In re Canyon Systems Corp.

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In re Canyon Systems Corp.

Case: In re Canyon Systems Corp. (2006)

Subject Category: Bankruptcy, Pyramid

Agency Involved: Bankruptcy Trustee

Court: S.D. Ohio Bankruptcy Court

6th Circuit

Case Synopsis: Canyon Systems filed for bankruptcy because of the failure of its gold selling program. The Bankruptcy Trustee filed an adversarial proceeding, claiming that transfers of gold and money to customers was fraudulent, and should be voided by the court because Canyon was an unlawful pyramid scheme under Ohio law.

Legal Issue: Can a trustee in bankruptcy recover damages from those who profited from an insolvent pyramid scheme.

Court Ruling: No, the bankruptcy trustee cannot recover damages under state law against those who profited from an unlawful pyramid scheme, but it can void fraudulent transfers of pyramid scheme profits. Canyon sold gold coins to investors. They paid 70% of the cash investment back to the investor in gold coins, and paid another 70% when the investor reach the bottom of a customer list. The

company also paid commissions and bonuses to sale people who induced others to invest money with the company. The company depended on a continued flow of new customers to maintain the guise of a legitimate enterprise, and the bankruptcy court concluded that it was an unlawful pyramid scheme. The bankruptcy court voided the transactions between the company and customers as fraudulent, and allowed the trustee to recover the money for the benefit of the company's creditor- other investors. However, the trustee did not have standing to pursue damages claims against those who made money from the scheme.

Practical Importance to Business of MLM/Direct Sales/Direct Selling/Network Marketing/Party Plan/Multilevel Marketing: A bankruptcy trustee can avoid fraudulent transfers of money or property prior to the debtor filing for bankruptcy. Payouts from an unlawful pyramid scheme are deemed to be fraudulent.

In re Canyon Systems Corp. , 343 B.R. 615 (2006) : No, the bankruptcy trustee cannot recover damages under state law against those who profited from an unlawful pyramid scheme, but it can void fraudulent transfers of pyramid scheme profits. Canyon sold gold coins to investors. They paid 70% of the cash investment back to the investor in gold coins, and paid another 70% when the investor reach the bottom of a customer list. The company also paid commissions and bonuses to sale people who induced others to invest money with the company. The company depended on a continued flow of new customers to maintain the guise of a legitimate enterprise, and the bankruptcy court concluded that it was an unlawful pyramid scheme. The bankruptcy court voided the transactions between the company and customers as fraudulent, and allowed the trustee to recover the money for the benefit of the company's creditor- other investors. However, the trustee did not have standing to pursue damages claims against those who made money from the scheme.

343 B.R. 615

United States Bankruptcy Court, S.D. Ohio,
Eastern Division at Columbus.

In re CANYON SYSTEMS CORPORATION, Debtor.
John Paul Rieser, Trustee, Plaintiff,
v.
Dennis Hayslip, et al., Ron Piljay, et al., Camden Enterprises, Lynn A. Kubal, Rose Kubal, Gail D. Mayes, Gregory N. Mayes, Gregory McCollum, Gerald L. Wendling, Mary A. Wilkie, and Nena Grant, Defendants.

Bankruptcy No. 97-33774.
March 31, 2006.

Motion granted in part and denied in part.
*620 John Paul Rieser, Patricia Friesinger, Dayton, OH, for Plaintiff.

Thomas R. Noland, Tina Woods, Dayton, OH, for Defendants Huffman, Marohl, Osier, Piljay, Camden Enterprises, Lynn A. Kubal, Rose Kubal, McCollum, Wendling, Wilkie and Grant.
Gary C. Schaengold, Dayton, OH, for Defendant Scott Johnson.
Melissa K. Schindler, Dayton, OH, Richard B. Reiling, Springboro, OH, for Defendants Schraeder, Withrow, Julia Carmack and Jeffrey Carmack.
Barry S. Galen, Dayton, OH, for Debtor.

MEMORANDUM OPINION AND ORDER GRANTING IN PART AND DENYING IN PART TRUSTEE'S MOTION FOR PARTIAL SUMMARY JUDGMENT

JOHN E. HOFFMAN, JR., Bankruptcy Judge.

Pending before the Court in these adversary proceedings are identical motions for partial summary judgment (collectively, "Motion") filed by the Plaintiff, John Paul Rieser, Chapter 7 Trustee ("Rieser" or "Trustee"), against all remaining defendants ("Defendants") in all remaining adversary proceedings in the bankruptcy case of Canyon Systems Corporation ("Canyon" or "Debtor"). For the reasons explained below, the Motion is granted in part and denied in part.

II. Procedural Background

Canyon filed a voluntary Chapter 11 petition on July 7, 1997 ("Petition Date"), following the collapse of its gold coin sales programs.[FN1] These programs promised participants large profits from purchasing and selling gold bullion coins. Less than a month after the Chapter 11 case was filed, and after the United States Trustee had moved to convert the case to a Chapter 7 liquidation proceeding, or in the alternative to appoint a Chapter 11 trustee, Canyon agreed to convert to Chapter 7. Rieser was appointed Chapter 7 Trustee.

FN1. Canyon operated two gold coin sales programs: the Double Eagle Gold Coin Program and the Advantage Gold Coin Program. The slight differences in the two programs are not material and thus will not be detailed in this opinion.

On July 6, 1999, the Trustee filed in excess of 400 adversary proceedings to recover money from individuals and companies who had bought or sold gold coins through one of Canyon's programs. *The complaints contain multiple federal and state law causes of action, but the gravamen of each is that prepetition transfers of cash and gold coins made to participants in Canyon's gold coin sales programs-which the Trustee alleges constituted a Ponzi scheme-are subject to avoidance and recovery.* On March 29, 2000, Judge William A. Clark, the judge originally assigned to the Canyon case, entered an order reassigning the case and all related adversary proceedings to Judge Hoffman.

*623 By way of the Motion, the Trustee seeks a ruling on the following issues: (1) whether Canyon was engaged in a Ponzi scheme from May 1996 through the Petition Date; (2) whether Canyon was continuously insolvent from its inception in May 1996 through the Petition Date; (3) whether the Trustee may, under § 548 of the Bankruptcy Code,[FN3] avoid all transfers of cash and gold coins made to each Defendant in the one year preceding the Petition Date that were in excess of that Defendant's original investment-sums referred to by the Trustee as the "false profits" received by the Defendants; [FN4] (4) whether the Trustee may, under § 544(b) of the Code and the Ohio Uniform Fraudulent Transfer Act ("UFTA"), avoid all false profits transferred to the Defendants from the time Canyon's gold coin sales programs began in May 1996 through the Petition Date; (5) whether the defense afforded to good-faith transferees for value under § 548(c) of the Code is available to the Defendants; and (6) whether the Trustee may set aside certain obligations, avoid contracts with and/or transfers to the Defendants, and recover damages and reasonable attorney fees from them under § 544 of the Code and Ohio Revised Code §§ 1333.91- 1333.95-the so-called Ohio Pyramid Sales Act.[FN5] Defendants Marohl, Huffman and Piljay also filed a motion for summary judgment ("Cross-Motion") (Doc. 251) in Adv. Pro. No. 03-2605. After the Trustee responded (Doc. 257) and Defendants replied (Doc. 269), the Court heard argument on both the Motion and Cross-Motion. At the conclusion of the argument, the Court entered an oral ruling denying the Cross-Motion, which was journalized by the Order Denying Motion of Defendants John Marohl, James Huffman and Ronald Piljay for Summary Judgment (Doc. 275). The Trustee's Motion was taken under advisement.

*624 III. Factual Background

Canyon was incorporated in Delaware in 1989 or 1990. (Section 341 Meeting of Creditors Transcript of Proceedings ("341 Tr.") 20.) Canyon was a dormant corporation until mid-May 1996, when it began operating in Ohio under the name of Canyon Coin Collectors ("CCC"). (341 Tr. 20-21, 27.) The company conducted business in 30 states from its main office in Kettering, Ohio and briefly opened small offices in Safety Harbor, Florida and Johnstown, Pennsylvania. (341 Tr. 21, 23, 26.)

Canyon was the brainchild of Jack Johnson, the company's President and CEO. [FN7] (341 Tr. 12.) Although Canyon's gold coin sales programs varied in some respects, in simplified form, they called for a participant's payment of a certain sum of money [FN8] in return for which the participant would receive gold coins valued at 70% of the amount paid. The gold coins sold by Canyon were not of "numismatic," or collector, quality, but rather were the type known as bulk gold, which is sold on the gold spot market. This transaction would result in the placement of the participant's name on a list to receive-at some unspecified time within 18 months of the purchase-additional gold coins worth 70% of the initial amount paid. These additional gold coins were known as "Complimentary Gold" or "Comp Gold." As names of new buyers were added to the top of the list, the original participant's name would move toward*625 the bottom of the list. When the name reached the bottom of the list, the participant would receive Comp Gold. *See* Motion, Ex. A, Marketing Brochure for Double Eagle Coin Program ("Double Eagle Brochure") and Motion, Ex. B, Marketing Brochure for Advantage Coin Program ("Advantage Brochure"). How quickly a participant's name moved to the bottom of the list and he/she

received Comp Gold depended on the volume of coins sold to new participants. *See* Motion, Ex. C, Independent Affiliate Training Video ("Training Video"), Wilkie presentation.

FN8. Each transaction included processing fees and checks issued in small amounts by the Debtor to the purchaser in order to round up to even numbers. For simplicity's sake, and because these amounts do not fundamentally change the outcome of the dispute, the Court will not include these adjustments in its examples. The Court notes, however, that most of these fees merely added to Canyon's liabilities.

By way of illustration, a purchaser paying $1,000 to Canyon would receive, within a few days of his/her purchase, gold coins having a value of $700. Sometime within the ensuing 18 months, he or she would receive an additional $700 in Comp Gold, for a total, over time, of $1,400 in gold coins in return for the initial $1,000 payment. Of the $700 in Comp Gold received, the first $300 would ostensibly make the investor "whole," by returning his/her entire $1,000 outlay, and the next $400 would constitute the investor's "profit" on the transaction. The total return on an investment of $1,000 would be 35%, since a $50 processing fee would be deducted from the $700 in Comp Gold distributed.

The Double Eagle Brochure contains the following description of the program:

Fill out the purchase order for the amount you wish to purchase. Purchases can be from $200 up to $1000 a business day, but they must be in $100 increments (for example, $200, $300, $500, etc.). There is a 5% processing fee on every order. For each $100 Gold Coin Purchase, CCC will list the customer on CCC's Double Eagle and Advantage Program list. At the end of each week the total profits from sales will be calculated and a substantial amount of the profits from sales will be used to purchase complimentary gold for the next succeeding customer on the Double Eagle and Advantage customer list.

As new sales are generated, you will move down the list to become the next succeeding customer on the Double Eagle and Advantage customer list. When you are at the bottom of the list, you will receive your complimentary gold. The American Eagle gold coins can be easily and quickly converted into cash. This makes it possible to purchase again and again to maximize your purchases to receive more complimentary gold.[FN9]

FN9. The Advantage Brochure is substantially the same, except that it provides for a daily minimum purchase of $100, and it substitutes the phrase "the majority of the profits" for the phrase "a substantial amount of profits." Motion, Ex. B, Advantage Brochure.

Motion, Ex. A, Double Eagle Brochure. The Double Eagle Brochure also contains the following example of how an initial $1,000 investment would, within an 18-month time frame, yield $1,350.[FN10]

FN10. Although the Double Eagle and Advantage Brochures do not state a specific time frame for the payment of Comp Gold, purchase orders signed by participants in the Debtor's gold coin sales programs state that Comp Gold would be payable no later than 18 months from the initial date of purchase. *See* Scott Johnson Dep., Ex. 5,

Advantage Program Purchase Order ¶ 8.

Purchase		Complimentary
$1000		DE $650
		ADV 350
You now have	$1000	
	$1000	
	$2000	
	x.70	(approximate %)
	$1400	
	-50	(processing fee
	$1350	(approximate)

*626 This example shows that with a $1000 purchase, you can receive complimentary American Eagle gold coins of $1000.00. If you chose to sell them you would have approximately $1350.00. *Id.* Most participants, however, liquidated both their initial gold and their Comp Gold immediately, rolling it over as a new purchase to increase the potential for receiving more Comp Gold. (Huffman Dep. 200-01, 212-13.) Each time a participant purchased additional gold with liquidated gold proceeds, his or her name would again be placed on the list to receive Comp Gold worth 70% of the new amount purchased. Literature provided to potential investors, along with the Training Video, described this convoluted system in detail. *See* Motion, Exs. A, B and C. The Double Eagle Brochure offers the following example of how participants who opted to exercise the "roll-over" option and re-invest (rather than sell) the Comp Gold received from Canyon could receive nearly a 95% return on their investment:

Purchase	Cash	Complimentary	
		DE	ADV
$1000		$650	$350
700		455	245
500	-10	325	175
300	50	195	105
200	10	130	70
	140	$1755	945
	190	x.70	(approximate %)
		$1890	

190	Cash
-135	processing fee
$1945	(approximate)

This example shows how your $1000 original purchase turned into $2700 in complimentary gold coins and if you chose to sell them you would have approximately $1945 in cash. One important point: you do not have to sell any gold or sponsor anybody to participate in the Double Eagle and Advantage Program. This is strictly a retail purchase program designed for you, the customer. Motion, Ex. A, Double Eagle Brochure.

While participants who continued to purchase gold with their proceeds would theoretically earn large profits, many were left with nothing but receipts for Comp Gold. (Huffman Dep. 212.) In actuality, by continuing to roll over the "profits" from their investment into new purchases worth only 70% of the amount rolled over (with the promise of at least a 35% return on the amount reinvested), the participants were cycling their way toward a total loss of their investments. Because Canyon sold non-numismatic gold, the only reason for a purchaser to buy gold from Canyon was the potential receipt of Comp Gold. And, because a buyer of gold from Canyon initially received gold worth only 70% of the purchase price, a purchaser interested in gold as an investment would have received more gold for his/her money from any other coin dealer. (Huffman Dep. 69.)

Canyon only marketed its gold coins through Independent Affiliates ("IAs"), who then sold the coins to other IAs or to non-IA purchasers. A purchaser of gold did not have to be affiliated with Canyon, but to sell gold, and earn cash commissions and additional gold coins, one had to be an IA. To qualify as an IA, a person had to pay Canyon $75 and was required to undergo sales training, which consisted of three parts: attending four training sessions,*627 viewing the Training Video, and passing an examination. Motion, Ex. C, Training Video, Marohl presentation. IAs were encouraged to build a "down-line" of other IAs, each of whom was then to build his or her own down-line. Each IA received a 10% commission on every sale of gold coins to another IA he/she sponsored. Motion, Exs. A and B; Canyon Coin Collectors Affiliates Guide, Marohl Dep., Ex. 5 at 4. The IA also received a 1% "override" on each sale of gold coins by another IA in his or her down-line, down to 10 levels below that of the IA. *Id.* The overrides were paid by way of a voucher redeemable for additional gold coins.

Given its organizational structure and the obligation to pay commissions, overrides and Comp Gold that arose with each purchase, Canyon's liability exceeded the revenue it received on each transaction. For example, in return for a $1,000 purchase, Canyon paid the purchaser $700 in coins, owed a $100 commission to the IA who sold the gold, and owed overrides of between $10 and $100 (depending on the depth of the down-line), to other IAs, leaving between $100 and $190 for Canyon. From this amount, Canyon paid its overhead, including salaries, rent, utilities and other expenses, and had to invest the remaining dollars in a manner that would generate enough funds within 18 months to pay the promised $700 return to the purchaser. (Huffman Dep. 92-100, 243.)

Before founding Canyon, Jack Johnson had been involved in previous unsuccessful coin sales ventures through organizations known as American Coin Collectors and Gold Unlimited. (341 Tr. 71, 105-06, 154; Scott Johnson Dep. 99-100.) Many of the Defendants also were involved on some level with these earlier gold coin sales programs. These programs had rapidly disintegrated, and Jack Johnson ostensibly designed Canyon's business so as to avoid the problems that plagued the earlier ventures. (Scott Johnson Dep. 100; 341 Tr. 154, 160-61, 163-64.) One attempted safeguard was the employment of Attorney Greg Engler to provide an opinion letter stating that Canyon's operation did not constitute a pyramid scheme and did not violate the Ohio Pyramid Sales Act, because fees charged to each new IA did not benefit other IAs. (341 Tr. 35, 160); Engler opinion letter at 1, unnumbered exhibit to Memorandum in Opposition to Motion for Summary Judgment (Doc. 261) filed by the Carmack Defendants, Schraeder and Withrow.

Jack Johnson and Canyon's officers and directors also stressed to investors that Canyon had substantial reserves in the form of real estate and gold. (Training Video, Dennis Walters presentation, Wilkie presentation; 341 Tr. 192-95, 200-05, 273-74; Marohl Dep. 129; Scott Johnson Dep. 108-11; Withrow Dep. 49.) Jack Johnson did in fact own rental properties in the Dayton, Ohio area. The properties were held in his own name and the name of a related entity called Canyon Investments, but the legal work necessary to pledge the properties as a reserve for Canyon was never completed. (341 Tr. 201-03.) The Johnsons' Chapter 7 trustee eventually liquidated these properties for the benefit of their creditors. *See In re Johnson,* Case No. 97-33775, Trustee's Interim Report (Doc. 216). Canyon's financial statements stated-and Jack Johnson routinely told investors and board members-that the company held gold reserves valued at over $1 million. (341 Tr. 166; Scott Johnson Dep. 114; Huffman Dep. 113; Marohl Dep. 26, 71, 114-15.) However, no formal gold reserve account was ever set up. (341 Tr. 194-97.) And, Canyon held no gold in reserve on the Petition Date. (341 Tr. 166, 273-76; Withrow Dep. 49.) Gold coins valued in excess of $1 million, which at one time were held by Canyon, were *628 liquidated systematically from August 1996 forward in order to enable the Debtor to purchase more gold. The liquidation of this gold was done to buoy confidence in Canyon's sales program because it had the effect of increasing sales volume, thus moving participants' names down the list and triggering more sales. The liquidation created additional liabilities, however, by requiring the payout of more Comp Gold. (341 Tr. 167-69; Scott Johnson Dep. 118-21.)

According to the Defendants, it was bad timing rather than the lack of a legitimate business enterprise that led to Canyon's financial downfall. They allege that because Jack Johnson had hired Marohl to develop new lines of business, and because Marohl had initiated a program to have IAs sell jewelry in addition to gold coins, Canyon was not insolvent on or prior to the Petition Date, but instead had an underlying business that would have generated sufficient cash to pay investors. But the demise of Canyon's coin business occurred when the jewelry sales program was in its nascent stage-Marohl testified in his deposition that the jewelry program was rolled out in April 1997, less than three months before the Petition Date. (Marohl Dep. 68-69, 86.) Thomas Kramer (“Kramer”), a certified public accountant and attorney retained as an expert by the Trustee, prepared a report (“Kramer Report”) that included profit and loss statements (“P & Ls”) showing that some minimal jewelry sales occurred as early as December 1996. The aggregate amount of jewelry sales over the course of the year Canyon was in

business, however, was only $10,259.37, or just 0.03% of Canyon's total income. (Kramer Report, April 1997 P & L.) Jack Johnson and Canyon's board members also discussed creation of a real estate business, an insurance business, a communications business and an art sales business, but none of these plans came to fruition. (341 Tr. 49-50; Marohl Dep. 86-87.)

Most of Canyon's office staff was comprised of Jack Johnson's family members. His son, Scott Johnson, was Canyon's Vice President of Sales. (Scott Johnson Dep. 102.) Scott's wife, Patricia, worked in Canyon's office answering phones and filing. (Patricia Johnson Dep. 24, 27-28, 39.) Jack Johnson's two step-daughters, Withrow and Schraeder, and his daughters Cindy Ball and Julia Carmack, and Julia's husband, Jeffrey Carmack, also worked for Canyon. (341 Tr. 40-41, 44, 109, 111; Patricia Johnson Dep. 42; Withrow Dep. 9-10, 29, 31-33, 35.) When Canyon's gold coin sales programs were set up, Jack Johnson placed himself at the top of the sales pyramid, his son Scott as the first IA, and his two daughters and two step-daughters at the top of the other IA lines, so that the sales generated by all later IAs resulted in payment of commissions and overrides to his family members. (341 Tr. 109-10, 140-47; Withrow Dep. 114-23; Marohl Dep. 130-34.)

IV. Legal Analysis

B. The Trustee's Fraudulent Transfer Claims

The Trustee asserts that Canyon's transfers of cash and gold coins to the Defendants in amounts exceeding their original investment-the so-called false profits-are subject to avoidance as both actual and constructive fraudulent transfers. He brings the avoidance claims under both § 548 of the Code and the Ohio UFTA (exercising his “strong-arm” powers under § 544(b) of the Code). The Trustee's claims are premised upon his contention that the transfers of false profits to the Defendants were made by Canyon in furtherance of a Ponzi scheme. Thus, the Court will first address the issue of whether Canyon's gold coin sales business was in fact a Ponzi scheme.

1. Ponzi Scheme

The Trustee asserts that Canyon's gold coin sales programs constituted a Ponzi scheme that operated for approximately 14 months-from May 1996 to the Petition Date. A Ponzi scheme is a fraudulent investment arrangement under which an entity makes payments to investors from monies received from new investors rather than from profits generated by legitimate business operations, although investors may believe an actual business exists from which profits are derived. *See, e.g., First Nat'l Bank of Barnesville v. Rafoth (In re Baker & Getty Fin. Servs., Inc.),* 974 F.2d 712, 714 (6th Cir.1992); *Wyle v. C.H. Rider & Family (In re United Energy Corp.),* 944 F.2d 589, 590 n. 1 (9th Cir.1991) (“A Ponzi scheme is a fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any ‘profits' of the underlying business venture. The fraud consists of funnelling proceeds received from new investors to previous investors in the guise of *630 profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.”); *Bauman v. Bliese (In re McCarn's Allstate Fin.,*

Inc.), 326 B.R. 843, 845 (Bankr.M.D.Fla.2005) ("A 'Ponzi scheme' is a fraudulent investment arrangement in which returns to investors come from monies obtained from new investors rather than an underlying business enterprise."); *Fisher v. Sellis (In re Lake States Commodities, Inc.) ("Lake States I"),* 253 B.R. 866, 869 n. 2 (Bankr.N.D.Ill.2000); *Flatau v. Madonian (In re Sheetex, Inc.),* 1999 WL 739628, at *2 (Bankr.M.D.Ga. Sept. 21, 1999); *In re Taubman,* 160 B.R. 964, 978 (Bankr.S.D.Ohio 1993).[FN13] Typically, Ponzi scheme investors are promised high rates of return on their investments. *Taubman,* 160 B.R. at 978. Early investors actually receive the promised returns, creating the impression of a legitimate, or at least profitable, business, and thereby enticing new investors into the plan. *See id.* But "[a]s a result of the absence of sufficient, or any, assets able to generate funds necessary to pay the promised returns, the success of such a scheme guarantees its demise because the operator must attract more and more funds, which thereby creates a greater need for funds to pay previous investors, all of which ultimately causes the scheme to collapse." *Id.*

FN13. A "Ponzi scheme" derives its name from a fraudulent investment arrangement masterminded by Charles Ponzi in the 1920s. Ponzi's plan, promising a 50% return on 45-day notes, collapsed when he was unable to repay investors. A post-bankruptcy accounting examination of his books and records revealed that Ponzi had never made any investments with his participants' money, but had merely paid early investors with funds received from later investors. *Merrill v. Abbott (In re Indep. Clearing House Co.),* 41 B.R. 985, 994 n. 12 (Bankr.D.Utah 1984), *aff'd in part, rev'd in part on other grounds sub nom. Merrill v. Dietz (In re Universal Clearing House Co.),* 62 B.R. 118 (D.Utah 1986) *and aff'd in part, rev'd in part on other grounds sub nom. Merrill v. Abbott (In re Indep. Clearing House Co.),* 77 B.R. 843 (D.Utah 1987) (en banc). *See also Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.),* 321 B.R. 527, 530 n. 2 (9th Cir. BAP 2005) ("The term 'Ponzi scheme' is the legacy of what Chief Justice Taft described as 'the remarkable criminal financial career of Charles Ponzi.' " (quoting *Cunningham v. Brown,* 265 U.S. 1, 7, 44 S.Ct. 424, 68 L.Ed. 873 (1924))).

A pyramid scheme is similar to a Ponzi scheme, the difference being that investors in a pyramid scheme expect "to profit from their efforts at obtaining new people to invest in the business into which they have already invested their own money[,]" rather than from the business itself. *Sheetex,* 1999 WL 739628, at *2. "In both Ponzi schemes and pyramid schemes, the supply of subsequent investors is eventually exhausted and the scheme collapses, with the later investors typically losing all of the money that they invested, and only the earliest investors, if any at all, will have recovered their investments." *Id.*

To prove that Canyon engaged in a Ponzi scheme, the Trustee must establish that: (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors. *Fisher v. Sellas (In re Lake States Commodities, Inc.) ("Lake States II"),* 272 B.R. 233, 242 (Bankr.N.D.Ill.2002) (citing *Floyd v. Dunson (In re Ramirez Rodriguez),* 209 B.R. 424, 431 (Bankr.S.D.Tex.1997)), *aff'd sub nom. Fisher v. Page,* 2002 WL 31749262 (N.D.Ill. Dec. 3, 2002).

Here, there is no question that investors made deposits with the Debtor. *631 In its bankruptcy schedules, the Debtor listed over 2,800 investors, spread over 30 states, holding claims in excess of $7.5 million. (341 Tr. 6.) Canyon promised these investors, through its Double Eagle and Advantage Brochures, its Training Video, and by presentations from IAs to potential purchasers, that not only would they be made whole, but that they could earn up to a 35% return on a one-time purchase of gold coins, and far more if the investor rolled over "profits" and made additional coin purchases. Canyon also promised IAs that they would receive commissions and overrides on sales by those in their down-lines. *See* Motion, Exs. A, B and C. Yet Canyon had no business that could generate these returns or pay these obligations. Its only business was the constant turnover of coins by purchasers who would pay for coins, receive coins, sell the coins back, use the proceeds to buy more coins, and so on. As aptly described by the Trustee in the deposition of Lee Ann Zavakos ("Zavakos"), a certified public accountant who was retained as the Defendants' expert witness, "[Canyon's 'business' was a] program where you buy, sell, buy, sell until you cycle yourself down from the original gold to a couple [of] pennies and a bunch of receipts for comp gold." (Zavakos Dep. 86.) Canyon's operations did not generate profits, but instead piled up liabilities for the company. The parties' respective expert witnesses-Kramer and Zavakos-agreed that the coin business was not profitable and, as configured, could never become profitable.

In Kramer's analysis of Canyon's gold coin sales program,[FN14] he concluded that

FN14. Kramer prepared both an affidavit ("Kramer Aff."), which is attached as Exhibit E to the Motion, and a nine-page opinion letter addressed to Rieser, which was presented to Zavakos as an exhibit during her deposition. The opinion letter is attached as an exhibit to Zavakos's deposition transcript. The conclusions set forth in the opinion letter and affidavit are virtually identical, although the opinion letter incorporates supporting charts that are not attached to the affidavit.

[t]he Programs were devices aimed at generating cash for the enterprise without any potential for profit generation. Canyon's business model was devoid of economic substance and insured an eventual collapse of the enterprise once the finite supply of participants willing to provide funding for the scheme was exhausted. A viable enterprise cannot be built by taking an unprofitable model and duplicating it numerous times. The whole objective of this scheme was to induce participants to give the enterprise money and fuel future participation through the recycling of gold under the "aggressive" program (as described in the Brochures and in the Video) and through the participation of others, in the hope that the participant's name would move [down] the ladder quicker and enable them to share in "complimentary" gold. In sum and substance, the Programs amounted to nothing more than an opportunity to deposit a sum of money with the enterprise, receive a portion of that money back, and have the remainder of the funds expended for the benefit of other participants in the hope that the participant's name would move [down] the list so that the participant could some day share in other participant's [sic] money.
(Kramer Aff. ¶ 7.)

The Trustee has met his burden of establishing that Canyon was engaged in a Ponzi scheme from May 1996 through the Petition Date. The undisputed evidence establishes the existence of each of the four

elements of a Ponzi scheme identified by the *Lake States I* and *Ramirez Rodriguez* courts. There is no dispute that deposits were made to Canyon by investors. As the Motion states-and Defendants do not dispute-Canyon's sales, which were, in effect, deposits by participants, amounted to nearly $33 million. (Motion at 6.) While Canyon was engaged in the business of buying and selling gold coins, it did so in a manner that guaranteed its demise. And its other line of business-jewelry sales-generated minimal revenue. Although Defendants suggest that Canyon sold, or would in the future sell, a sufficient amount of jewelry to negate the impact of the gold coin losses, there is not a shred of evidence to support their position. Both experts agreed that the jewelry business yielded negligible returns-Kramer documented that jewelry sales represented less than one percent of Canyon's total income. Because the gold coin programs generated no profits for the company-a point upon which both experts agree-Canyon had no identifiable source of capital it could draw on to purchase jewelry for resale. Thus, contrary to its representations to participants, Canyon conducted no legitimate business operations. Nor is there any dispute*633 that Canyon's business operations failed to generate any profits. Finally, there was no identifiable source of payments to participants other than infusions of cash from later participants. In sum, Canyon's gold coin sales programs had all of the hallmarks of a classic Ponzi scheme.

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D. Ohio Pyramid Sales Law

In the seventh claim for relief set forth in his Complaints, the Trustee alleges that Canyon's gold coin programs constituted an illegal pyramid sales plan or program within the meaning of the Ohio Pyramid Sales Act ("OPSA"). The Trustee seeks two forms of relief under the OPSA. First, pursuant to § 544(b) of the Code (set forth and discussed below) and Ohio Revised Code § 1333.93, the Trustee requests an order voiding the contracts between Canyon and each Defendant. *See* Complaint (Adv.Pro. No. 03-2605), ¶ 100. Second, the Trustee seeks to recover under Ohio Revised Code § 1333.93 "from [each] Defendant the amount the Defendant received from the scheme by receiving distributions [of Comp Gold]" as well as "the amount of consideration paid by all other participants in the Gold/Comp Gold Programs who did not receive Comp Gold, or who did not receive all of the Comp Gold needed to make them whole, together with attorney fees." Complaint (Adv.Pro. No. 03-2605), ¶ 100-101. Thus, the Trustee seeks not only to have the contracts between Canyon and the Defendants declared void, but also a money judgment against each Defendant ("OPSA Damage Claim") "in an amount equal to all out-of-pocket losses and damages suffered by all participants or purchasers in any of the Gold/Comp Gold Programs, ... [which is] as yet undetermined but believed to be in excess of Five Million Dollars ($5,000,000.00); and ... additionally ... damages *652 from [each] Defendant in an amount equal to [the total of all Comp Gold, commissions and overrides received by each Defendant], ... together with reasonable attorney fees...." *See* Complaint (Adv.Pro. No. 03-2605), at 22, ¶ I (emphasis and capitalization deleted).

The Defendants concede that Ohio Revised Code § 1333.93 provides a basis to void their contracts with Canyon. The Defendants, however, maintain that the Trustee is not entitled to the relief he seeks on his OPSA Damage Claim for two reasons. First, they point out that Ohio Revised Code § 1333.93 is

inapplicable here because Canyon's gold coin programs did not constitute an illegal pyramid scheme as defined in Ohio Revised Code § 1333.91(A), and the Defendants did not in fact receive compensation either: (1) "for introducing [a] person [or persons] into participation in ... [Canyon's] pyramid sales plan or program;" or (2) "when another participant has introduced the person into participation in ... [Canyon's] pyramid sales plan or program." Second, the Defendants argue that § 544(b) of the Code does not grant the Trustee standing to bring the OPSA Damage Claim.[FN21] Thus, according to the Defendants, even if Ohio Revised Code § 1333.93 applies here-i.e., the Court finds that Canyon operated an illegal pyramid scheme and further determines that the Defendants did actually receive compensation for introducing new participants into the scheme-any damage claim created by the statute may not be brought by the Trustee. Because the OPSA creates a cause of action in favor of a pyramid scheme participant against those who received compensation for introducing the participant to the scheme, Defendants argue that the claim the Trustee seeks to bring belongs to individual creditors and may not be asserted on behalf of Canyon's bankruptcy estate.

FN21. None of the Defendants responded to the Trustee's argument in the Motion that § 544(b)(1) affords him standing to assert claims under the OPSA, including damage claims. Nonetheless, at an earlier stage of this adversary proceeding the Defendants filed motions to dismiss the Trustee's OPSA claims on standing grounds. The Court deferred a ruling on this standing question pending resolution of the remaining issues raised in the Motion.

1. Applicability of Ohio Revised Code § 1333.93

Section 1333.93 of the Ohio Revised Code provides:

Any contract made in violation of section 1333.92 of the Revised Code is void. Any person who has paid consideration for the chance or opportunity to participate in a pyramid sales plan or program may recover, in a civil action, the amount of the consideration paid, together with reasonable attorney fees, from any participant who has received compensation under either of the following circumstances:

(A) For introducing the person into participation in a pyramid sales plan or program;

(B) When another participant has introduced the person into participation in a pyramid sales plan or program.

Ohio Rev.Code Ann. § 1333.93. In passing on Defendants' contention that Ohio Revised Code § 1333.93 is simply not applicable here because they did not receive compensation for introducing other participants into a pyramid scheme within the meaning of the statute, the Court must first determine whether Canyon's gold coin programs fit the definition of a pyramid scheme under the OPSA. Section 1333.91 of the Ohio Revised Code states:

*653 (A) A "Pyramid sales plan or program" means any scheme, whether or not for the disposal or distribution of property, whereby a person pays a consideration for the chance or opportunity to receive compensation, regardless of whether he also receives other rights or property, under either of following circumstances:

(1) For introducing one or more persons into participation in the plan or program;

(2) When another participant has introduced a person into participation in the plan program.

(B) “Compensation” means money, financial benefit, or anything of value. Compensation does not include payment based upon sales made to persons who are not participants in a pyramid sales plan or program, and who are not purchasing in order to participate in the plan or program.

Ohio Rev.Code Ann. § 1333.91. Ohio Revised Code § 1333.92 provides that “[n]o person shall propose, plan, prepare or operate a pyramid sales plan or program.” Ohio Rev.Code Ann. § 1333.92.

Under Canyon's gold coin sales programs, only IAs could sell coins. Each IA received compensation-in the form of commissions and overrides-for every sale of coins to a new person that the IA introduced into the program. IAs also received commissions and overrides on each sale generated by every participant in that IA's down-line (down to 10 levels below the IA).

This scheme fits within Ohio's statutory definition of a pyramid sales plan or program. *See, e.g., State v. Guinn,* 42 Ohio St.3d 92, 537 N.E.2d 656, 657-58 (1989) (program consisted of “airplane” scheme that had the following features: (1) the positions in the program, were, from top down, “pilot,” “co-pilots,” “crew,” and “passengers;” (2) each new passenger paid $1,500 to the pilot; (3) when all eight positions at the bottom of the pyramid were filled with passengers, the pilot would leave the plan; (4) after the pilot left the plan, the pyramid would break in half, each participant would move up one position, and the splitting would continue until each investor reached the top of his own pyramid.); *In re Disposition of Prop. Held by Geauga County Sheriff,* 129 Ohio App.3d 676, 718 N.E.2d 990, 991 (1998) (nearly identical program); *State ex. rel. Celebrezze v. Howard,* 77 Ohio App.3d 387, 602 N.E.2d 665, 667-69 (1991) (nearly identical program); *State ex rel. Celebrezze v. First Fin. Sec., Inc.,* Case No. 87-CV-12-8048 (Franklin County Ct. of Common Pleas Nov. 27, 1992) (participants paid $75 for the chance to receive commissions for introducing others into plan). The programs in the foregoing cases were held to violate the Ohio Pyramid Law because they compensated participants-who moved up the pyramid and eventually cashed out-for merely introducing others into participation in the program.

According to the Defendants, Canyon's gold coin sales programs do not meet the statutory definition of a pyramid scheme contained in Ohio Revised Code § 1333.91(A), and they did not engage in the activity proscribed by the statute, because they (and other participants in these programs) were not paid compensation merely for introducing new participants to the scheme. Rather, they argue, IAs were paid only for completing sales of gold coins, or in the event that other IAs in their down-line did so. This argument is unpersuasive. Granted, IAs did not receive compensation *solely* for introducing new participants to Canyon's gold coin sales programs. Commissions and overrides became payable to an IA when new participants that he/she recruited bought *654 gold (or new recruits in the IA's down-line did so). Yet, it is undisputed that IAs were compensated not only on the basis of their own sales, but for sales generated by those they brought into the program. Thus, those Defendants who received commissions and overrides did in fact receive “compensation” for “introducing one or more persons

into participation" in the Debtor's program, within the meaning of the OPSA. Further, the Defendants do not contend that the compensation they received from Canyon was based upon sales made to persons who were not participants in the gold coin programs, which would take the transaction outside of the scope of the statute. *See* Ohio Rev.Code Ann. § 1333.91(B). Presumably, the participants in each IA's downline made purchases in order to participate in the plan or program because, as discussed above, unless one were participating in the program in anticipation of receiving Comp Gold, there was no reason to purchase gold from Canyon and receive gold valued at only 70% of the purchase price.

2. The Trustee's Standing to Assert the OPSA Damage Claim

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Because § 544(b)(1) provides only the power of avoidance, it does not confer authority on the Trustee to pursue state law damage claims. "[T]he power to do so must come from somewhere other than § 544(b)." *Myers,* 320 B.R. at 669.

Further, the Court concludes that while Canyon's contracts with the Defendants are void under Ohio Revised Code § 1333.93, the Trustee lacks standing to recover damages and reasonable attorney fees from the Defendants under the OPSA. Thus, Count Seven of the Complaints is DISMISSED.

Trial on all remaining issues will be set by separate order of the Court.

IT IS SO ORDERED.

http://www.mlmlegal.com/legal-cases/InReCanyonSystemsCorp.php