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Foundation for New Era Philanthropy Scandal Rocks the Boat for Charities in Need of Funds

The New Era 'Ponzi' scheme resulted in bankruptcy with charities looking to recoup $81 million in losses

WENDELL R. BIRD

The largest scandal involving charities, with the exception of PTL (Praise the Lord) and Jim Bakker,[1] emerged in 1995 with the Foundation for New Era Philanthropy. New Era filed for bankruptcy protection, and it became evident that there were no "anonymous benefactors" to provide promised matching grant funds. Instead, matching funds came from later receipts from individual donors or charities, and New Era amounted to a grant Ponzi[2] scheme.

The New Era scandal raises some significant tax questions about whether and how exempt organizations may return donations to donors or to a bankruptcy trustee for a conduit charity, particularly when the conduit is disqualified from exemption. The bankruptcy trustee has demanded that charities return about $80 million in "matching grants" that were not really matched by anonymous donors and that other charities return millions in outright grants that were not really funded by donors.

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NEW ERA'S GRANT PROGRAM

The Foundation for New Era Philanthropy derived its name from offering a new approach to fundraising, with a heavy emphasis on matching grants from "anonymous benefactors."

Matching donor grants. The three-party transactions involved a donor to a charity that deposited the funds with New Era for six months (or nine months) with the understanding that a larger amount (typically double) would then be delivered to the charity. New Era alleged that this was possible through "anonymous benefactors."

Matching charity funds. In the two-party transactions, a charity deposited its own funds with New Era for six months (or nine months) with the promise of a larger amount (typically double) to be delivered back to the charity. New Era requested that charities deposit with them only newly raised funds and only funds that were not necessary to meet the charity's normal operating budget.

On its Form 990, New Era reported 1993 contributions received of $41,259,917 and contributions paid and other program services of $36,319,839. Its contributions received in prior years were $8,641,170 in 1992, $2,616,847 in 1991, $1,402,946 in 1990, and $306,201 in 1989.

The trustee has characterized the New Era scheme as "a fraudulent scheme, whereby the Debtor misdirected subsequent principal funds placed into the Fund to pay principal and matching funds to prior depositors or contributors' designated third-party charities. Schemes of this nature are commonly referred to as 'Ponzi' schemes.... [T]he Debtor operated the Fund as a 'Ponzi' scheme."

LOSSES BY NEW ERA VICTIMS

New Era's voluntary petition listed assets at $80 million and liabilities at $551 million, less Prudential Securities accounts of $45

million.[3] The interim trustee's schedules and statement of affairs listed $97,991,671 in cash losses (exclusive of promised doubling of donations). This amounted to "cash in" of $225,940,164, and "cash out" of $153,392,891.

Current estimates are that charities hold approximately $81 million in claims against the bankruptcy estate as their total net loss and that donors hold approximately $47 million in claims for their total net loss, for a total in claims of $128 million. (The donors' net loss has not been offset by the doubling of their payments that was promised by New Era.) There is some belief that the donors should not be deemed to have any claims or at least should not be able to enforce those claims beyond assigning them, since they were not expecting any funds back from New Era.

The interim trustee's schedules listed 255 donors and charities that placed cash in New Era. These included financiers, such as Laurent Rockefeller, a Goldman Sachs partner, and William Simon, and institutions such as the University of Pennsylvania, the American Red Cross, and the Nature Conservancy.[4]

PROCEDURAL HISTORY OF BANKRUPTCY PROCEEDINGS

New Era filed voluntarily for bankruptcy on 5/15/95, hoping to keep chapter 11 status. With the petition, New Era filed an emergency motion to seal the required list of creditors. The *Philadelphia Inquirer*, the *New York Times*, and other publications and creditors opposed the motion. The judge denied the motion, on 5/18/95. The judge converted the bankruptcy to chapter 7 and ordered the appointment of a trustee on 5/19/95.

Prudential Securities held approximately $20 million of New Era-related funds. Immediately before New Era's bankruptcy filing, on 5/11/95, Prudential had seized $42 million of those funds, claiming they were security for a margin account on which New Era had defaulted. On May 15, Prudential filed a motion to excuse turnover of the funds to New Era or its trustee and to freeze the funds. Thus, Prudential knew in advance of the bankruptcy filing. The court granted that motion on May 16 and May 18 and on May 24 ordered Prudential to turn over the funds to the trustee, along with a list of accounts.

Trustees. An interim trustee, John Carroll, was appointed on 5/19/95. He unified creditors against him when he notified them that he would oppose all their proofs of claim and notices of claim, evidently seeking to disqualify all or most creditors from voting on a permanent trustee. A successor trustee, Arlin M. Adams (a former Third Circuit judge), was elected by the creditors on 6/26/95 and confirmed 7/6/95. He selected legal counsel, Buchanan Ingersoll of Philadelphia, and accountants.

Creditors. The first creditors' meeting was on 6/26/95 and set the last day to file proofs of claim 90 days later, on 9/25/95. Two primary unofficial committees of creditors have been formed: the Philadelphia Informal Creditors Committee (primarily secular organizations) and the United Response (primarily religious organizations, sponsored by the Evangelical Council for Financial Accountability). There is a cooperative attitude and some overlap between those groups.

THE FUNDS AVAILABLE FOR CHARITIES

There are three primary sources for recovery by net negative donees (that is, those charities that received no return of their funds): trustee funds, positive donees, and third parties.

Trustee funds. The trustee received approximately $31 million from Prudential's accounts for New Era or its charitable participants and from other accounts. The trustee is negotiating with Prudential. He settled with Jack Bennett (the president of New Era) in exchange for Bennett turning over all his assets, including his interest in his home, and cooperating in causing his companies to turn over their assets.

Positive donees. The net positive donees received funds beyond what they or other donors deposited, either as matching grants or as handouts by Jack Bennett. The trustee is entering settlement agreements with positive donees allowing them to repay the excess or positive amount and be released.[5] The response to this repayment program has been limited. The trustee can be expected to file claims against

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[1] Teague v. Bakker, 35 F.3d 978 (CA-4, 1994).

[2] Charles A. Ponzi was a swindler, born in 1926, who engaged in a scheme in which early investors were paid off with money from later investors.

[3] In re Foundation for New Era Philanthropy (Bkrptcy. DC Pa., 5/15/95), voluntary petition at 3.

[4] In re Foundation for New Era Philanthropy (Bkrptcy. DC Pa., 6/16/95), schedule of net cash loss.

[5] E.g., In re Foundation for New Era Philanthropy (Bkrptcy. DC Pa., 11/22/95), Motion of Arlin M. Adams, Trustee, for Approval of Settlement Agreement and Release between Trustee and Turning Point for Women, at 5.

those positive donees that do not voluntarily settle.

Third parties. The most likely third parties against whom trustee claims and private claims will be, or are being, litigated are Prudential Securities and New Era's accountants and attorneys (discussed below).

Allocations. The most likely allocation of New Era funds is as follows:

- Administrative claims, such as the trustee, his legal counsel, and his accountants.
- Trade creditors.
- Negative donees, who placed funds with New Era for themselves or for other charities and whose funds were not delivered before bankruptcy.

A significant shortfall in repaying the net negative donees is expected, and there will probably be nothing to pay donees' promises beyond their actual funds lost, unless a suit against Prudential is successful.

LEGAL PRINCIPLES FOR ALLOCATING AMONG CHARITIES

New Era's bankruptcy case is under chapter 7 of the U.S. Bankruptcy Code, which provides for liquidation of the debtor. Under bankruptcy law, any total net amounts received from New Era in excess of funds previously contributed to New Era within the 12 months prior to the bankruptcy will likely be a "fraudulent conveyance" that must be paid back to the bankruptcy estate. One exception covers "new value," or subsequent payments by the organization back to New Era, which can offset prior payments received from New Era during the preference period. Another exception exists for payments earmarked for the recipient organization. If the trustee were not proceeding on a net loss basis, funds received from New Era prior to making any payments to New Era may also be fraudulent conveyances, which must be paid back to the bankruptcy estate.

In addition, any amount received from New Era within 90 days before the May 15 bankruptcy filing will almost certainly be a "preference payment" that must be paid back to New Era. Any preference payments received from New Era within that 90-day period, however, should be offset by subsequent payments by the organization to New Era, but likely will not be offset by payments to New Era before the preference payment was received. The earmarking exception might not apply.

In addition to bankruptcy law, even if payments occurred more than one year before the bankruptcy, the fraudulent conveyance law of the applicable state may require that funds received from New Era be paid back to New Era.

For a chapter 7 liquidation, the Bankruptcy Code provides that certain payments by New Era before its bankruptcy be paid back to New Era for distribution to New Era's creditors. Under the Bankruptcy Code, the two primary tools for requiring third-party creditors to return funds received from New Era are provisions regarding "preferences" and "fraudulent conveyances."

Several cases have addressed the bankruptcy of a Ponzi scheme, which generally involves the use of funds from new investors to pay returns promised to earlier investors.[6] These cases involved the application of preference and fraudulent conveyance doctrines to payments received and paid out by organizations that turned out to be Ponzi schemes.

PREFERENCE PAYMENTS DURING THE PRECEDING 90 DAYS

The Bankruptcy Code provides that certain payments to creditors within 90 days prior to New Era's May 15 bankruptcy filing (that is, after February 15) must be paid back to the debtor's "bankruptcy estate" for distribution to all the creditors.

Voidable preferences. Section 547 of the Bankruptcy Code provides that a payment is a voidable preference if the transfer was:

- To or for the benefit of a creditor.
- For or on account of an antecedent debt owed by the debtor before the transfer was made.
- Made while the debtor was insolvent.
- Made within 90 days before the filing of the petition (or within one year if the creditor was an "insider").
- One that enables the creditor to receive a greater percentage of its claim than it would have received had the transfer not taken place and the debtor's assets had been liquidated in a chapter 7 case.

Payments by New Era to organizations within 90 days of the

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[6] See, e.g., In re M&L Business Machine Company, Inc., 160 Bkrptcy. Rptr. 851 (Bkrptcy. DC Colo., 1993); In re International Loan Network, 160 Bkrptcy. Rptr. 1 (Bkrptcy. D.C., 1993); In re Mark Benskin & Co., Inc., 161 Bkrptcy. Rptr. 644 (Bkrptcy. DC D.C., 1993); In re United Energy Corp., 944 F.2d 589 (CA-9, 1991); and In re Independent Clearing House Co., 77 Bkrptcy. Rptr. 843 (Bkrptcy. DC Utah, 1987).

bankruptcy filing will almost certainly be classified as voidable preferences. The organizations that contributed funds to New Era are listed in the bankruptcy petition as "creditors" and will be considered unsecured creditors of the New Era bankruptcy estate.[7] Payments to New Era created a "debt" under the Bankruptcy Code's broad definition of debt. The bankruptcy trustee will be able to show that New Era was insolvent and specify which payments were made within 90 days of the bankruptcy. The question of whether the preference exceeds the expected recovery on liquidation will depend on the facts of each organization's situation. The preference period is one year (instead of 90 days) if the creditor was an insider or affiliate of the debtor.

Exception for new value payments. Under section 547(c)(4) of the Bankruptcy Code, however, if a creditor provides "new value" to the debtor after receiving a preference payment, only the net preference amount must be returned to the bankruptcy estate. This is often called the "subsequent advance" defense. This netting process only applies to payments to the debtor made *after* the voidable preference payment was made to the creditor within 90 days of bankruptcy.[8]

For example, if New Era paid an organization $10,000 50 days before the bankruptcy and ten days later the organization contributed $6,000 back to New Era, the net preference would be $4,000. A $50,000 contribution by an organization to New Era 70 days before the bankruptcy, however, would not offset the $10,000 preference because it was made *before* receiving the preference payment.

Exception for earmarked payments. A payment may not be considered a preference payment if it consisted of "earmarked" funds. Under the "earmarking doctrine," when property of a third party is given to the debtor, but is earmarked for payment to a specific creditor of the debtor, the bankruptcy trustee cannot void the transfer as a preference as long as the property does not become property of the debtor.

The earmarking doctrine could be especially helpful if a third-party donor gave funds to New Era that were designated to be distributed to a particular organization. The key factual determination is whether the funds became the property of the debtor (New Era) or were segregated sufficiently to constitute earmarked funds. If the third-party donor funds were not segregated and were deposited directly into New Era's account and commingled with other New Era funds, the funds were not sufficiently earmarked, and the earmarking doctrine likely will not apply. If, however, the donor funds were deposited in a separate account and clearly designated for the exclusive use of the recipient organization, these payments may be earmarked sufficiently to prevent their disbursement from being construed as a voidable preference.

The trustee is taking the position, to avoid the earmarking or deposit rule, that "for the contributors to deduct the contributions from their income, they had to agree that the contribution was a gift to the Debtor and to give up all rights, title and interest in and to the principal contributed into the Fund."[9] That argument, however, would only apply to individual donors and not charity donors or charities depositing their own funds for matching.

FRAUDULENT CONVEYANCES DURING THE PRECEDING YEAR

Any payments by New Era to an organization within 12 months prior to the bankruptcy in excess of amounts previously contributed by the organization will likely be voidable preferences that must be returned to the New Era bankruptcy estate. The trustee is likely to use the fraudulent conveyance provisions of the Bankruptcy Code to require the repayment of certain funds distributed by New Era within a year prior to the 5/15/95 bankruptcy filing.

The Bankruptcy Code has two definitions of fraudulent conveyance; the first is set out in section 548(a)(1), and the second in section 548(a)(2).

Section 548(a)(1) definition. The Bankruptcy Code provides that the debtor has fraudulently conveyed property if all of the following requirements are met:

- There is a transfer of an interest of the debtor in property to a third party.
- The transfers take place within one year of the filing of the bankruptcy petition.
- The transfers were made by the debtor with actual intent to hinder, delay, or defraud creditors.

The question of whether the funds were transferred within one year depends on the organization's particular facts. Courts addressing the issue have consistently held that Ponzi schemes inherently involve intent to hinder, delay, or defraud.

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[7] See M&L Business Machine Company, Inc., *supra* note 6.

[8] *Id.*

[9] See, e.g., Motion of Arlin M. Adams, *supra* note 5, at 5.

Section 548(a)(2) definition. The Bankruptcy Code provides a second definition of constructive "fraudulent conveyance" consisting of the following elements:

- There must be a transfer of an interest of the debtor in property.
- The transfer must have been made within one year of the date the bankruptcy petition was filed.
- The debtor must not have received reasonably equivalent value in exchange for the property transferred.
- The debtor must have been insolvent or have been made insolvent by the transfer.

Regardless of which definition is used, an organization may be able to defeat the fraudulent conveyance argument and keep funds it has received from New Era to the extent that funds received were less than the dollar amount of funds contributed to New Era. The possible means for doing so are the "reasonably equivalent value" defense and the "for value and in good faith" defense.

Exception for reasonably equivalent value. The second definition of fraudulent conveyance under section 548(a)(2) does not apply if the debtor received reasonably equivalent value in exchange for the property transferred. The court in *In re Independent Clearing House* Co., 77 Bkrptcy. Rptr. 843 (Bkrptcy. DC Ut., 1987), held that the debtor received a "reasonably equivalent value" in exchange for all transfers to the creditors that did not exceed the amount the creditor had previously paid to the debtor. To the extent a creditor received more than it gave the debtor, however, the excess represented a fraudulent conveyance. This argument is based on the theory that anyone who unknowingly invests in a Ponzi scheme has a legal and equitable right to receive his investment back and any amount paid out by the Ponzi scheme first goes to pay back this investment. Because the payout by the scheme reduces the legitimate amount owed to the investor, the debtor has received "reasonably equivalent value" for the payment.

The "reasonably equivalent value" exception, however, will likely apply only to the extent that the debtor receives property or satisfaction of an already existing debt. This becomes important in the New Era situation because some organizations received funds from New Era before paying any money to it. These transfers are likely to be considered fraudulent conveyances by New Era's trustee because the recipient organization had not yet made any initial payment that was being recouped.

The New Era situation differs from other Ponzi schemes in that third-party donors were involved, with the result that some organizations received New Era funds prior to making any payment to New Era. In the typical scheme, an investor pays funds in before receiving any return. *In re International Loan Network*, 160 Bkrptcy. Rptr. 1 (Bkrptcy. DC D.C., 1993), however, presents an analogous situation in which some persons apparently invested money on behalf of others. The court found that it was the individual on whose behalf a person invested money who has the claim against the bankruptcy estate. The right to participate belonged to the name of the person listed. In the New Era situation, this may allow organizations that received third-party donor money and matching grants to be treated as the creditor with respect to the third-party donations, and this might avoid the problem of receiving funds prior to contributing any funds.

Exception for value and good faith. An exception provided by section 548(c) may insulate the creditors from the trustee's power to avoid fraudulent conveyances, regardless of which definition of fraudulent conveyance is used. Section 548(c) exempts transactions when the creditor "takes for value and in good faith."

The *In re Independent Clearing House Co.* court held that contributors to a Ponzi scheme gave "value" to the extent of their contribution to the scheme. The court concluded that only the amounts received in excess of amounts previously contributed were fraudulent conveyances. Once again, the cases do not address situations when the recipient received funds prior to investing any funds in the scheme.

The question of whether contributions to the Ponzi scheme were made in "good faith" is a factual one. Courts have found an absence of good faith when the contributor to the Ponzi scheme knew it was a Ponzi scheme. In *M&L Business Machine*,[10] the court found an absence of good faith when the participant in the Ponzi scheme failed to exercise due diligence, accepted post-dated checks, and was promised very large profits. For the most part, those who contributed money to New Era appear to have a strong argument that they acted in good faith.

Possible exception for earmarked payments. It is possible that the exception discussed above for earmarked payments will apply during the year prior to bankruptcy, as it does during the prior 90 days.

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[10] *Supra* note 6.

STATE FRAUDULENT CONVEYANCE LAWS

Section 544(b) allows the bankruptcy trustee to avoid "any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim." Under "applicable law," state law applies, usually that state's fraudulent conveyance act. Most states have fraudulent conveyance statutes that function essentially like the fraudulent conveyance provisions under the Bankruptcy Code as discussed earlier. The key difference is that state fraudulent conveyance statutes often reach back for a longer period than the one year provided by the Bankruptcy Code.

LEGAL PRINCIPLES FOR CLAIMS AGAINST THIRD PARTIES

Third party claims may lie against the president of New Era, Prudential Securities, and New Era's accountants and attorneys.

Jack Bennett. Bennett was the president of New Era. Although its Form 990 for 1993 claimed he had no compensation, his consulting company received very substantial payments from New Era.

Bennett apparently designed the New Era structure and made the false claim that New Era had anonymous benefactors that would match donors' and charities' funds. The Trustee has settled with Bennett in exchange for Bennett turning over all his assets and cooperating in causing his companies to repay amounts received from New Era directly or indirectly. Charities and others may have fraud and other claims against Bennett, but there is no reason to think that they are collectible.

Prudential Securities. Prudential was the depository for a substantial part of New Era's funds. New Era told donors and charities that their funds would be in "quasi-escrow" accounts at Prudential, and this information was confirmed by Prudential personnel when various donors and charities called. In fact, Prudential did not manage the accounts as escrow accounts and allowed New Era free access to the funds, with Prudential claiming a lien to secure New Era's margin account and never informing the "quasi-escrow" charities. The secured debt reached a peak of approximately $53 million, which Prudential eliminated entirely immediately before the bankruptcy filing. Prudential's foreclosure may have triggered the bankruptcy filing, though the timing was so close that it indicated collaboration.

A typical New Era memorandum to charities informed them that

> The Foundation for New Era Philanthropy has established a quasi-escrow account in the amount of $________at Prudential Securities for the benefit of *[charity]* with a maturity on *[date]*.
>
> The investment vehicle used: U.S. Treasury Bill
>
> The code given to the agent to designate your account: *[a code]*.

Charities can be expected to argue that funds delivered to "quasi-escrow accounts" at Prudential Securities were never New Era's and were always earmarked to the charity as its property, held in a "quasi-escrow" account at Prudential. The effect of that argument would be that the funds were never part of New Era's bankruptcy issue. The success of this argument is not easy to predict. A possible problem with the argument is that, contrary to Prudential's representations, the cash account at Prudential was not separated fully into individual identifiable subaccounts and particular Treasury bills may not have been identified to particular subaccounts.

New Era accountants and attorneys. New Era's accountants were John P. McCarthy & Co., which audited New Era for 1993, with an unqualified auditor's report, and performed accounting services in 1994. The firm had not conducted the 1994 audit when New Era filed for bankruptcy. New Era's attorneys were Dechert Price & Rhoades.

CONCLUSION

The New Era scandal shows that experienced financiers as well as novices need to be cautious about transactions that sound too good to be true, because they probably are too good to be true. The bankruptcy proceeding shows that creditors can bring about rational results by a cooperative spirit between knowledgeable counsel. The unfortunate thing is that charitable giving ratchets down much more than the amount involved in a charitable scandal and never ratchets up with good news about charitable benefits to the country. ■