases,[3] the analysis and justification for doing so has remained relatively unclear.[4]

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[1] *See, e.g.*, Clearfield Trust Co. v. United States, 318 U.S. 363 (1943) (finding that when the United States "disburses its funds or pays its debts, it is exercising a constitutional function or power" that "[has] its origin[s] in the Constitution and the statutes of the United States" and holding that "[i]n absence of an applicable Act of Congress it is for the federal courts to fashion the governing rule of law according to their own standards."); *see also* United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979) (holding that "[t]he SBA and FHA unquestionably perform federal functions within the meaning of *Clearfield*. Since the agencies derive their authority . . . from specific Acts of Congress passed in exercise of a 'constitutional function or power,' their rights, as well, should derive from a federal source." (citation omitted)).

[2] *See supra* note 1.

[3] *See, e.g.*, Boyle v. United Techs. Corp., 487 U.S. 500 (1988) (allowing private contractor to assert "military contractor defense" under federal common law to displace state products liability law); Hinderlider v. La Plata River, 304 U.S. 92 (1938) (allowing adoption of federal common law to apportion interstate water rights).

[4] *Compare* Bank of Am. Nat'l Trust v. Parnell, 352 U.S. 29 (1956) (denying the adoption of federal common law among private litigants where effect on federal interest was considered too "speculative" and "remote."), *and* Miree v. DeKalb County, 433 U.S.

As a result, federal courts are left with limited guidance as to when the application of federal common law is proper in adjudications between private parties. Furthermore, a federal court's authority to hear disputes among diverse citizens is not limited to actions where the court derives its jurisdiction from 28 U.S.C. § 1332, which makes analysis in certain situations even more problematic. Under 28 U.S.C. § 1367, federal courts have special authority to hear actions that are ancillary or supplemental to a federal court's original jurisdiction over cases involving federal claims or federal questions.[5] The Supreme Court has never directly addressed what the proper application of federal common law should be, or whether application would be proper at all in the novel situation where a federal court is exercising ancillary or supplemental jurisdiction between private litigants under 28 U.S.C. § 1367.

It would seem appropriate to allow the substantive application of federal common law where the federal government is a party to an action in such ancillary proceedings. The Supreme Court has clearly provided justification for doing so where the authority of the governmental agency or entity flows from the Constitution or some federal source of law whereby the action itself furthers some federal purpose.[6] However, it is

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25 (1977), *with Boyle*, 487 U.S. at 513 (finding "significant conflict" between state law and federal interest to warrant adoption of federal common law among private litigants). *See also* ROBERT N. CLINTON, RICHARD A. MATASAR & MICHAEL G. COLLINS, FEDERAL COURTS: THEORY AND PRACTICE 750-81 (2003) [hereinafter FEDERAL COURTS].

[5] *See, e.g.*, Peacock v. Thomas, 516 U.S. 349 (1996). The Court explained:

> Ancillary jurisdiction typically involves claims by a defending party haled into court against his will, or by another person whose rights might be irretrievably lost unless he could assert them in an ongoing action in a federal court. Ancillary jurisdiction may extend to claims having a factual and logical dependence on "the primary lawsuit," but that primary lawsuit must contain an independent basis for federal jurisdiction. The court must have jurisdiction over a case or controversy before it may assert jurisdiction over ancillary claims. In a subsequent lawsuit involving claims with no independent basis for jurisdiction, a federal court lacks the threshold jurisdictional power that exists when ancillary claims are asserted in the same proceeding as the claims conferring federal jurisdiction. Consequently, claims alleged to be factually interdependent with and, hence, ancillary to claims brought in an earlier federal lawsuit will not support federal jurisdiction over a subsequent lawsuit. The basis of the doctrine of ancillary jurisdiction is the practical need "to protect legal rights or effectively to resolve an entire, logically entwined lawsuit."

*Id.* at 355 (citations omitted)).

[6] *See, e.g.*, *Kimbell Foods*, 440 U.S. 715; *Clearfield Trust*, 318 U.S. 363. Typically, a federal court will not be exercising ancillary jurisdiction where the federal government or federal agency is party to an action since the authority to bring the action by the government is usually derived from the Constitution or some federal statute. For example, the FDIC derives its authority to bring actions under federal banking laws giving it federal question jurisdiction. Similarly, the SEC is authorized to bring actions under the Securities and Exchanges Acts. Assuming that the jurisdiction of a federal court

less certain whether a rule of federal common law may be applied substantively over state law in favor of a private litigant in such a proceeding. Surprisingly, this question has been addressed under the unique and narrow circumstances surrounding the disgorgement proceedings of Securities and Exchange Commission (SEC) receivers appointed to disgorge fraudulent transfers made as part of multi-jurisdictional Ponzi schemes.[7]

A receiver will bring a claim against an investor where the receiver believes the investor received fraudulent transfers in the form of "profits" as part of a Ponzi scheme. This fraudulent conveyance action brought before a federal court by a receiver is not brought under federal law nor is it connected in any way to the Federal Bankruptcy Code.[8] Furthermore, no federal uniform fraudulent conveyance statute exists under which the receiver may file an action for disgorgement. As a result, the cause of action against the investor must be brought under the color of state fraudulent conveyance law.[9] Consequently, extraordinary conflicts-of-law issues arise in disgorgement proceedings where transfers have been made to investors across state lines as part of multi-state Ponzi schemes. Conflicts-of-law exist because of the great divergence from jurisdiction to jurisdiction in fraudulent conveyance law as well as other relevant state law which may be applicable to the proceeding.[10]

In such disgorgement proceedings, elaborate and well-reasoned arguments can be made for the application of state law favorable to the Ponzi scheme investor since it is never clear which state law is applicable when considering the form in which transfers are made and to the entity or entities to which the transfers are made.[11] For example, an investor who is a shareholder of an offshore entity can conceivably manipulate

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exercising ancillary jurisdiction under 28 U.S.C. § 1367 is akin to diversity jurisdiction, (as discussed in Part II.B.), if a federal interest or function was implicated in an ancillary suit of the federal government's, the logic of *Clearfield Trust* and *Kimbell Foods* could be controlling.

7 *See* Bryan v. Bartlett, 435 F.2d 28 (8th Cir. 1970); Terry v. June, 359 F. Supp. 2d 510 (W.D. Va. 2005).

8 *See* discussion *infra* Part II.A.

9 *See* discussion *infra* Part II.A.

10 For example, Michigan follows the Uniform Fraudulent Transfer Act (UFTA). *See* MICH. COMP. LAWS § 566-34 (2004). Under this law, a debtor may not transfer assets with "actual intent to hinder, delay, or defraud any creditor of the debtor," but will not void transfers made to "a person who took in good faith and for a reasonably equivalent value . . . ." *Id.* In contrast, Virginia law will void conveyances made with "intent to delay, hinder, or defraud creditors" exempting a "purchaser for valuable consideration, unless it appears that he had notice of [fraud] . . . ." *See* VA. CODE. ANN. § 55.80; *see also* *Terry*, 359 F. Supp. 2d at 516. The key distinction between the two is the "notice" requirement under the Virginia Statute.

11 *See* discussion *infra* Part II.B.

state veil-piercing doctrines to thwart disgorgement.[12] As a consequence, uniformity of outcome in such proceedings is lost and the receiver is burdened with choice of law issues with each subsequent disgorgement action filed against Ponzi scheme investors from different jurisdictions. This substantially increases the receiver's time and cost of litigation and ultimately decreases the total amount of recovered funds available for distribution to defrauded investors.

The Eighth Circuit has suggested that a receiver appointed by a federal court to disgorge fraudulent transfers as part of a Ponzi scheme is serving a federal interest and function.[13] The court reasoned that a federally appointed receiver serves as a quasi-federal entity (similar to the FDIC) to enforce the Securities and Exchange Acts by disgorging illegal profits made from violations of the Acts and is thus simultaneously serving a federal interest and function.[14] This proposition supported the application of a uniform fraudulent conveyance rule under a federal common law standard in one such ancillary proceeding[15] and could conceivably serve as the standard in the future for other similar ancillary proceedings involving private litigants. Furthermore, the decision may have broader implications concerning the substantive application of federal common law over state law in ancillary proceedings.

It is well recognized that the application of federal common law implicates major constitutional concerns.[16] Indeed, a federal court exercising authority to implement common law does "engage in interstitial 'lawmaking,' as part of the process of interpreting positive law"[17] raising serious separation of powers issues. Federal judge-made law may also have the consequence of impeding upon the autonomy and independence of states by preempting state law signaling federalism concerns.[18] Although the Supreme Court has arguably narrowed the scope of federal common law to "several well-recognized enclaves,"[19] it has done so by "'simply [listing] areas of law or categories of cases in

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12 *See* discussion *infra* Part II.B.2.

13 *See* Bryan v. Bartlett, 435 F.2d 28 (8th Cir. 1970).

14 *Id*.

15 *See* Terry v. June, 359 F. Supp. 2d 510 (W.D. Va. 2005).

16 *See generally* Bradford R. Clark, *Federal Common Law: A Structural Reinterpretation*, 144 U. PA. L. REV. 1245 (1996); Martin H. Redish, *Federal Common Law, Political Legitimacy, and the Interpretive Process: An "Institutionalist" Perspective*, 83 NW. U. L. REV. 761 (1989).

17 Clark*, supra* note 16, at 1248.

18 *See id.*

19 *Id.* at 1250.

which federal common law is permissible' without providing any 'underlying rationale other than grandfathering.'"[20]

It is the purpose of this paper to trace the development of SEC appointed receiverships in the Ponzi scheme context and analyze whether the analogy made by the Eighth Circuit, namely that these receivers are quasi-federal agents serving federal purposes and functions, can be reconciled with the *Erie* doctrine. Part I of this paper will give a general overview of the evolution of federal common law since the Supreme Court's decision in *Erie*. A careful analysis of the development of federal common law in the post-*Erie* era reveals that the substantive application of a rule of federal common law over state law would be met with the least level of objection when two circumstances are satisfied all of which are directly implicated in the ancillary disgorgement proceeding of the SEC appointed receiver.

The first scenario occurs when the party claiming the benefit of the federal common law rule derives their authority directly from either the Constitution or some federal source of law creating a "uniquely federal interest."[21] The second circumstance arises when the consequence of not substantively adopting the federal common law formulation over state law shatters uniformity in outcome having the ultimate consequence of frustrating an integral federal purpose of an Act of Congress or some other integral federal policy. Simultaneously, the frustration of federal purpose must also be the result of a state law's conflict with the federal purpose which will either override or will be irrelevant to a state's reliance on the displaced law.

When these circumstances are implicated, it is generally the case that traditional constitutional dangers of substantively applying federal common law are not implicated. Specifically, this paper will show that the federalism concerns of the *Erie* doctrine are not at issue when federal common law is adopted in the disgorgement proceedings of SEC appointed receivers. However, separation of powers issues (the analysis of which is conspicuously less developed in the major Supreme Court cases allowing the adoption of federal common law rules over state law) may be of concern when considering what law should be adopted as federal judge-made law in ancillary proceedings to displace conflicting

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[20] Martha A. Fields, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 881, 911-12 (1986) (citation omitted).

[21] In the majority of these cases, this party has either been the government of the United States or an executive agency of the United States. *See, e.g.*, O'Melveny & Myers v. FDIC, 512 U.S. 79 (2004); United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); Clearfield Trust Co. v. United, 318 U.S. 363 (1943).

state laws. Nevertheless, it is likely not to a degree significant enough to allow for the frustration of integral federal functions.

Part II of this paper will show how the Eighth Circuit's reasoning in *Bryan v. Bartlett*[22] falls within the scheme enumerated above. First, this part will give a brief overview and background of Ponzi schemes and the impetus behind appointment of receivers for the benefit of defrauded investors from such schemes. Secondly, this part will highlight the conflicts of law issues which arise in ancillary disgorgement proceedings brought by federally appointed receivers over entities used in multi-state Ponzi schemes. Furthermore, it will discuss how resolution of these issues can frustrate the receiver's ability to recover "false profits" from investors for the benefit of defrauded investors and how conflicts analysis can conceivably benefit investors investing as offshore entities upsetting the receiver's recovery efforts. This portion of Part II will primarily discuss how the facts of a multinational Ponzi scheme led a federal district court in the Western District of Virginia exercising ancillary jurisdiction to adopt the Uniform Fraudulent Transfers Act ("UFTA") as federal common law using the Eighth Circuit's rationale.

Part III concludes.

## I. BACKGROUND OF FEDERAL COMMON LAW

Though Justice Brandeis famously asserted in *Erie v. Tompkins*, "[t]here is no federal general common law,"[23] the decisions of the Supreme Court following *Erie* clearly show the application of federal common law as a rule of decision over state law is proper under certain conditions.[24] In fact, on the same day *Erie* was decided, the Supreme Court allowed the adoption of a general rule of decision under federal common law to apportion the water of an interstate stream between two states.[25] As a general rule, the Court has stated "in the absence of an applicable Act of Congress it is for the federal courts to fashion the governing rule of law according to their own standards."[26]

However, the substantive application of federal common law, where there is a dispute between two states, still carries with it serious constitutional concerns.[27] Primarily, problems with separation of powers

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22 435 F.2d 28 (8th Cir. 1970).
23 304 U.S. 64, 78 (1938).
24 *See* cases cited *supra* note 1.
25 *See* Clark, *supra* note 16, at 1264 (citing Hinderlider v. La Plata River, 304 U.S. 92, 110 (1938)); *see also* FEDERAL COURTS at 761.
26 Clearfield Trust Co. v. United States, 318 U.S. 363, 367 (1943).
27 Clark, *supra* note 16, at 1248; Redish, *supra* note 16, at 765.

and federalism may arise.[28] Professor Bradford R. Clark adequately explains the dilemma:

> First, federal common law, because not clearly rooted in statutory or constitutional sources, appears to involve judicial lawmaking - a task at least in tension with federal separation of powers. To be sure, federal courts undoubtedly engage in interstitial "lawmaking," as part of the process of interpreting positive law. By hypothesis, at least, federal common lawmaking begins where interpretation ends. Such open-ended lawmaking by courts raises constitutional concerns because it bears a troublesome resemblance to the exercise of legislative power-power apparently reserved by the Constitution to the political branches.
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> Second, because federal common law preempts state law, federal common law also raises two related federalism concerns, at least as applied to matters within the legislative competence of the states. Federal common law arguably intrudes upon state authority by departing from the Constitution and the Rules of Decision Act, which—as interpreted in *Erie Railroad Co. v. Tompkins*—appear to require federal courts to apply state law "except in matters governed by the Federal Constitution or by Acts of Congress." Federal common law further threatens the autonomy and independence of the states by requiring state courts to apply federal judge-made law notwithstanding contrary state law, even though the Constitution's reference to the "supreme Law of the Land" does not obviously include federal judge-made law.[29]

In response to these concerns, the Supreme Court has spoken in terms of limiting the scope of federal common law to "several well-recognized enclaves."[30] The Supreme Court has recognized those enclaves to be "in such narrow areas as those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases."[31] While some commentators suggest the "enclave" approach provides some foundation for courts to "mitigate the constitutional difficulties,"[32] others observe they provide little in the way of guidance since they "'simply [list] areas of law or categories of cases

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[28] *See* Clark, *supra* note 16.

[29] *Id*. at 1248-49 (citation omitted).

[30] *Id.* at 1249 (citing Tex. Indus. v. Radcliff Materials, 451 U.S. 630, 641(1981); Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 426-27 (1964)).

[31] *Texas Indus*., 451 U.S. at 641; *see also* Clark, *supra* note 16, at 1248.

[32] Clark, *supra*, note 16, at 1248.

in which federal common law is permissible' without providing any 'underlying rationale other than grandfathering.'"[33]

Commentators have struggled with fashioning a uniform standard for courts to adopt when applying a federal common law rule of decision.[34] Indeed, the application of federal common law is amorphous and enigmatic considering the relatively low level of[35] and seemingly inconsistent[36] guidance provided by the Supreme Court. This paper does not assert any proposed approach is applicable to the ancillary disgorgement proceeding of an SEC appointed receiver. It merely observes that the constitutional questions surrounding the substantive application of federal common law to these sorts of proceedings, mainly questions of federalism, are not necessarily implicated as a practical matter in these ancillary proceedings. Whether the application of a substantive rule of federal common law is appropriate in the constitutional sense is subject to philosophical constitutional inquiry and is beyond the scope of this paper.

### *A. Evolution of Federal Common Law in the Post-*Erie *Era*

In the post-*Erie* era, the Supreme Court has addressed the application of federal common law in cases where the U.S. government has been a party[37] as well as in diversity actions between private parties.[38] While the Supreme Court's rationale for allowing or denying the application of federal common law is relatively unclear and possibly inconsistent especially with respect to private parties,[39] the substantive application of federal common law over state law is clearest under three distinct and recognizable circumstances. A brief overview of the Supreme Court's decisions regarding federal common law in cases involving both the federal government and private citizens as parties over the last six decades reveals such a trend.

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[33] *Id*. (citing Fields, *supra* note 20, at 911-12).

[34] *E.g.*, Clark, *supra* note 16, at 1251 (advocating a "reconceptualization" of federal common law.); Fields, *supra* note 20 (adopting the approach that "federal [common] law can apply whenever federal interests require a federal solution."); Redish, *supra* note 16, at 766-67 (strictly construing the Rules of Decision Act); *see also* Louise Weinberg, *Federal Common Law*, 83 NW. U. L. REV. 805 (1989).

[35] *See* Fields, *supra* note 20.

[36] *See* cases cited *supra* note 3.

[37] *See, e.g.*, United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); Clearfield Trust Co. v. United States, 318 U.S. 363, 367 (1943); *see also* D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942) (holding FDIC was a federal corporation exercising an important federal interest).

[38] *See* cases cited *supra* note 3.

[39] *See id.*; *see also* FEDERAL COURTS at 774-75.

1. The Federal Government as a Litigant

The clearest and most frequently cited Supreme Court decision regarding the application of federal common law to displace state law where the federal government is a litigant is perhaps *Clearfield Trust Co. v. United States.*[40] In *Clearfield Trust*, the United States was attempting to recover from Clearfield Trust funds drawn through a forged endorsement upon a check issued by the U.S. government.[41] Clearfield Trust had guaranteed all prior endorsements upon the check in compliance with federal regulations prior to presenting it to the Federal Reserve Bank for payment.[42] The forgery was reported to the United States but was not immediately made known to Clearfield Trust.[43] Subsequently, an action against Clearfield Trust was brought in federal court by the U.S. several months later. At issue was whether the rights of the parties were governed by state law and whether the federal government was barred from recovery for unreasonable delay as a result.[44]

The Supreme Court held:

> We agree . . . that the rule of [*Erie*] does not apply to this action. The rights and duties of the United States on commercial paper which it issues are governed by federal rather than local law. When the United States disburses its funds or pays its debts, it is exercising a constitutional function or power. This check was issued for services performed under the Federal Emergency Relief Act of 1935, 49 Stat. 115. The authority to issue the check had its origin in the Constitution and the statutes of the United States and was in no way dependent on the laws of Pennsylvania or of any other state. The duties imposed upon the United States and the rights acquired by it as a result of the issuance find their roots in the same federal sources. In absence of an applicable Act of Congress it is for the federal courts to fashion the governing rule of law according to their own standards. . . .
>
> In our choice of the applicable federal rule we have occasionally selected state law. But reasons which may make state law at times the appropriate federal rule are singularly inappropriate here. The issuance of commercial paper by the United States is on a vast scale and transactions in that paper from issuance to payment will commonly occur in several states.

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[40] 318 U.S. 363 (1943).
[41] *Id*. at 365.
[42] *Id.*
[43] *Id.*
[44] *Id.* at 366.

> The application of state law, even without the conflict of laws rules of the forum, would subject the rights and duties of the United States to exceptional uncertainty. It would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain.[45]

From the Court's ruling in *Clearfield Trust*, it is evident that where the authority of the government comes directly from a federal source, the source being either the Constitution or a federal statute, the need for applying a rule of federal common law may be warranted.[46] The Court suggests the need is increased if the application of state law "would subject the rights and duties of the United States to *exceptional* uncertainty"[47] and result in "making identical transactions subject to the vagaries of the laws of the several states."[48] The ultimate effect of adopting state law in this case would have been to frustrate the federal government's ability to discharge its duties. The forged check in this case was an offense against the United States.[49] As the Court discussed, the U.S. had a clear right and duty to sue for recovery on this check; a right which flowed from the Constitution and the statutes of the United States.[50]

Therefore, the principle to be drawn from *Clearfield Trust* with respect to the application of federal common law over state law is that where the federal government is a party to an action, if the source of the government's authority is derived from the Constitution or from a "statute[] of the United States,"[51] the adoption of a uniform rule is proper if the adoption of state law would shatter uniformity and frustrate an essential federal interest.[52] The Court appeared to implicate a problem with adopting a rule of state law in a manner which would seriously impede the government's ability to affect an affirmative duty and right which was distinctly federal in nature and purpose. In fact, this principle has subsequently guided the Supreme Court in decisions regarding the application of federal common law where the federal government is a litigant, most notably in *United States v. Kimbell Foods, Inc.*[53]

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45 *Id*. at 366-67 (citations omitted).
46 *See id*. at 367.
47 *Id.* at 367 (emphasis added).
48 *Id*.
49 *See* FEDERAL COURTS at 751 n.2 (citing 18 U.S.C. § 262 (2006)).
50 *See Clearfield Trust Co.*, 318 U.S. at 366.
51 *Id.* at 366.
52 *See id.* at 366-67.
53 440 U.S. 715 (1979).

In *Kimbell Foods*, two actions filed in two different states (Texas and Georgia) by the SBA and FHA were on appeal to the Supreme Court. The Texas action concerned whether priority should have been given to an SBA commercial lien over that of a private creditor's (Kimbell's) lien even though the SBA's lien was perfected subsequent to Kimbell's.[54] Though both liens were perfected in accordance with Texas law, the SBA argued the "choate lien rule" applied under federal common law over Texas law giving priority to their lien since Kimbell's lien interest was not sufficiently specific to allow them "first in time" status.[55] The Georgia action involved an FHA lien issued to secure a tractor that was subsequently acquired by a repairman through Georgia law after the tractor owner could not pay for repairs made by the repairman.[56] In the recovery suit filed by the FHA against the repairman, the District Court found Georgia law to be applicable giving priority interest to the repairman.[57] On appeal, although the Court of Appeals ruled against the FHA, it held federal common law to be applicable to the circumstances of the case and devised a special rule derived from the Uniform Commercial Code to award the tractor to the repairman.[58]

While the Supreme Court found the authority of the SBA and FHA to be derived from a federal source consistent with the factors in *Clearfield Trust*,[59] it did not find that the uncertainties resulting from the "application of state law would frustrate specific objectives of [their] federal programs" enough to adopt a uniform federal rule.[60] Relying on precedent from *United States v. Yazell*,[61] the Supreme Court held:

> Because SBA operations were "specifically and in great detail adapted to state law," the federal interest in supplanting "important and carefully evolved state arrangements designed to serve multiple purposes" was minimal. Our conclusion [in *Yazell*] that compliance with state law would produce no hardship on the agency was also based on the SBA's practice of "individually [negotiating] in painfully particularized detail" each loan transaction. These observations apply with equal force here and compel us again to reject generalized pleas for uniformity as

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54 *Id.* at 720.
55 *Id.*
56 *Id*. at 723.
57 *Id*. at 724.
58 *Id.* at 724-25.
59 *Id*. at 726-27.
60 *Id*. at 728.
61 382 U.S. 341 (1966).

> substitutes for concrete evidence that adopting state law would adversely affect administration of the federal programs.[62]

Since the FHA regulations also incorporated state law in a manner similar to the SBA, the same logic also precluded the application of a uniform rule to their action.[63]

The Court further ruled:

> Because the ultimate consequences of altering settled commercial practices are so difficult to foresee, we hesitate to create new uncertainties, in the absence of careful legislative deliberation. Of course, formulating special rules to govern the priority of the federal consensual liens in issue here would be justified *if necessary to vindicate important national interests.* But neither the Government nor the Court of Appeals advanced any concrete reasons for rejecting well-established commercial rules which have proven workable over time. Thus, the prudent course is to adopt the readymade body of state law as the federal rule of decision until Congress strikes a different accommodation.[64]

The level of uncertainty in outcome that could frustrate uniformity adversely affecting a federal interest which in turn would warrant the application of a federal common law rule was clarified by *Kimbel Foods*. The Court in *Kimbell Foods* appeared to establish a vague guideline. Even though authority from a federal source may be found[65] and uniformity in outcome may lead to uncertainty in result, these factors alone will not necessitate displacing state law in favor of a uniform federal rule.[66] The *degree* to which a federal interest is frustrated must also be considered and weighed against a state's reliance upon the law in question.[67] In *Kimbell Foods*, both the SBA and FHA anticipated the applicability of state law to their lending programs and conformed their programs to these expectations[68] indicating that the federal programs would not necessarily be disturbed absent a uniform rule. In light of these factors, the Court appeared more concerned with how a uniform

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[62] United States v. Kimbell Foods, Inc., 440 U.S. 715, 729-30 (1979) (citations omitted).

[63] *See id*. at 730-31.

[64] *Id*. at. 739-40 (emphasis added).

[65] *See id.*

[66] *See id*. at 727-28.

[67] *See id*. at 728 ("Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs.").

[68] *See id.*

federal rule would alter "settled commercial practices"[69] established around state law. Consequently, displacement should only occur when "specific objectives" of a federal law or a federal purpose are frustrated.[70]

Arguably, the Court's decision reveals that with regard to uniformity, a two pronged analysis is necessary. First, a court should consider to what level the state law being displaced by a uniform federal rule is relied upon. In the commercial context, *Kimbell Foods* shows that if state commercial law is well settled and generally relied upon, indicating an anticipation that state law will apply to a particular transaction, a uniform federal rule is likely not appropriate. Second, if a state's reliance on the law is considerably frustrated by adoption of a uniform rule, a court should consider to what level that reliance is frustrated if a uniform federal rule is adopted. Reiterating the Court's position in *Kimbell Foods*, if the "ultimate consequences of altering settled commercial practices are . . . difficult to foresee,"[71] then a uniform rule displacing state law is not suitable.

It is important to note that an interesting dilemma does surface in light of both *Clearfield Trust* and *Kimbell Foods* with respect to the twin dangers of federalism and separation of powers issues implicated from the application of federal judge-made law. In *Clearfield Trust*, the Court finds the circumstances compelling enough to warrant adoption of a uniform federal rule so as not to frustrate an important federal function regardless of whether significant state law would be displaced. However, little consideration is given to whether the judiciary, as a lawmaker, is competent to fashion the uniform rule necessary to achieve the specific federal purpose invoking some separation of powers concern. Similarly, the Court in *Kimbell Foods* also seems overly concerned with how *state* law, with regard to commercial expectations, would be frustrated by adoption of a federal rule. The Court does not delve deeply into whether a federal court is authorized to create such a rule (probably because it did not need to reach the issue); although it did note that "formulating special rules to govern . . . here would be justified *if necessary to vindicate important national interests*" perhaps indicating if compelling federal interests did exist, as they did in *Clearfield Trust*, displacing even settled state law could be appropriate.[72]

Both cases seem to suggest that if the federal interest or function in question is significantly frustrated, the balance is tilted considerably in favor of adopting a judicial rule of law. The problem left unanswered by

[69] *Id*. at 739-40.
[70] *Id*. at 728.
[71] *Id*. at 739.
[72] *Id.* at 740 (emphasis added).

the Supreme Court, as alluded to previously, is whether the "interstitial lawmaking"[73] of a federal judge is sufficiently weighed against the federal legislature's authority, interest and competence to address the conflict. However, it is possible to construe the Supreme Court's lack of consideration for the separation of powers issue in another manner; and that is, when the frustration of the federal interest or function is so egregious that it would severely hinder an essential or central federal purpose unnecessarily subjugating the federal government to the uncertainty of state law, as was the case in *Clearfield Trust*. The urgency and need for implementing a rule of law to adequately dispose of an issue in favor of the federal government will always outweigh any separation of powers considerations. Furthermore, it should be noted that a legislature's ability to act to displace or rectify judge-made law is not affected in any way by the adoption of a uniform rule as federal common law.

Regardless of these Constitutional concerns, the lessons to be drawn from *Clearfield Trust* and *Kimbell Foods* in analyzing the application of federal common law to the ancillary proceedings of the SEC appointed receiver is to focus on the nature of a commercial transaction and the state laws applicable to that transaction. This will play an important role in determining whether adopting a uniform rule under federal common law is proper when considering the fraudulent transfer made as part of the Ponzi scheme.

2. Private Litigants

It is well settled that the substantive application of federal common law to displace state law is not limited only to cases where the federal government is a litigant.[74] However, considerable confusion remains as to what circumstances must exist in order to adopt a rule of federal common law in actions between private parties. The Supreme Court's development of federal common law in litigation involving private litigants has seemingly been inconsistent.[75] In fact, commentators have observed "some [Supreme Court] cases suggest that the federal interest may be less immediately implicated in litigation to which the United States is not a party,"[76] while other cases have allowed the adoption of federal common law among private litigants where the federal interest

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[73] *See* Clark, *supra* note 16, at 1287.

[74] *See, e.g.*, Boyle v. United Techs. Corp., 487 U.S. 500 (1988); Hinderlider v. La Plata River, 304 U.S. 92 (1938).

[75] *See* cases cited *supra* note 3.

[76] FEDERAL COURTS at 764 (discussing Bank of Am. Nat'l Trust & Sav. Ass'n v. Parnell, 352 U.S. 29 (1956).

was ostensibly just as tenuous.[77] Nevertheless, the controlling principle behind the adoption of federal common law to displace state law in these cases has been whether there will be a *direct* effect upon an identifiable federal interest or function in the absence of such adoption having the consequence of frustrating a specific federal objective or creating a significant conflict with federal law.[78]

Perhaps the most significant Supreme Court case dealing with the substantive application of federal common law between private litigants which may provide some guidance for private litigation in ancillary proceedings where federal interests are implicated is *Boyle v. United Technologies Corp*.[79] In *Boyle*, the father of a Marine helicopter pilot brought a defective repair and negligent manufacture claim against the independent defense contractor who designed the helicopter flown by the pilot.[80] The pilot perished in a crash alleged to have been the result of negligent repair flaws and design defects which prevented his timely escape after the helicopter went down.[81] At issue was whether a "military contractor defense" could be asserted by the contractor under federal common law to preclude the father's recovery under his state law claim since the contractor designed the helicopter in accordance with a contract entered into with the United States.[82]

The Court concluded two areas of "uniquely federal interest[]"[83] were involved. First, the Court recognized that the obligations of the United States under contract were governed exclusively by federal law.[84] While the case at hand did not involve the obligations of the United States under contract, but rather the liability to third persons, the liability nevertheless arose from performance of a federal contract.[85] Second, the Court acknowledged that the "civil liability of federal officials for actions taken in the course of their duty"[86] was, in many instances, controlled by federal law.[87] Analogizing from *Yearsley v. W.A. Ross Const. Co.*,[88] an earlier decided case in which a private landowner was

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77 *See, e.g.*, *Boyle*, 487 U.S. 500.

78 *Compare Bank of Am.*, 352 U.S. 29, *and* Miree v. DeKalb County, 433 U.S. 25 (1977), *with Boyle*, 487 U.S. 500.

79 487 U.S. 500 (1988).

80 *Id.* at 502.

81 *Id*. at 503.

82 *Id*. at 504.

83 *Id.*

84 *Id*. at 504-05.

85 *See id*. at 505.

86 *Id*.

87 *Id*.

88 309 U.S. 18 (1940).

precluded from holding a private contractor liable under state law for building dikes for the federal government, the Court reasoned:

> "[I]f [the] authority to carry out the project was validly conferred, that is, if what was done was within the constitutional power of Congress, there is no liability on the part of the contractor for executing its will." The federal interest justifying this holding surely exists as much in procurement contracts as in performance contracts; we see no basis for a distinction.[89]

The Court went on to distinguish *Boyle* from other previously decided cases involving private litigants where the "'federal interest in the outcome of the [dispute] before . . . [was] far too speculative, far too remote a possibility to justify the application of federal law. . . .'"[90] Instead, *Boyle* involved a case where the circumstances would have a more *direct* effect.[91] The Court extrapolated:

> The imposition of liability on Government contractors will directly affect the terms of Government contracts: either the contractor will decline to manufacture the design specified by the Government, or it will raise its price. Either way, the interests of the United States will be directly affected.[92]

Therefore, the federal objective implicated was not too attenuated or speculative.[93]

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[89] *Boyle*, 487 U.S. at 506 (quoting *Yearsley*, 309 U.S. at 20-21) (second alteration in original).

[90] *Id*. (quoting Miree v. DeKalb County, 433 U.S. 25, 32-33 (1977).

[91] *See id.*

[92] *Id.* at 507.

[93] *Boyle* was decided by a divided court (5-4) that disagreed strongly on whether the facts of *Boyle* were necessarily distinguishable from past cases involving the displacement of state law by federal common law among private litigants. Justice Brennan keenly observed there was no distinction in the present case from past cases:

> In *Miree* v. *DeKalb County*, for example, the county was contractually obligated under a grant agreement with the Federal Aviation Administration (FAA) to "restrict the use of land adjacent to . . . the Airport to activities and purposes compatible with normal airport operations including landing and takeoff of aircraft." At issue was whether the county breached its contractual obligation by operating a garbage dump adjacent to the airport, which allegedly attracted the swarm of birds that caused a plane crash. Federal common law would undoubtedly have controlled in any suit by the Federal Government to enforce the provision against the county or to collect damages for its violation. The diversity suit, however, was brought not by the Government, but by assorted private parties injured in some way by the accident. We observed that "the operations of the United States in connection with FAA grants such as these are undoubtedly of considerable magnitude,' and that 'the United States has a substantial interest in regulating aircraft travel and promoting air travel safety." Nevertheless, we held that state law should govern the claim because "only the rights of

Having concluded that a "uniquely federal interest" existed, the Court then turned to *Kimbell Foods* second criterion for determining whether to displace settled state law, namely, gauging whether a "significant conflict" between the identified federal interest or related federal legislation would result if state law were applied[94] or whether "application of state law would 'frustrate specific objectives' of federal legislation."[95] Ultimately the Court found that allowing a state law claim to proceed would in fact disrupt an exception to the Federal Tort Claims Act which precluded claims "based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency . . . whether or not the discretion involved be abused."[96] The Court concluded:

> We think that the selection of the appropriate design for military equipment to be used by our Armed Forces is assuredly a discretionary function within the meaning of this provision. It often involves not merely engineering analysis but judgment as to the balancing of many technical, military, and even social considerations, including specifically the trade-off between greater safety and greater combat effectiveness. And we are further of the view that permitting "second-guessing" of these judgments through state tort suits against contractors would produce the same effect sought to be avoided by the FTCA exemption. The financial burden of judgments against the contractors would ultimately be passed through, substantially if not totally, to the United States itself, since defense contractors will predictably raise their prices to cover, or to insure against, contingent liability for the Government-ordered designs. To put

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> private litigants are at issue here," and the claim against the county "will have *no direct effect upon the United States or its Treasury.*"
> [The Court then discussed other cases involving private litigants]
> . . .
> Here, as in *Miree* . . . a Government contract governed by federal common law looms in the background. But here, too, the United States is not a party to the suit and the suit neither "touch[es] the rights and duties of the United States," nor has a 'direct effect upon the United States or its Treasury,' The relationship at issue is at best collateral to the Government contract. We have no greater power to displace state law governing the collateral relationship in the Government procurement realm than we had to dictate federal rules governing equally collateral relationships in the areas of aviation, Government-issued commercial paper, or federal lands.

Boyle v. United Techs. Corp, 487 U.S. 500, 519-21 (1988) (Brennan J., dissenting) (emphasis added) (citations omitted).

94 *Boyle*, 487 U.S. at 507 (quoting Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63, 68 (1966)).

95 *Id.* (quoting United States v. Kimbell Foods, Inc., 440 U.S. 715, 728 (1979)).

96 *Id.* at 511 (quoting 28 U.S.C. § 1346(b) (2006)).

> the point differently: It makes little sense to insulate the Government against financial liability for the judgment that a particular feature of military equipment is necessary when the Government produces the equipment itself, but not when it contracts for the production. In sum, we are of the view that state law which holds Government contractors liable for design defects in military equipment does in some circumstances present a 'significant conflict' with federal policy and must be displaced.[97]

### *B. Post-*Erie *Developments of Federal Common Law and Their Potential Applicability in the Ancillary Disgorgement Proceedings of the SEC Appointed Receiver*

Though the party claiming the benefit of the federal common law rule in *Boyle* was a private litigant, the Supreme Court was not prevented from finding a uniquely federal interest. The principle that a private litigant cannot be prevented from invoking a rule of federal common law will be helpful to the SEC appointed receiver who is necessarily a private litigant. More importantly, *Clearfield Trust* and *Kimbell Foods* both establish that where the source of authority of the party claiming the benefit of the federal rule is derived from a federal source of law, the need for adopting a uniform rule may be warranted. This establishes the first criteria for federal common law analysis. This criteria will be important to the SEC appointed receiver whose authority is arguably derived from the Securities and Exchanges Acts.[98]

While a federal interest may be implicated, the inquiry does not stop there. According to the law of *Boyle* and *Kimbell Foods* taken together, before adoption of the federal rule, it appears the court must consider whether the federal interest or purpose will be *directly* affected. A consequence that is too remote or speculative on the interest appears not be sufficient to warrant adoption of a uniform federal rule. Furthermore, significant conflict between the displaced state law and the identified federal interest must exist or it must be shown that displacement of the state law is necessary to avoid frustration of the federal interest. This analysis sets up the second criteria for federal common law analysis. For the SEC appointed receiver, conflict between state law and the goals and purposes of the Securities and Exchanges Acts will be at issue when considering the displacement of state fraudulent conveyance law or state veil-piercing doctrines.

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[97] *Id.* at 511-12.
[98] *See* discussion *infra* Part II.

It should be noted that the Supreme Court's analysis in these cases take the federalism issues into consideration, but does little to quell the separation of powers concerns associated with the implementation of judge-made law.[99] The competency of the judiciary to act as a quasi-legislature is rightly questioned when considering the adoption of a uniform rule of federal common law. Though the Supreme Court has ruled that a federal interest can be compelling enough to displace state law overriding federalism concerns, as was the case in *Clearfield Trust* and *Boyle*, the authority and competence of the judiciary to create uniform rules to affect federal interests signals a dilemma with separation of powers which has not been thoroughly addressed by the Supreme Court.

Arguably, the Supreme Court's relatively minimal consideration of this issue was in cases where the frustration of the federal interests or functions were so egregious that they would have severely hindered essential or central federal purposes unnecessarily subjugating the federal government to the uncertainty of state law, as was the case in *Clearfield Trust*; or they were cases which would allow for the "second-guessing"[100] of intrinsically federal discretionary powers, as was the case in *Boyle*. The urgency and need for implementing a rule of law to adequately dispose of conflicts issues in favor of the federal government where such integral federal interests were implicated may have outweighed any separation of powers considerations. Furthermore, as mentioned earlier, Congress's ability to act to displace or rectify judge-made law is not affected in any way by the adoption of a uniform rule of federal common law.

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[99] This was indeed a deeply disturbing fact for Justice Stevens, who dissented in *Boyle*:

> When judges are asked to embark on a lawmaking venture, I believe they should carefully consider whether they, or a legislative body, are better equipped to perform the task at hand. There are instances of so-called interstitial lawmaking that inevitably become part of the judicial process. But when we are asked to create an entirely new doctrine—to answer "questions of policy on which Congress has not spoken,"—we have a special duty to identify the proper decisionmaker before trying to make the proper decision.
>
> When the novel question of policy involves a balancing of the conflicting interests in the efficient operation of a massive governmental program and the protection of the rights of the individual—whether in the social welfare context, the civil service context, or the military procurement context—I feel very deeply that we should defer to the expertise of the Congress.

*Boyle*, 487 U.S. at 531-32 (1988) (Stevens J., dissenting) (citation omitted).

[100] *Boyle*, 487 U.S. at 511.

The adoption of a uniform rule under federal common law to displace state fraudulent conveyance law is similarly one of compelling federal concerns to the SEC appointed receiver. As discussion in the next part will show, the application of different state fraudulent conveyance laws to the disgorgement proceedings will severely frustrate the impetus behind the Securities and Exchanges Acts to protect unsophisticated investors. The need to adopt a uniform fraudulent conveyance rule in such proceedings implicates no real frustration or binding obligation on state law and is in fact irrelevant to a state's reliance on fraudulent conveyance law, which is primarily a law applicable in the bankruptcy context. Furthermore, adoption of different state veil-piercing doctrines over a federal veil-piercing standard to reach majority shareholders of offshore entities investing in Ponzi schemes creates a significant conflict with the goals of the 1933 and 1934 Acts if the corporate veils of such entities are not pierced. The next part will show that the frustration of these federal purposes by adoption of state law create the compelling circumstances necessary to adopt a uniform rule of federal common law.

## II. FEDERAL COMMON LAW IN THE DISGORGEMENT PROCEEDINGS OF SEC APPOINTED RECEIVERS

### *A. Ponzi Schemes and the Appointment of Receiverships*

#### 1. The Ponzi Scheme as a Violation of the Securities and Exchange Acts

In order for a Ponzi Scheme[101] to violate the Securities and Exchange Acts of 1933 and 1934, the Ponzi scheme must first satisfy section 2(a)(1) of the 1933 Act. The 1933 and 1934 Acts only govern

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[101] Ponzi schemes take their name from Charles Ponzi, whose scheme led him to the Supreme Court in 1924. Cunningham v. Brown, 265 U.S. 1 (1924). Today, the term "Ponzi scheme" is used to describe an investment scheme that is not backed by a legitimate business venture wherein investors are paid profits from the principal sums of newly attracted investors. The type of Ponzi scheme that this paper will deal with exists when the perpetrator of the scheme creates one or more corporations through which he or she lures investors into fictional business ventures. The main source of income for these "dummy" corporations is the acquisition of new funds from investors, lured into the scheme through promises of high returns on their investments, which are then paid to older investors as "profit." *See generally In re* Bullion Reserve of N. Am., 836 F.2d 1214, 1218 n.8 (9th Cir. 1988)); Rodriguez v. Dunson (*In re* Rodriguez), 209 B.R. 424, 431 (S.D. Tex. 1997) (citing *In re* United Energy Corp., 944 F.2d 589, 590 n.1 (9th Cir. 1991)); Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998). A good example of a modern Ponzi scheme dealt with in this paper is found in *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).

what can be defined as "securities."[102] The Supreme Court has read section 2(a)(1) liberally, saying that Congress defined "security" so broadly that it may encompass virtually any instrument that might be sold as an investment.[103] Whether or not a transaction falls within the meaning of a security is based on the economic realities involved in the transaction.[104]

The Securities Act, for purposes of characterization of a Ponzi scheme, partially defines an "investment contract" as a security.[105] The term "investment contract" is defined as any "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party . . . ."[106] The well-known *Howey* test delineates a three part standard for purposes of determining whether a transaction falls within the SEC's interpretation of an investment contract. This standard shows that in order for an "investment contract" to be deemed a security the transaction must include (1) an investment of money, (2) in a common enterprise with (3) the expectation of profits produced by the efforts of others.[107]

The typical Ponzi scheme requires the investment of money.[108] Therefore, the first prong of the *Howey* test is satisfied. Second, investors in the Ponzi scheme usually invest their money into a single entity, usually a fictional corporation established by the operators of the scheme. As a result, investments can be seen as becoming part of a common enterprise in conformance with the second prong of the *Howey* test.[109] Ponzi schemes lure investors through promises of high returns on investments through the efforts of the scheme operators. Restated, investments are made in the scheme, generally by average and unsophisticated investors, solely for the high rate of promised returns coming from the "investment" efforts of the scheme operators through

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[102] *See* Securities Exchange Act of 1933, § 2(a)(1), 15 U.S.C. § 77a *et. seq.* (2006).

[103] Reves v. Ernst & Young, 494 U.S. 56, 60 (1990).

[104] Tcherepin v. Knight, 389 U.S. 332, 336 (1967).

[105] *See* Securities Exchange Act of 1933, § 2(a)(1), 15 U.S.C. § 77a *et. seq.* (2006).

[106] SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

[107] *Id.* at 299.

[108] *See* Scholes v. Lehmann, 56 F.3d 750, 752 (7th Cir. 1995).

[109] A typical Ponzi scheme involves this "horizontal commonality" or pooling of investments. Using the *Scholes* example, the money raised through new investor funds was used predominantly to pay existing investors; money was constantly pooled and dolled out to pay older investor's their promised return of ten to twenty percent of their investments. *Scholes*, 56 F.3d at 752.

their managing of the fictional entity.[110] Therefore, in a typical Ponzi scheme, the three criteria delineated in *Howey* are met.

Section 17(a) of the 1933 Act, section 10 of the 1934 Act, and Rule 10(b)(5) encompass the basic anti-fraud provisions of the Acts applicable against the perpetrator or perpetrators of a Ponzi Scheme.[111] These provisions all prohibit fraudulent conduct or practices in connection with the offer or sale of securities.[112] In order to be liable for securities fraud, the accused must have "(1) made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities."[113] A showing of scienter is an element of an enforcement action pursuant to the antifraud provisions of the Securities Acts.[114] Scienter is "the mental state embracing intent to deceive, manipulate, or defraud."[115] Intent on the part of the perpetrator of the alleged Ponzi scheme, or the perpetrator as an agent for the corporation heading the scheme, is required in order to enforce any of these provisions of the Acts.[116]

2. The Appointment of a Receiver and the Disgorgement of Fraudulent Transfers

Since the promised rates of return in a Ponzi scheme are always in excess of any real investment and creditors are unable to be paid by nature of the scheme's structure, a "Ponzi corporation" is deemed to be

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[110] In *Scholes*, investors were solicited solely through the promise of return on their investments and invested so that they could see the promised ten to twenty percent per month return on their investment. *Scholes*, 56 F.3d at 752.

[111] Section 17(a) of the 1933 Act makes it unlawful for any person through the use of interstate commerce to (1) "employ any device, scheme, or artifice to defraud" or to (2) "obtain money or property by means of an untrue statement of material fact or any omission to state a material fact," or to (3) "engage in any transaction, practice, or course of business which operates, or would operate as a fraud or deceit upon the purchaser."

[112] Section 10(b) of the 1934 Act is a broad rule that makes unlawful any deceptive device used or employed through interstate commerce or in contravention of such rules as the Commission may prescribe. Rule 10b-5 mirrors § 17(a) of the 1933 Act, but also broadens the regulatory scope in that it omits obtaining money or property from part 2 of section 10(b) of the 1934 Act and states that any untrue statement of material fact or omission is unlawful regardless of whether the statement is made or not made upon obtaining money or property. Furthermore, it makes it unlawful to engage in any fraudulent or deceitful act upon any person, not just the purchaser of the security in question.

[113] *E.g.*, SEC v. Monarch Funding Corp., 192 F. 3d 295, 308 (2d Cir. 1999).

[114] *E.g.*, Aaron v. SEC, 446 U.S. 680, 701-02 (1980).

[115] *E.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

[116] *Aaron*, 446 U.S. at 701-02.

effectively insolvent from its inception.[117] A federal court, in dealing with the assets of an insolvent Ponzi corporation, may appoint a receiver to marshal and collect misappropriated funds in order to redistribute those funds to creditors and defrauded investors. The legal fiction is that the receiver acts on behalf of the corporation and not the investors in the scheme because the Ponzi corporation is considered to be a "legal entit[y] separate from principal and injured by [fraudulent] transfers."[118] The fraudulent transfers are the fictitious "profit" distributions paid to old investors from new investor funds. The appointment of a receiver takes the corporation and its assets out of the hands of the wrongdoer and places them in the hands of the receiver.[119]

The receiver may bring actions based on law or equity in any state, federal, or foreign court to recover fraudulent conveyances made as part of the scheme.[120] A receiver is generally appointed in the jurisdiction where the SEC brings action against the operators of the scheme. In actions brought in federal court, the federal court maintains ancillary or pendent jurisdiction over any claims filed by the receiver to disgorge fraudulent transfers.[121] Because the Ponzi corporation is not considered bankrupt under the meaning of the U.S. Bankruptcy Code, the receiver proceeds to disgorge fraudulent transfers under the applicable state fraudulent conveyance law as opposed to federal fraudulent conveyance law.[122]

Receiverships in Ponzi scheme situations allow defrauded investors to obtain redress efficiently through the receiverships power. A receiver in a typical Ponzi scheme proceeding of securities fraud seeks out and recovers the corporation's misappropriated assets, used and acquired as a result of the scheme, in order to redistribute them among defrauded investors involved in the scheme. Similar to a trustee in bankruptcy, a receiver may only sue to redress injuries to the entity in receivership.[123]

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[117] *In re* Taubman, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993); *see also* Rodriguez v. Dunson (*In re* Rodriguez), 209 B.R. 424, 432 (Bankr. S.D. Tex. 1997) (citing Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 871 (Bankr. D. Utah 1987) (also stating that Ponzi schemes "become[] increasingly insolvent as the scheme progresses.")).

[118] *See* Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995).

[119] *See* McCandless v. Furland, 296 U.S. 140, 159-61 (1935).

[120] 28 U.S.C § 754 (2006). This statute allows a receiver to sue in the district where he was appointed in order to enforce claims anywhere in the country.

[121] *See, e.g.*, United States v. Franklin Nat'l Bank, 512 F.2d 245, 249 (2d Cir. 1975) ("The ancillary suit is cognizable in the main suit regardless of the citizenship of the parties or the amount in controversy because the res over which the receiver took control is already before the court."); Int'l Controls Corp. v. Vesco, 490 F.2d 1334, 1350 (2d Cir. 1974); Tcherepnin v. Franz, 485 F.2d 1251, 1255-56 (7th Cir. 1973); Esbitt v. Dutch-Am. Mercantile Corp., 335 F.2d 141 (2d Cir. 1964).

[122] *See generally* Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995).

[123] *Id.* at 753.

The receiver's job is to maximize the value of the Ponzi corporation, ultimately for the benefit of the corporation's defrauded investors and creditors.[124] Stated in other terms, the receiver's goal is to maximize the recovery of funds invested in the scheme so that they may be returned in some degree to the wronged investors.

*B. The Receiver's Choice of Law Problems*

The greatest obstacle for a receiver to overcome in disgorging fraudulent transfers made to investors is resolving the extraordinary number of conflicts of law issues which arise during litigation.[125] As discussed earlier, the receiver must bring actions against individual investors under state fraudulent conveyance law in federal court through the federal court's pendant or ancillary jurisdiction over the federal claims against the operators of the Ponzi scheme.[126] Therefore, the first conflict of law issue to decide is under which state fraudulent conveyance law the receiver should proceed. Depending on whom the action is brought against and which jurisdiction the investor resides in, this can be a daunting task as the ensuing discussion shows.

Often times, the lucrative nature of a Ponzi scheme will attract the more sophisticated investor with its high promised rates of return. These investors often invest as single shareholders of offshore entities. Sometimes, as is often the case, these investors can be indirect insiders to the general scheme.[127] The shareholder investing on behalf of her wholly owned offshore corporation and receiving distributions under the name of the offshore corporation is particularly troublesome and can give rise to numerous conflicts issues. Ideally, the appropriate measure to take in such a circumstance would be to pierce the veil of the offshore corporation in order to reach the domestic single or majority shareholder receiving contributions from the scheme in a U.S. federal court. However, the divergence of veil-piercing doctrines from jurisdiction to jurisdiction may impede the possibility of such an action or may shift a heavier burden of proof on the receiver extending the amount of time in litigation and cost of litigation.[128]

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[124] *Id.* at 754.

[125] *See generally* Terry v. June, 359 F. Supp. 2d 510 (W.D. Va. 2005).

[126] *See* discussion *supra* Part I.

[127] The receiver in *Terry* was confronted with many such entities. For example, the son of Robert June, Sr., the defendant in *Terry*, was an employee of Dowdell who managed his father's investments. He also operated several dummy corporations which received funds from Dowdell's general scheme. *See Terry*, 359 F. Supp. 2d 510; *see also* discussion, *infra*.

[128] For example, in determining whether the veil should be pierced, Michigan considers if: (1) the corporation and shareholders have a complete identity of interests;

Using the Eighth Circuit's reasoning from *Bryan v. Bartlett* as adopted by the Western District of Virginia in *Terry v. June*,[129] this section will also show how a uniform federal veil-piercing doctrine and a uniform fraudulent conveyance rule can be applied under federal common law in these circumstances to displace conflicting state laws.

1. The Problem with Determining Which Fraudulent Conveyance Law Applies

For conflicts of law purposes it is important to first characterize the nature of the legal issue.[130] Generally, for purposes of determining conflicts of law, many federal courts have characterized fraudulent conveyances as torts.[131] While some courts have held otherwise,[132] a

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(2) the corporation is a mere instrumentality of the shareholders; (3) the corporation is a device to avoid legal obligation or; (4) the corporation is used to defeat public convenience, justify a wrong, protect fraud or defend a crime. Bodenhamer Bldg. Corp. v. Architectural Research Corp., 873 F.2d 109, 112 (6th Cir. 1989) (citing Kline v. Kline, 205 N.W.2d 297 (Mich. Ct. App. 1981); Williams v. Am. Title Ins. Co., 269 N.W.2d 481 (Mich. Ct. App. 1978)). A finding of any one will warrant piercing. On the other hand, Delaware may look to a combination of multiple factors under an "alter ego" theory "when such matters as fraud, contravention of law or contract, public wrong, or where equitable considerations among members of the corporation require it, are involved." Harco Nat'l Ins. Co. v. Green Farms, Inc., No. 1131, 1989 Del. Ch. LEXIS 114, *11-12 (Del. Ch. Sept. 19, 1989) (quoting Pauley Petroleum, Inc. v. Cont'l Oil Co., 239 A.2d 629 (Del. 1968)). The standard appears to be more rigid and requires a heavier burden of proof than the Michigan doctrine.

[129] 359 F. Supp. 2d 510 (W.D. Va. 2005).

[130] *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 7 (1971).

[131] *See, e.g.*, Midlantic Bank, N.A. v. Strong, No. 94-CV-4901-SJ, 1996 U.S. Dist. LEXIS 22384, *21-22 (E.D.N.Y. Nov. 26, 1996); Elgin Sweeper Co. v. Melson, Inc., 884 F. Supp. 641, 650 n.12 (N.D.N.Y. 1995); Kaliner v. Load Rite Trailers (*In re* Sverica Acquisition Corp.), 179 B.R. 457, 469-470 (Bankr. E.D. Pa., 1995)("[W]e believe that a fraudulent conveyance is more akin to a tort than a contract . . ."); Ferrari v. Barclays Bus. Credit, Inc. (*In re* Morse Tool), 108 B.R. 384, 387 (Bankr. D. Mass. 1989) (stating underlying basis of fraudulent conveyance action not necessarily contractual); Hassett v. Far West Sav. & Loan Assoc. (*In re* O.P.M. Leasing Servs., Inc.), 40 B.R. 380, 391-95 (Bankr. S.D.N.Y. 1984), *aff'd on other grounds*, 44 B.R. 1023 (S.D.N.Y. 1984) (deeming a fraudulent conveyance a tort in selecting applicable conflict of law principles); *In re* Penn Packing Co., 42 B.R. 502, 505 (Bankr. E.D. Pa. 1984) (stating fraudulent conveyance act claim a tort for purposes of choosing Pennsylvania statute of limitations); Kidde Indus. v. Weaver Corp*.*, No. 11683, 1994 Del. Ch. LEXIS 24 (Del. Ch. Feb. 15, 1994) ("Although not technically a fraud claim, fraudulent conveyance actions are based at least to some degree on fraud."); LEFLAR, AMERICAN CONFLICTS LAW § 185 at 380 n.6 (3d ed. 1977) (approving "tort characterization" in determining "law governing validity of allegedly fraudulent or preferential transfers and assignments."); Ehrenzweig & Westen, *Fraudulent Conveyances in the Conflict of Laws: Easy Cases May Make Bad Law*, 66 MICH. L. REV. 1679, 1689 (1968) ("[T]he conflicts law of torts . . . controls . . . fraudulent conveyances."); Comment*, Choice of Law in Fraudulent Conveyance*, 67 COLUM. L. REV. 1313, 1314 (1967) ("[T]he central issue [in determining choice of law] can be most meaningfully described not as one of property law, but as one of tort law.").

strong argument in favor of classifying fraudulent conveyances as torts committed against the Ponzi corporation is that the nature of the scheme itself warrants such an interpretation. When investors receive distributions in excess of their contribution, the corporation becomes increasingly insolvent.[133] In fact, the corporation is insolvent the moment the distribution is made.[134] Each transfer made to an investor in excess of their contribution effectively depletes the assets of the Ponzi corporation.[135] Therefore, it can be argued that each distribution accepted and retained by an investor amounts to a tort against the Ponzi corporation contributing to its insolvency.

This argument may be successful in establishing that a tort has been committed against the Ponzi corporation and that an investor should be held liable. However, the matter of *where* the tort has occurred still remains unresolved. For resolving conflicts of law questions, this is the essential issue. Determining where the tort has occurred may determine which state's fraudulent conveyance law is to be applied. Of course, this analysis is easier stated than done.

To begin with, in diversity actions a federal court must apply the conflicts laws of the state in which it sits.[136] While the federal court's jurisdiction over the receiver's claim is ancillary to the federal question claim against the Ponzi scheme operators and is not a diversity action, the receiver's fraudulent conveyance actions will be exclusively state law claims.[137] Therefore, it can be argued that the conflicts laws of the forum state should be applied as in diversity actions brought under state law.[138] This approach presents the most practical and outcome determinative

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[132] *See*, *e.g.*, United States v. Neidorf, 522 F.2d 916, 917-18 (9th Cir. 1975) (holding liability of transferee of a fraudulent conveyance is based not upon tort but upon quasi-contract); Desmond v. Moffie, 375 F.2d 742, 743 (1st Cir. 1967) (finding fraudulent conveyance claim under Massachusetts Uniform Fraudulent Conveyance Act not to be a tort for purposes of choosing appropriate statute of limitations); Branch v. FDIC, 825 F. Supp. 384 (D. Mass. 1993) (finding fraudulent conveyance claim not to be a tort claim for purposes of the Federal Tort Claims Act); FDIC v. Almodovar, 671 F. Supp. 851, 871 (D.P.R. 1987) (finding fraudulent conveyance claim not to be a tort for purposes of choosing appropriate statute of limitations); United States v. Franklin Nat'l Bank, 376 F. Supp. 378, 381 (E.D.N.Y. 1973) ("New York Debtor and Creditor Law, which adopts verbatim the Uniform Fraudulent Conveyance Act, does not confer upon the creditor a right of action in tort against the grantee.").

[133] Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995).

[134] *See id.*

[135] *See id*.

[136] *See, e.g*., Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941).

[137] *See Scholes*, 56 F.3d at 753 (holding receiver may sue only to redress injuries to the entities in receivership).

[138] This in fact was the argument adopted by the receiver in *Terry*. See Partial Summary Judgment Motion of Receiver, May 6, 2005, http://www.dowdell-receivership.com /graphics/cv052_docket040.pdf.

solution to resolving which state's conflicts principles should be applied in order to determine what state law is applicable.

Naturally, the next step would be to apply the forum state's conflicts principles to determine which state's law governs. Most states have adopted either the "rational relationship" test under the Restatements[139] or follow the well-settled principle of *lex loci delicti*, also known as the "place of the wrong" test.[140] The "rational relationship" inquiry focuses on which state has the most significant relationship with the transaction, or the tort in the Ponzi scheme context.[141] The principle of *lex loci delicti* requires the court to look into the last act necessary to complete the transaction or tort.[142] For purposes of fraudulent conveyances, under both of these tests the court would be required to examine either how the conveyances came about or what the last act necessary to complete the tort of fraudulent conveyance was. Under this analysis, it appears the focus of inquiry in the Ponzi scheme context would be where the acts occurred which depleted the Ponzi corporations assets. This could mean either looking to where the investment contract was formed, what state or states the majority of the distributions to the investor were made in or from, or, if distributions were made by checks or wire transfers to investors, where the last acts necessary to complete those transactions occurred.

Regardless of the approach taken, the analysis is unnecessarily protracted and fails to provide a predictable outcome from case to case. A strong position can be taken on each of the above mentioned possibilities for resolving conflicts of law disputes.[143] This compounds problems for the receiver. It results in the receiver being burdened with more litigation against the investor with respect to resolving these issues increasing time and cost. More importantly, there is no uniformity in outcome. Fraudulent conveyance diverges from jurisdiction to jurisdiction.[144] The application of fraudulent conveyance law in one jurisdiction could conceivably allow an investor to keep her distributions while the law of another may require a similarly situated investor to

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[139] *See, e.g.*, Amica Mut. Ins. Co. v. Gifford, 434 So. 2d 1015 (Fla. Dist. Ct. App. 1983).

[140] *See, e.g.*, McMillan v. McMillan, 219 Va. 1127 (1979); Baise v. Warren, 158 Va. 505 (1932).

[141] *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971).

[142] *See McMillan*, 219 Va. at 1129; *Baise*, 158 Va. at 508.

[143] In fact, the defendant in *Terry* successfully argued to a federal magistrate judge that Virginia law should apply to the action before the case was appealed by the receiver to the district court. Terry v. June, 359 F. Supp. 2d 510, 512 (W.D. Va. 2005).

[144] Contrast Virginia fraudulent transfer law requiring the receiver to show "lack of valuable consideration" in order to void transfer as opposed to the UFTA approach which only requires a showing of insolvency when transfer is made.

disgorge. In essence, the receiver is faced with fresh choice of law issues in each new action brought against investors to disgorge distributions which can break either in favor of the investor or the receiver. In the end, the consequence is more time and money spent in recovering investor funds and depletion of the recovery which is to be redistributed back to investors who have lost their principle investment in the scheme.

2. Problems with Piercing Offshore Entities

The most traditional method of asset and liability protection has been the establishment of corporations, limited liability partnerships and limited liability companies.[145] In particular, establishing such entities offshore in island nations such as the Bahamas or the Cayman Islands can provide a substantial form of asset and liability protection for the individual investor. Many sophisticated Ponzi investors who are indirect insiders to the scheme, knowing of the nature of the scheme and the scheme's eventual demise, having tremendously benefited from its generous "profit" distributions, enter the scheme as single or majority shareholders of such entities in order to thwart litigation or, at the very least, make it costly and difficult to disgorge their ill-gotten gains.

Establishing jurisdiction over offshore entities imposes a substantial barrier. Under U.S. law, the corporation or entity must be served in accordance with the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters.[146] This assumes the offshore entity resides in a country that is a party to the treaty.[147] The Convention requires "[t]he authority or judicial officer competent under the law of the State in which the documents originate" to forward copies of the document to the designated Central Authority in the country where the documents are to be served.[148] Once delivered to the Central Authority, the Central Authority must approve that service has complied with the provisions of the Convention, and only then will it proceed to serve the documents.[149]

This poses some major obstacles for the receiver. Process can take between three and six months to complete, placing an extraordinary time impediment on recovering investor funds. Fraudulent conveyance actions

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[145] Ritchie W. Taylor, Note, *Domestic Asset Protection Trusts: The "Estate Planning Tool of the Decade" or a Charlatan?*, 13 BYU J. PUB. L. 163, 165 (1998).

[146] Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters, Nov. 15, 1965, 16 I.L.M. 1331 (1977) [hereinafter Hague Convention on Service Abroad].

[147] Currently the Hague Convention on Service Abroad is in force in these offshore nations: Bahamas, Barbados, St. Vincent and the Grenadines.

[148] Hague Convention on Service Abroad, ch. 1, art. 3

[149] *Id*. ch. 1, art. 4

brought by the receiver are subject to a statute of limitations (generally two years) from the time of appointment. Discovering distributions made in excess of the principle invested and tracing transfers made to individual shareholders of such entities can take over a year, leaving the receiver with limited time to bring an action against such an entity. Furthermore, assuming service is accomplished, jurisdiction is found proper, and a judgment is attained, a federal court exercising ancillary jurisdiction may not retain jurisdiction to enforce the judgment.[150] This may leave the receiver with having the judgment enforced against the individual or majority shareholder in either a state court in the state in which the investor resides, or in the foreign court of the country in which the entity is incorporated or formed.

Such a result poses two practical problems. Under the first scenario, a state court will naturally adopt its own veil-piercing doctrine in order to determine whether the judgment can be enforced against an individual shareholder. Depending on the stringency of the veil-piercing doctrine, it will either prevent the receiver from piercing to reach the shareholder or may require the receiver to prove more facts which warrant piercing under the state's doctrine, increasing the receiver's time and cost of litigation.

Under the second scenario, a foreign court may be reluctant to enforce a judgment entered in a non-native jurisdiction because it may be dissatisfied with the manner in which process is served or because of due process concerns.[151] The principal of "territoriality" may also be cumbersome to overcome in enforcing any judgments obtained in the United States.[152] One commentator remarked:

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[150] In *Peacock v. Thomas*, 516 U.S. 349 (1996), the Supreme Court of the United States overruled the Fourth Circuit's holding that a district court retained ancillary jurisdiction to enforce a judgment entered under an ERISA claim. The Court held:

> [C]laims alleged to be factually interdependent with and, hence, ancillary to claims brought in an earlier federal lawsuit will not support federal jurisdiction over a subsequent lawsuit. The basis of the doctrine of ancillary jurisdiction is the practical need "to protect legal rights or effectively to resolve an entire, logically entwined lawsuit." But once judgment was entered in the original ERISA suit, the ability to resolve simultaneously factually intertwined issues vanished. . . . Neither the convenience of litigants nor considerations of judicial economy can justify the extension of ancillary jurisdiction over [a plaintiff's] claims in [a] subsequent proceeding.

*Peacock*, 516 U.S. at 355 (citation omitted).

[151] For example, in the United Kingdom, by statute, foreign judgments which enforce both civil and criminal liability are severable and judgments awarding penalties or awards over compensatory damages are equally unenforceable. *See* ENFORCEMENT OF FOREIGN JUDGMENTS IN PERSONAM, c.157 (HALSBURY'S LAWS OF ENGLAND).

[152] Lynn M. LoPucki, *The Death of Liability*, 106 YALE L. J. 1, 13 (1996).

> As an initial matter, a judgment can be enforced only within the territorial jurisdiction of the court that entered it. To enforce against property in another [foreign] jurisdiction, the holder must establish its judgment in that jurisdiction. The 'full faith and credit' clause of the United States Constitution assures that a judgment of one state will be enforced in the courts of another; the principle merely requires formal proof of the existence and validity of the judgment. Foreign countries, however, may require that the underlying cause of action be relitigated. The United States is not yet party to any treaties for the enforcement of judgments [abroad]. [153]

### *C. Overcoming Conflicts of Law Issues Through Adoption of Federal Common Law*

Taking the *Clearfield Trust, Kimbell Foods* and *Boyle* cases into consideration in the SEC appointed receivership context, three major hurdles emerge for the SEC appointed receiver of a Ponzi corporation to overcome. First, the receiver must establish some source of federal authority for invoking a uniform federal rule. The Eighth Circuit's reasoning in *Bryan v. Bartlett* is satisfying and in conformance with established law with respect to this factor. Next, a receiver must show that adoption of a uniform rule is necessary to affect a federal interest or purpose. Finally, the receiver must show that the displacement of state law will not raise the general concerns of federalism when federal common law is applied substantively. This analysis was not made in *Bryan*, most likely because adoption of a uniform federal fraudulent conveyance rule in the Ponzi receiver context, which was at issue in the case, was irrelevant to the ordinary transactions which state fraudulent conveyance laws normally address, and did not implicate the unforeseeable consequences mentioned in *Kimbell Foods*.[154] However, this analysis may be important in adopting a uniform federal veil-piercing doctrine over state law in a disgorgement proceeding dealing with a Ponzi investor investing as an offshore entity.

#### 1. The Concept of a Receiver Serving a Federal Interest and Function

The proposition that a court-appointed receiver serves a federal interest is directly supported in *Bryan v. Bartlett*.[155] In *Bryan*, the SEC sued a bank seeking to enjoin violations of the Securities Acts of 1933

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[153] *Id*.
[154] *See supra* discussion Part I.1.
[155] 435 F.2d 28 (8th Cir. 1970).

and 1934.[156] The court entered a temporary injunction and appointed a federal equity receiver over the bank to protect defrauded investors.[157] The receiver then sued the bank's directors to recover on certain promissory notes belonging to the bank.[158] The directors argued that state law should govern their defenses in the case[159] but the Eighth Circuit disagreed:

> We find this proposition doubtful. Federal jurisdiction in this case is based, not on diversity of citizenship, but on a federal equity receivership arising from violation of the federal securities regulation statutes. The receiver was appointed in this case to prevent further violations of the federal securities laws and to preserve the assets for the benefit of the investor-creditors of the companies, who are primarily individual citizens of many different states and whose financial interests were endangered by the securities law violations of the defendants. As Professor Loss points out, "surely this [an SEC receivership proceeding] is an instance of the post-Erie survival of a 'federal common law' (in this case, equity)."
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> We find no cases directly in point on this issue, but an analogy may be drawn from the case of *D'Oench, Duhme & Co. v. F.D.I.C.* In that case, the F.D.I.C. brought suit on a note which it had acquired an asset from collateral for a loan made to a state bank. The defense of want of consideration was asserted, but the parties could not agree on which state law was to be applied to the transaction, it being alleged that under Missouri law the defense was proper, while under Illinois law the defendant would be estopped to deny liability on this ground. The Supreme Court held that the matter was not a question of state law, but of federal law. There were two reasons for this result. First, the corporation was an agency of the federal government and second, the policy underlying the Federal Reserve Act to protect the assets of public banks from misrepresentation required the questions presented to be determined by federal standards. Here the receiver, while not a federal corporation, is an officer of a federal court appointed because of violations of federal law. The policy underlying the federal Securities Act of 1933 is to protect investors from the fraudulent sale of securities and the common loss of investment which follows from violations of the act. In unsnarling the tangled affairs of these corporations to preserve insofar as

156 *Id*. at 31.
157 *Id*. at 32.
158 *Id*.
159 *Id*.

> possible assets for distribution to the defrauded investors, the receiver is performing a federal function. These are substantial reasons for applying a federal rule of decision to this case.[160]

The federal interest in the Ponzi receiver context is made clear. According to *Bryan*, the federal interest is the vindication of investors defrauded from the Ponzi scheme operators' violations of the Securities Acts. In this respect, the Receiver serves an important federal function and purpose by enforcing the Securities Acts through the Court's ancillary powers. In essence, the receiver is made a quasi-federal agent whose authority is derived from the Securities Acts. This analogy conforms neatly to the "federal source of power" and "frustration of purpose" propositions described in *Clearfield Trust*.

The degree to which the federal purpose would be exacerbated is not directly considered but assumed in *Bryan*. However, the discussion from the preceding section clearly reveals that the receiver's practical barriers resulting from the adoption of conflicting state fraudulent conveyance law and state veil-piercing doctrines. Considering the implications of these factors, a serious "frustration of federal purpose" under *Kimbell Foods*' two-pronged inquiry with respect to uniformity can be established.

*a. Applying the Uniform Fraudulent Transfer Rule*

The need for a federal rule of law in this case far outweighs a state's reliance or interest in fraudulent conveyance law. In the Ponzi scheme context, the reliance is irrelevant since a state's interest in imposing fraudulent conveyance law is related to a debtor's attempt to hide or divert assets from her creditors.[161] In a Ponzi scheme, the transfers are paid as fictitious "profit" distributions and, though fraudulent, are not made with the specific intent to defraud creditors through the diversion of assets. Rather, the transfers are made to show large returns on principal investments in order to deceive and lure new investors so that the scheme may continue. Applying a uniform federal rule to this context has no implication upon or binding effect on debtor transactions aimed at defrauding creditors. Arguably, it is irrelevant to a state's reliance on fraudulent conveyance law. Therefore, the *Kimbell*

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[160] *Id.* at 32-33 (citing 3 L. LOSS, SECURITIES REGULATION 1513 n.113 (1961)) (alteration in original). Technically, the language in *Bryan* is dicta because the court stated "[e]ven if the case is deemed to be governed by Arkansas law, we have investigated the law of that state closely and find no conflict with the decision here rendered." *Id.* at 33.

[161] *See generally* 1 MICHIE'S JURISPRUDENCE, *Fraudulent and Voluntary Conveyances*, §§ 4, 12 (1999).

*Foods* Court's concerns with the displacement of state law are not applicable in this context and a uniform federal rule may be applied substantively.

The question then becomes what fraudulent transfer rule should be adopted as a uniform federal rule. The use of uniform statutes as federal common law has often been held appropriate to displace state law.[162] One aspect to consider in this determination is which uniform law has been adopted by most states.[163] In the past, federal courts have applied the Uniform Fraudulent Conveyance Act (UFCA) as federal common law.[164] Currently, the Uniform Fraudulent Transfers Act (UFTA) has replaced the UFCA and has been adopted by forty-two states and the District of Columbia.[165] In the receivership context, it is reasonable to consider the UFTA as a national standard.[166]

The language of the UFTA is considerably favorable for the receiver. Most significantly, the UFTA shifts the burden of having to prove valuable consideration of the investor in good faith by the receiver to having the investor prove valuable consideration. Furthermore, since transfers made as part of a Ponzi scheme are presumed to be fraudulent, it is very difficult for an investor to prove that a fictitious "profit" distribution is not made with the intent to defraud. Assuming valuable consideration is proved on the part of an investor, it will only allow for the retention of the principle investment and not for any profits received. This tilts the balance of litigation considerably in favor of the receiver. As a result, once it can be shown that investors have received funds in excess of their principle investments from a Ponzi operation, investors will be more likely to settle their disputes than to litigate.

### *b. Federal Veil-Piercing Doctrine*

Additionally, where a violation of a federal statute benefits a corporation, veil-piercing under federal common law may be appropriate.[167] Not only do violations of the Securities Acts benefit the offshore corporation by allowing it to profit from fraudulent transfers as part of a Ponzi operation, but primarily the single or majority shareholder

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[162] FDIC v. British-Am. Corp., 755 F. Supp. 1314, 1325 (E.D.N.C. 1991) (citing United States v. Wegematic Corp., 360 F.2d 674, 676 (2d Cir. 1966); Everett Plywood & Door Corp. v. United States, 419 F.2d 425, 429-30 (Ct. Cl. 1969)).

[163] *See id.*

[164] *See id*. (citing United States v. Neidorf, 522 F.2d 916 (9th Cir. 1975); United States v. Johnston, 245 F. Supp. 433, 443 (W.D. Ark. 1965)).

[165] *See* Terry v. June, 359 F. Supp. 2d 510, 520 (W.D. Va. 2005).

[166] *See id.*

[167] *See* Note, *Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 HARV. L. REV. 853, 867-68 (1982).

benefits from the violations as an alter ego. In other words, acceptance of funds from the Ponzi scheme can be construed as tortious acts falling outside of the corporate function to aide in violations of the Acts.

It is firmly established that a domestic shareholder of a foreign corporation may be held liable for an act done by the corporation under the laws of the United States.[168] It is also well settled that "a state may impose liability upon a shareholder of a foreign corporation [under the state's law] for an act done by the corporation in the state, if the state's relationship to the shareholder is sufficient to make reasonable the imposition of such liability upon him."[169] In *First National City Bank v. Banco Para El Comercio Exterior De Cuba*, the Supreme Court of the United States reasoned:

> As a general matter, the law of the state of incorporation normally determines issues relating to the *internal* affairs of a corporation. Application of that body of law achieves the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation. Different conflicts principles apply, however, where the rights of third parties *external* to the corporation are at issue. To give conclusive effect to the law of the chartering state in determining whether the separate juridical status of its instrumentality should be respected would permit the state to violate with impunity the rights of third parties under international law while effectively insulating itself from liability in foreign courts.[170]

Whether to impose liability upon a foreign corporation under foreign law or United States State law is clear within the context of an "external" claim filed by a third party. The language of *First National Bank* can be used against foreign corporations to protect victims of torts committed by the corporation within the state under state law. Federal courts have generally considered fraudulent transfers to be torts.[171] The application of a federal common law rule in such a case does not necessarily run the risk of creating precedent which will subvert substantive state corporate law by the imposition of federal law nor will it thwart any other federal policy if the transfer is considered a tort

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[168] *See, e.g.*, First Nat'l City Bank v. Banco Para El Comercio Exterior De Cuba, 462 U.S. 611 (1989).

[169] RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 307, reporter's note (1971) (citing Thomas v. Martthiessen, 232 U.S. 221 (1914); Pinney v. Nelson, 183 U.S. 144 (1901)); s*ee also* Henry Hansmann & Reinier Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 HARV. L. REV. 446, 452 (1992).

[170] *First Nat'l City Bank*, 462 U.S. at 621-22 (citation omitted).

[171] *See supra* Discussion Part II.A.

committed against the Ponzi corporation. This is because the action should be considered "external" and beyond the scope of the corporate charter or an *ultra vires* act.[172]

Arguably, a shareholder does rely significantly upon the veil-piercing doctrine of the state in which they are incorporated. However, in determining whether to disregard the corporate entity, "[t]he strength of the particular federal interest violated must be weighed, not only against state corporate law, but also against other federal policies that may be implicated."[173] This analysis allows the court to serve as a sort of "gatekeeper" that balances the equities in determining whether to allow a veil-piercing to proceed under federal standards. It also conforms with the standards of *Kimbell Foods*.

As discussed earlier, veil-piercing doctrines vary from jurisdiction to jurisdiction with some being more stringent than others. It is conceivable for one jurisdiction to allow piercing of an offshore entity to reach a shareholder that has received fraudulent transfers as part of a Ponzi scheme while another jurisdiction will maintain the integrity of the corporate form.[174] The danger of *Clearfield Trust* in "making identical transactions subject to the vagaries of the laws of the several states"[175] is evident. The federal common law standard for piercing the corporate veil is then appropriate.

The federal common law veil-piercing doctrine perhaps provides the least cumbersome and surmountable method for reaching an offshore shareholder in the Ponzi scheme context. It also provides the most uniform approach for the receiver when dealing with such entities. The federal doctrine establishes a two-pronged balancing test to determine whether the veil should be pierced.[176] The first prong asks whether there is "such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist."[177] The second prong must assess whether an "inequitable result will follow 'if the acts are treated as those of the corporation alone.'"[178]

It is presumable that a single shareholder of the entire stock or majority holder of an offshore corporation receiving fraudulent transfers

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[172] *See, e.g.*, City Coal & Ice Co. v. Union Trust Co., 140 Va. 600, 605-06 (1924) (explaining the doctrine of *ultra vires*).

[173] *Piercing the Corporate Veil: The Alter Ego Doctrine Under Federal Common Law*, *supra* note 166, at 868 (citing Tran Qui Than v. Regan, 658 F.2d 1296 (9th Cir. 1981); Spiess v. C. Itoh & Co. Am., 643 F.2d 353 (5th Cir. 1981)).

[174] *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971).

[175] *See* Clearfield Trust Co. v. United States, 318 U.S. 363 (1943).

[176] Flynn v. Greg Anthony Constr. Co., 95 F. App'x 726, 734 (6th Cir. 2003).

[177] *Id*.

[178] *Id*. (quoting Labadie Coal Co. v. Black, 672 F.2d 92, 96 (D.C. Cir. 1982)).

in their entirety on behalf of the entity receives the full benefit of those transfers. It can easily be said that the shareholder has a unity of interest with the corporation. The difficulty under state law comes when an individual invests on behalf of the corporation as an "employee" of the corporation in the Ponzi operation. It becomes especially difficult when the offshore corporation is engaged in other legitimate business activity managed by the majority shareholder and is not established merely as a "shell" corporation. The federal common law doctrine is arguably a more relaxed standard and would still allow the veil to be pierced in such a context (where the offshore entity is engaged in a legitimate enterprise) if there is a minimal showing of the first factor.

As for the second prong, the burden placed on the receiver of acquiring jurisdiction over the offshore corporation and the very real possibility that a domestic judgment against the corporation will not be enforced abroad certainly qualify as "inequitable results" in the event the veil is not pierced. The prospect speaks heavily in favor of piercing and while there may be only a minimal finding of "unity of interest," the presence of a federal interest, that being the enforcement of the Securities Act by recovering lost investor funds to the Ponzi scheme, could tilt the balance towards piercing.

2. The Case of *Terry v. June*

While the language of *Bryan* was dicta,[179] it proved persuasive for the district court in the Western District of Virginia. In this case, the district court exercised ancillary jurisdiction over the disgorgement proceedings of a receiver appointed by the SEC to recover false profits made as part of a multinational Ponzi scheme.[180] The facts of *Terry v. June*[181] are unprecedented and the court's analysis truly reflects the "post-*Erie* survival of a 'federal common law.'"[182]

The district court appointed Roy M. Terry, Jr. and the law firm of DurretteBradshaw as Receivers over a fraudulent Bahamian corporation, "Vavasseur," developed and marketed as an investment and trading program.[183] Terry L. Dowdell was chief officer and administrator of the program.[184] Over a period of approximately four years, Dowdell lured investors with promises of high rates of return, as high as 160 percent of

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179 *See supra* note 160.
180 *See* Terry v. June, 359 F. Supp. 2d 510 (W.D. Va. 2005).
181 *Id.*
182 Bryan v. Bartlett, 435 F.2d 28 (8th Cir. 1970) (quoting 3 L. LOSS, SECURITIES REGULATION 1513 n.113 (1961)).
183 *See Terry*, 359 F. Supp. 2d at 512-13.
184 *Id.* at 512.

principle investment, in the form of "profit" distributions.[185] In fact, Dowdell paid these "profit" distributions to investors with funds he and his associates solicited from newer investors.[186] Dowdell and his associates never actually invested any money in any sort of venture.[187] The scheme, which began in Florida and later moved to Virginia, was entirely fraudulent.[188] Ultimately, the SEC and Federal Bureau of Investigation (FBI) discovered and shut down the operation.[189] The scheme attracted investors from no fewer than 26 states and foreign countries[190] and generated in excess of $121 million.[191]

Robert June, Sr., a Michigan resident, was one of many investors involved in Dowdell's program.[192] June's son, Robert June, Jr., was an employee of Dowdell who managed his father's investments.[193] Following the collapse of the scheme, the law firm of DurretteBradshaw, P.L.C., filed an action in federal district court against June to recover funds as Receivers of Vavasseur (hereinafter "Receivers").[194] The Receivers alleged June had received "substantial earnings" on his investment which were, in reality, merely the funds of later investors in Dowdell's scheme.[195] The Court maintained supplemental jurisdiction over the case because it was ancillary to the SEC's main case against Dowdell.[196]

After filing a complaint against June, the Receivers moved for summary judgment.[197] At issue was which state fraudulent conveyance law would be applicable to the case.[198] Though the scheme and program were operated mainly from two states, Florida and Virginia, Virginia being the state where Dowdell solicited June as an investor, the Court concluded that the UFTA was applicable under federal common law.[199] The Court reasoned:

> [T]he present case . . . [is] one of those limited instances where the application of federal common law is appropriate, because

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185 *Id.* at 513.
186 *Id.*
187 *Id.*
188 *Id*. The scheme's main operator, Terry Dowdell, moved from Florida to Virginia.
189 *Id.*
190 *Id.*
191 *Id.*
192 *Id.*
193 *Id.*
194 *Id.*
195 *Id.*
196 *Id.*
197 *Id.*
198 *Id.*
199 *Id.* at 520.

there is a significant conflict between the federal interests involved and the application of state law. First, there is a strong need for uniformity in the treatment of the Receiver's various claims against those who allegedly received fraudulent transfers from the Dowdell fraud scheme. There is a federal interest in the consistent enforcement of the federal securities laws, in which the Receiver's asset recovery efforts play a significant role. The Receiver has represented—and the defendant has not disputed—that the scope of the fraud includes no fewer than 26 states and foreign countries. Of the many individuals around the world who made similar investments in the same investment program, and who received fictitious profits in return, it would be unfair and illogical to allow some of those investors to retain their profits while forcing others to disgorge theirs. Yet that is the possible result of applying the laws of different states and nations to the Receiver's various suits.

Second, the application of varying state and foreign laws could frustrate the objectives of the Receiver, which are federal in character, namely the protection of investors from the fraudulent sale of securities by recovering assets for distribution to the victim investors. The application of Virginia's fraudulent conveyance law could make the recovery of assets more difficult in this case, because it seems to set a higher bar than does the UFTA for setting aside fraudulent conveyances. Moreover, the lack of a nationwide common law rule could subject the Receiver to additional litigation over the proper law to apply in different cases. The Receiver's additional expenses would be paid from funds that would otherwise be returned to the fraud victims, hindering the federal interest in maximum compensation for the victims of securities fraud.

The need for uniformity and the objective of asset recovery, by themselves, may not be sufficient grounds for applying federal common law. This case, however, also involves securities regulation—an area governed by federal laws that are enforced in federal courts by a federal agency, the Securities and Exchange Commission. The Receiver here is performing federal functions. He was appointed by a federal court; his powers are governed by the court order and by federal statutes. The Receiver's efforts are an integral adjunct to the SEC's enforcement of the federal securities laws. The federal securities statutes confer upon district courts broad equitable powers to fashion appropriate remedies, including the appointment of a receiver, to effectuate the purposes of the securities laws. The Magistrate Judge's order of July 12, 2002 authorizes the Receiver to take necessary

> measures, including the bringing of legal actions, to prevent the dissipation of any receivership assets. The collection of these assets for their eventual disbursement to the fraud victims is a federal interest, which the court finds to be in conflict with the potential application of diverse state (and foreign) laws.[200]

## III. CONCLUSION

The facts of a multinational or multi-state Ponzi scheme are generally very unique. The application of federal common law to ensure the uniformity of outcomes and to ensure the quick resolution of ancillary claims resulting from the fraud perpetrated against innocent investors in a multi-jurisdictional Ponzi scheme is not only warranted under such narrow circumstances but, arguably, is necessary to effectively accomplish the federal purpose for which the receiver is appointed. Courts commonly look to the spirit and purpose of the Securities Acts when unusual circumstances arise that threaten the average investor and the general integrity of the securities market.[201]

Ponzi schemes should generate particular concern to courts that consider such potential harm. The attractive and lucrative appearance of a Ponzi operation is especially alluring to unsophisticated investors seeking a generous return on their investment. Since Ponzi schemes are destined to collapse, a cost-effective and time-efficient process should be in place to maximize recovery of lost funds. Indeed, maximum recovery is the goal and purpose in appointing a receiver over collapsed entities operating such fraudulent programs. Decreasing the time and cost of the receiver's litigation certainly accomplishes this goal. Permitting the receiver to benefit from the adoption of a uniform fraudulent conveyance law under federal common law principles and also allowing a federal common law veil-piercing standard in actions against investors that have received fraudulent transfers on behalf of wholly owned offshore corporations goes far in accomplishing this task by setting a uniform standard to apply in the various disgorgement actions they must commence against entities which have profited from ill-gotten gains.

Conversely, courts should be concerned with the precedent established by failing to adopt uniform rules under federal common law. Variations in fraudulent conveyance law admittedly will frustrate

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[200] *Id.* at 518-19 (citations omitted).

[201] *See, e.g.*, Reves v. Ernst & Young, 494 U.S. 56, 60 (1990) (stating "[t]he fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market'") (citing United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975)).

uniformity for the receiver bringing civil ancillary actions against Ponzi scheme investors. A very real consequence of applying different state fraudulent conveyance laws to essentially the same proceedings will be, in the words of *Terry*, "unfair and illogical" since it would "allow some . . . investors to retain their profits while forcing others to disgorge theirs."[202] Furthermore, the burden placed on the receiver in resolving conflicts of law only increases the cost of the receiver's litigation, which is paid from recovered investor funds.

Another consequence may be an indication to shareholders of such offshore corporations that there is unwillingness in federal courts to hold individual shareholders liable through federal common law if there is a conflict with state corporate law. Indirect insiders who benefit from such schemes can often be immune from prosecution by the SEC. As a result, they would have an added wall of protection in setting up offshore entities if they could avoid civil liability by making litigation timely and expensive for the receiver by operating in a state with lax veil piercing laws and by lengthening the time to serve process on these entities. Such an outcome would frustrate the goal of the receiver by making disgorgement proceedings difficult, timely, and expensive, and could even discourage prosecutions.

The receivership in the Ponzi scheme context clearly illustrates the necessity of federal common law. The purpose of judge-made law is to intervene where statutes fail to address clear injustice and a legislature cannot act soon enough to remedy that injustice. The dangers in usurping a state legislature's authority in such a narrow context seem nonexistent. Federal common law exists, and must exist, to displace the inequities which arise and to address the unavoidable conflicts, within a system of government interconnected with other smaller governments. Furthermore, the need for more flexible and malleable principles of federal common law are arguably necessary in the global business context to maintain the integrity of federal policy and purpose in the face of competing foreign law, as illustrated above.

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[202] *Terry*, 359 F. Supp. 2d at 518.