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# Midnight in the Garden of Good Faith: Using Clawback Actions to Harvest the Equitable Roots of Bankrupt Ponzi Schemes

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## ARTICLES

# MIDNIGHT IN THE GARDEN OF GOOD FAITH: USING CLAWBACK ACTIONS TO HARVEST THE EQUITABLE ROOTS OF BANKRUPT PONZI SCHEMES

*Jessica D. Gabel*<sup>†</sup>

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#### INTRODUCTION: TOO GOOD TO BE "GOOD FAITH"

The unmasking of a Ponzi scheme usually means that the scam has run its course and the jig is up. A receiver boards the windows and changes the locks, broke investors sue, lucky investors get sued, and the bad guys go to jail.<sup>1</sup> Indeed, in the two years since the Madoff scandal broke, there is no shortage of candidates for the Ponzi flavor of the month, but the fifteen minutes of fame fade as fast as the fictitious profits.<sup>2</sup> As bankruptcy courts encounter more fraudulent investment schemes, avoidance actions brought by the trustee have become more common. Accordingly, victims and claimholders

<sup>1</sup> See generally Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998) (providing a general overview of Ponzi schemes).

<sup>2</sup> See Diana B. Henriques, *Proposed Tax Breaks for Ponzi Victims*, N.Y. TIMES BUCKS BLOG (March 25, 2010, 7:19 PM), <http://bucks.blogs.nytimes.com/2010/03/25/proposed-new-tax-breaks-for-ponzi-victims/> (stating that Ponzi losses have become so common that a tax break for victims may be necessary).

remain in limbo while courts attempt to preserve and allocate whatever may remain.

The first decade of the twenty-first century exemplifies the macroeconomic boom-bust-boom cycle. By 2007 and 2008, the economy dropped to historic lows last seen during the Great Depression.<sup>3</sup> In the drama that unfolded as the “Great Recession,” banks, Wall Street executives, government officials, investors, and home buyers were all eventually cast as both villain and victim.<sup>4</sup> In the ensuing mess of finger-pointing, bailouts, and cries for reform, the arch-villain emerged: Bernie Madoff. He bilked thousands of investors out of billions of dollars. Madoff certainly was not the only Ponzi architect, though he was perhaps the biggest. Since Madoff’s scheme collapsed, authorities have uncovered Ponzi schemes of all shapes and sizes.<sup>5</sup> Unfortunately, for those who fell under the Ponzi spell, their ability to seek restitution is both incomplete and inconsistent.

Once Ponzi schemes are exposed, the tattered remains often run to bankruptcy court, where the court appoints a trustee to reassemble the pieces and maximize any remaining assets for the benefit of creditors, including investors.<sup>6</sup> Since few assets usually remain, the trustee steps in as the repo-man to bring property back into the bankruptcy estate—either through a preferential transfer action or a fraudulent transfer action. In this article, I focus on the latter as applied to Ponzi investments. In particular, I examine the good faith defense to fraudulent transfer actions.

The term “Ponzi scheme” is synonymous with fraud. Ponzi transactions are simple in the execution: the fraudsters retain the investors’ capital in exchange for empty promises of high returns.<sup>7</sup> Once the investor seeks to withdraw her returns (as opposed to principal), it triggers fraudulent transfer liability under section 548 of the Bankruptcy Code, because the investor receives fictitious profits. On the other hand, repayment of principal arguably calls in an actual pre-existing debt, yet it too can give rise to fraudulent transfer

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<sup>3</sup> See Enrique Martínez-García & Janet Kocch, *A Historical Look at the Labor Market During Recessions*, FED. RES. BANK OF DALL. ECON. LETTER, Jan. 2010, at 1, 2 (comparing the Great Recession to other economic downturns, including the Great Depression).

<sup>4</sup> See Mark Landler & Sheryl Gay Stolberg, *As Fingers Point in the Financial Crisis, Many of Them Are Aimed at Bush*, N.Y. TIMES, Sept. 20, 2008, at A15 (detailing all the parties that people blamed as the market collapsed).

<sup>5</sup> Leslie Wayne, *The Mini-Madoffs: Troubled Times Are Bringing More Ponzi Inquiries to Light*, N.Y. TIMES, Jan. 28, 2009, at B1.

<sup>6</sup> McDermott, *supra* note 1, at 158.

<sup>7</sup> See *id.* (discussing the anatomy of a Ponzi scheme).

liability.<sup>8</sup> Section 548(c) of the Bankruptcy Code does, however, provide a “good faith” defense to an investor to the extent value was given. In this article, I argue that such defenses should not be available in federal Ponzi cases.

In addition to the fraudulent transfer action, the bankruptcy trustee can assert preferential transfer actions, which are typically easier to prove than fraudulent transfer actions. Indeed, the Bankruptcy Code allows the trustee to recover the *full amount* of all investor withdrawals—whether of principal or profit—made within ninety days prior to the date of the filing of the bankruptcy petition.<sup>9</sup> Referred to as “preferences,” these payments carry a legal presumption that they have “preferred” the interests of the withdrawing creditor over the interests of other creditors at a time when bankruptcy was all but a foregone conclusion. This policy attempts to level the playing field among creditors. Moreover, the statute itself (11 U.S.C. § 547(b)) provides an easy-to-follow roadmap in proving that a preferential transfer occurred.<sup>10</sup>

But the ninety-day window limits the reach of preference actions, and, there may be no transactions within the window to avoid, depending upon the delay between the discovery and shutdown of the scheme and the corresponding bankruptcy filing.<sup>11</sup> While the Bankruptcy Code extends the ninety-day window to one year in cases of insider withdrawals, most investors who unwittingly contributed to the scheme are subject to the ninety-day rule.<sup>12</sup> Those investors must

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<sup>8</sup> Note, however, that in some cases preferential transfer and fraudulent conveyance laws have been used interchangeably to recover both principal and profits in Ponzi schemes. RICHARD I. AARON, *Preferential Transfers: The Hard Preferences to Insiders*, in 1 BANKRUPTCY LAW FUNDAMENTALS § 10:11 (West 2010).

<sup>9</sup> See 11 U.S.C. § 547(b) (2006) (outlining the legal requisites for showing the occurrence of a preferential transfer).

<sup>10</sup> *Id.*

<sup>11</sup> The withdrawals of funds—be it principal or interest—generally occur in the months leading up to the collapse of the scheme. As the federal officials (the Securities and Exchange Commission, the Department of Justice, etc.) move in to lock up shop, the bankruptcy filing may not occur for weeks or months. If it is the latter, then withdrawals in the ninety days prior to the bankruptcy from which the trustee can lodge preference actions may not exist. Consequently, the trustee must look to other sections of the Bankruptcy Code, namely the section on fraudulent transfers, to effectuate any recovery. See 11 U.S.C. § 544 (allowing the trustee to avoid certain unperfected liens); 11 U.S.C. § 548 (allowing the trustee to avoid preferential transfers).

<sup>12</sup> See 11 U.S.C. § 547(b)(4) (providing the time limits for the trustee’s power to avoid preferential transfers). In the case of insiders, family members and close friends of the fraudster are typically the individuals, and sometimes companies, that receive exorbitant profits in Ponzi schemes. The Madoff case typified this notion given the amount of avoidance actions brought by the trustee against Madoff family members. See, e.g., Bob Van Voris, *Madoff Firm Trustee Seeks \$50 Billion as Clawback Window Closes*, BLOOMBERG BUSINESSWEEK (Dec. 13, 2010, 12:02 AM), <http://www.businessweek.com/news/2010-12-13/madoff-firm-trustee-seeks-50-billion-as-clawback-window-closes.html> (discussing the massive payments Bernie Madoff made

return the funds withdrawn, and will then receive an unsecured claim against the bankruptcy estate in the amount of their principal.<sup>13</sup> Most courts will not include any alleged profit in the claim amount since the profit was the product of an illegal scheme.<sup>14</sup>

Investors can assert statutory defenses to protect their withdrawals from preference actions provided for under section 547(c). One of the most common of these defenses is the “ordinary course of business” defense.<sup>15</sup> The Bankruptcy Code provides that a trustee may not avoid an otherwise preferential transfer if the transaction related to the ordinary course of the debtor’s business.<sup>16</sup> Courts, however, have been reluctant, if not hostile, to find that a debtor made a transfer in the ordinary course of business when the “business” is a Ponzi scheme.<sup>17</sup> After all, a Ponzi scheme by its nature is neither ordinary nor legal.<sup>18</sup>

Other defenses to a fraudulent transfer action, however, do achieve some success in a Ponzi scheme. Section 548(c) of the Bankruptcy Code and similar provisions of equivalent state laws provide a defense for a transferee who has received the transfer “in good faith”

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to family and friends).

<sup>13</sup> See 11 U.S.C. § 547(b)(5) (providing that a creditor must have received more than the creditor otherwise would have as an unsecured creditor for a transfer to be considered a preference).

<sup>14</sup> See, e.g., *Sender v. Hannahs (In re Hedged Inv. Assocs., Inc.)*, 176 B.R. 214, 216 (D. Colo. 1994) (rejecting the trustee’s assertion that a debtor partnership was entitled to the promise of “guaranteed earnings” where the earnings were the product of a Ponzi scheme).

<sup>15</sup> See 11 U.S.C. 547(c)(2) (providing the requirements for establishing an ordinary course of business defense to the preference action).

<sup>16</sup> *Id.*

<sup>17</sup> The ordinary course of business defense has been a work-in-progress for decades. Previously, its application and success in courts was inconsistent and unpredictable. In an attempt to fix an ongoing issue with the interpretation of “ordinary course of business,” the 2005 amendments to the Bankruptcy Code included a slight revision of 11 U.S.C. § 547(c)(2). See *Woods v. Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)*, 482 F.3d 1118, 1123–24 n.4 (9th Cir. 2007) (discussing this relaxation). The amendments relaxed the test for “ordinary course” such that a creditor must first prove that the suspect debt itself was incurred in the “ordinary course of business or financial affairs” of that particular debtor and creditor. *Id.* The creditor must then also demonstrate that the transfer itself was made *either* in the ordinary course of business between the debtor and creditor—a subjective test—or according to ordinary business terms—an objective test. *Id.* Prior to 2005, a creditor had to satisfy both the subjective and objective tests. *Id.*

<sup>18</sup> Indeed, despite stalwart arguments that Ponzi investments are merely a common practice embedded in an uncommon enterprise, courts reject such contentions. There are, however, a very small minority of cases that at least provide a slit of light at the end of the tunnel. See, e.g., *Am. Cont’l Corp. v. All Preference Defendants (In re Am. Cont’l Corp.)*, 142 B.R. 894, 900 (D. Ariz. 1992) (holding that payments to bondholders of principal and interest were considered part of the ordinary course of business exception to trustee’s avoidance powers, despite securities fraud indictments against debtor’s senior management); *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 888 (D. Utah 1987) (denying Ponzi investors’ motion to set aside default judgment and dismissed the investors’ claims against the trustee).

and “for value.”<sup>19</sup> For purposes of fraudulent transfer actions, “value” includes “satisfaction . . . of a present or antecedent debt.”<sup>20</sup> Fraudulent transfers in Ponzi schemes operate under the general rule that a defrauded investor receives “value” up to the principal amount of the investment but not “in excess of principal” (i.e., interest).<sup>21</sup> The justification is that the investor technically has a fraud claim against the debtor for the false promise of profits based on the actual investment of principal, but the same is not true for an investor’s “fictitious, nonexistent ‘profits.’”<sup>22</sup> Consequently, if the debtor transfers all or a portion of the principal back to the investor, then that transaction satisfies the fraud claim (an antecedent debt) and achieves section 548(c)’s “for value” requirement.<sup>23</sup> As a corollary, an investor’s fraud claim cannot encompass payments that outstrip the principal because the manufactured profits are not a genuine “value” that the investor can realize.<sup>24</sup>

Lucky investors who pulled out early—and are therefore able to retain their principal—benefit at the expense of later investors, who face a possibly empty bankrupt estate from which to recover their principal. This lopsided situation contradicts bankruptcy policy, which aims to treat similarly-situated creditors equally.<sup>25</sup> In this article, I test the utility and reach of section 548(c)’s good faith defense in the confines of a Ponzi scheme and argue that it should be unavailable as a defense in Ponzi cases before federal bankruptcy courts.<sup>26</sup> Limiting the application of the good faith defense in these circumstances would allow trustees to recover all of the debtor’s payments to investors—whether principal or interest—and distribute the funds equally among all defrauded investors.

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<sup>19</sup> 11 U.S.C. § 548(c); *see also* Bear Stearns Secs. Corp. v. Gredd (*In re Manhattan Inv. Fund Ltd.*), 397 B.R. 1, 22 (S.D.N.Y. 2007) (discussing the good-faith defense and remanding to the bankruptcy court for a trial on the factual issues).

<sup>20</sup> 11 U.S.C. § 548(d)(2)(A).

<sup>21</sup> *In re Int’l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6506657, at \*7 (Bankr. N.D. Ga. Dec. 1, 2009).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* (citing *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1340-41 (10th Cir. 1996); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 596 (9th Cir. 1991); *Eby v. Ashley*, 1 F.2d 971, 973 (4th Cir.1924)).

<sup>24</sup> *Id.* (citing *Sender v. Buchanan (In re Hedged-Inv. Assocs., Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996); *Wyle*, 944 F.2d at 595 n.6)).

<sup>25</sup> *See, e.g., Gregory v. Cmty. Credit Co. (In re Biggers)*, 249 B.R. 873, 879 (Bankr. M.D. Tenn. 2000) (stating this general policy of the Bankruptcy Code).

<sup>26</sup> As more fully discussed above, a critical component of my thesis—removing section 548(c) as a defense to a fraudulent transfer action in Ponzi schemes—is that its sole application is in federal bankruptcy cases and limited to the two-year window provided for by 11 U.S.C. § 548(b). The purpose here is to avoid preemption issues that could arise under comparable state fraudulent transfer laws. Although a downstream application of this thesis is not foreclosed, those questions go beyond the scope of this article.

## I. THE PONZI KINGDOM: STITCHING THE EMPEROR'S NEW CLOTHES

Ponzi schemes are a unique bankruptcy beast. Creditors become crime victims instead of debt collectors. The average bankruptcy case winds its way through proceedings designed to balance various interests.<sup>27</sup> The Bankruptcy Code itself maintains two distinct goals: to provide a “fresh start” for the debtor,<sup>28</sup> whereby the bankrupt party is kept under the protection of the bankruptcy court as it unburdens some of its debt load,<sup>29</sup> and to treat creditors fairly.<sup>30</sup> While not all creditors are treated equally (either in or out of bankruptcy), the Bankruptcy Code endeavors to level the playing field. For the most part, the Bankruptcy Code is uncompromising about these two basic principles.<sup>31</sup> In Ponzi schemes, however, that foundation is somewhat fractured.

### *A. Ponzi Construction Codes*

Ponzi schemes arise out of fraud. The deceit required to maintain them results in a complex maze of people, funds, and transactions, and a culprit sprinting to stay ahead of the pack. In short, a perpetrator lures victims to put money into some sort of investment device (stocks, property, commodities) with the promise of an “extraordinary return on the investment.”<sup>32</sup> But the enterprise lacks any legitimacy.<sup>33</sup> Rather, the culprit operates a vicious cycle using funds obtained from the newest investors to pay “profits” to earlier ones.<sup>34</sup> The perpetrator may even return principal to those who request it.<sup>35</sup> Maintaining the fraud requires a revolving door: that those pleased with their

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<sup>27</sup> See 11 U.S.C. § 507 (2006) (establishing the priority structure by which claims are paid); 11 U.S.C. § 727 (providing the exceptions to a court granting discharge).

<sup>28</sup> See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (discussing “[o]ne of the primary purposes of the Bankruptcy Act”).

<sup>29</sup> This is less of a concern in cases where a corporation or other business files for Chapter 7 bankruptcy and liquidates its assets. Presumably, the end of the bankruptcy process means the end of the business, thereby obviating the need for the “fresh start.” See 11 U.S.C. § 727(a)(1) (providing that the debtor must be an individual to receive a Chapter 7 discharge); see also *In re Boca Village Ass’n, Inc.*, 422 B.R. 318, 324 (Bankr. S.D. Fla. 2009) (discussing this obviation).

<sup>30</sup> See, e.g., 11 U.S.C. § 727(d) (allowing creditors to move the court to revoke a debtor’s discharge if the debtor behaved fraudulently); 11 U.S.C. § 507 (establishing the priority scheme by which creditors are paid); see also *Grogan v. Garner*, 498 U.S. 279, 286–87 (1991) (discussing fair treatment of creditors).

<sup>31</sup> See *id.* (discussing the balance that Congress must strike between conflicting interests).

<sup>32</sup> *In re Int’l Mgmt. Assocs., LLC*, No. A06–62966–PWB, 2009 WL 6506657, at \*5 (Bankr. N.D. Ga. Dec. 1, 2009).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*



investment gains simply will reinvest their monies directly back into the scheme.<sup>36</sup>

At some point, the scheme starts to run on fumes—it lacks enough new investors to pay out the old investors, and checks either begin to bounce or just stop coming altogether.<sup>37</sup> The collapse creates victims of varying sorts. Some investors may get out ahead and receive both their principal investment and at least a portion of their fictitious profits.<sup>38</sup> Other investors may recoup only their principal or some returns but no principal.<sup>39</sup> The unluckiest—the last to buy into the scheme—usually go hungry, getting nothing as they scabble at the bottom of the barrel. Those who have not recovered the entirety of their principal confront the possibility of receiving “little or nothing from the assets that remain” because their money has either gone to pay earlier investors, conveniently disappeared, or funded extravagant luxuries.<sup>40</sup> Generally, when the dust settles the perpetrator’s company, or, in some cases, companies, finds its way into bankruptcy court.<sup>41</sup>

### *B. Historic Ponzi Schemes*

The history of any pioneer nation is rife with bubbles, speculation, fraud, deceit, and discovery. From land speculation before the Revolutionary War to modern day boiler room pump-and-dump tactics, swindlers have always bilked suckers for profit.<sup>42</sup> Ponzi schemes share the two most important elements of all large-scale frauds: the thrill of “inside” information and the assurance of a can’t-lose proposition.

Perhaps the first large-scale architect of the scheme was a man named William Miller.<sup>43</sup> “520 percent Miller,” as he was known, offered investors startling returns, including a ten percent *weekly*

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<sup>36</sup> See *Cunningham v. Brown*, 265 U.S. 1, 7–8 (1924) (describing the original Ponzi scheme produced by Charles Ponzi himself).

<sup>37</sup> *Int’l Mgmt. Assocs.*, 2009 WL 6506657, at \*5.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* For example, in the Scott Rothstein case, the fraud amounted to an estimated \$400 million. Damien Cave, *Fraud Accusations Against Florida Lawyer Set Off a Race to Return His Donations*, N.Y. TIMES, Nov. 4, 2009 at A14. Even after his arrest and his law firm’s bankruptcy filing, newspaper reports noted that “[b]ehind a gate at his waterfront mansion . . . a Cadillac, a Lexus and a white Bentley could [be] seen in the driveway. A security guard said no one was home.” *Id.*

<sup>41</sup> *Int’l Mgmt. Assocs.*, 2009 WL 6506657, at \* 5.

<sup>42</sup> See generally DAVID W. MAURER, *THE BIG CON: THE STORY OF THE CONFIDENCE MAN* (Anchor Books 1999) (providing a survey of various swindling techniques).

<sup>43</sup> Mary Darby, *In Ponzi We Trust*, SMITHSONIAN, Dec. 1998, at 134, 136.

dividend.<sup>44</sup> Miller, a bookkeeper for a tea company, recruited heavily from his church and Bible study class, claiming inside information on the stock market.<sup>45</sup> Miller took his cue from contemporary “bucket shops,” shady trading houses that put investors’ money in a “bucket” without actually buying any stock. When the stock that the investors thought they already owned went down in value, the trader would purchase it and pocket the difference, thus amounting to an early, criminal version of short selling.

Miller went one step further by actually paying investors with the deposits of later backers.<sup>46</sup> By the end of the year, Miller’s scheme had produced over \$480,000 before savvier hucksters duped Miller himself. Shortly after his financial ruin, he turned jailhouse informant.<sup>47</sup> While doing time in Sing-Sing prison, he managed to earn the nickname of “Honest Bill” and a pardon from the governor before finding himself working as a bookkeeper for the very same tea company.<sup>48</sup>

Charles Ponzi, by contrast, actually did have the germ of a great business idea when he began his venture in Boston in the early 1900s. He discovered an arcane investment loophole in the form of a stamp known as an “International Reply Coupon.”<sup>49</sup> These coupons, first created in 1906 to reduce the uncertainty and expense of sending reply envelopes internationally, were calibrated to currency rates before the First World War.<sup>50</sup> While post-war currencies were significantly devalued, coupon prices stayed the same, and so while the Italian Lira maintained only 25 percent of its pre-war value against the dollar, it still bought exactly the same amount of stamps.<sup>51</sup>

At the time, people commonly purchased an international reply coupon when sending an international letter.<sup>52</sup> The reply coupons were essentially a voucher that allowed the letter’s recipient to redeem a postage stamp to send a reply. An investor could simply convert US dollars to Italian Lira at a ratio of 1:20, and use that money to buy up coupons. Then, he could return the stamps to the US and exchange them at face value for a profit.<sup>53</sup> There was nothing

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<sup>44</sup> *Miller Confesses Fraud*, N.Y. TIMES, June 10, 1903, at 16.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *520 Per Cent. Miller Exposed in Court: Brother-in-Law Turns on Swindler Who Lived under an Alias Since Quitting Prison*, N.Y. TIMES, Nov. 29, 1914, at C6.

<sup>48</sup> Darby, *supra* note 43, at 136.

<sup>49</sup> MITCHELL ZUCKOFF, *PONZI'S SCHEME* 94–5 (2005).

<sup>50</sup> *Id.* at 94.

<sup>51</sup> *Id.* at 95.

<sup>52</sup> *Id.* at 94.

<sup>53</sup> *Id.* at 95.

problematic about this scheme, exploiting market disparities is known today as arbitrage, and it is a useful tool in currency exchange.<sup>54</sup>

Regardless of the theoretical brilliance of Ponzi's scheme, it remained a practical impossibility. The overhead costs of taking part in all these complicated transactions would be sure to weigh down his profits, and would require a network of dedicated agents that simply did not exist.<sup>55</sup> Still, he mass-marketed his stamp scheme extremely successfully, promising 50 percent returns in forty-five days, or 100 percent in ninety.<sup>56</sup> When the Post Office changed their rates on supply coupons to thwart him, he still managed to win angry crowds over with sandwiches and coffee while they waited to redeem their investments.<sup>57</sup> Rather than admit the mistake, Ponzi continued to pay earlier investors with new investors' money. He managed to still attract new investors by relying on the reputation spread by earlier investors who had enjoyed higher-than-normal returns.<sup>58</sup>

Only months after his peace offering of coffee and sandwiches, Ponzi's scheme crashed and burned in a spectacular failure. And when one of Ponzi's employees declared his boss hopelessly insolvent, the original Ponzi scheme earned its name.<sup>59</sup> Ponzi's resulting bankruptcy case eventually found its way to the United States Supreme Court.<sup>60</sup> As is true in many Ponzi schemes, a few early investors smelled the hint of fraud in the air and withdrew funds in the months leading up to the bankruptcy. Ponzi's trustees attempted to recover those withdrawn funds as avoidable preferences.<sup>61</sup> The investors prevailed at both the trial<sup>62</sup> and appellate levels.<sup>63</sup> Those courts determined that the redeeming investors could retain their gains regardless of whether the trustee could trace their funds separately from those investors who did not make withdrawals.<sup>64</sup>

The Supreme Court, however, refused to extend that courtesy to the redeeming investors because it would violate the policy of equality in bankruptcy.<sup>65</sup> The Court reasoned that the withdrawals

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<sup>54</sup> See BLACK'S LAW DICTIONARY 119 (9th ed. 2009) (defining arbitrage).

<sup>55</sup> ZUCKOFF, *supra* note 49, at 96.

<sup>56</sup> *Id.* at 174-75.

<sup>57</sup> *Id.* at 210. Indeed, investigations showed that there were fewer coupons in circulation than were necessary to maintain Ponzi's business.

<sup>58</sup> *Id.* at 211.

<sup>59</sup> *Id.* at 228.

<sup>60</sup> *Cunningham v. Brown*, 265 U.S. 1 (1924).

<sup>61</sup> *Id.* at 4.

<sup>62</sup> *Lowell v. Brown (In re Ponzi)*, 280 F. 193, 204 (D. Mass. 1922).

<sup>63</sup> *Lowell v. Brown*, 284 F. 936, 944 (1st Cir. 1922).

<sup>64</sup> *Id.* at 944.

<sup>65</sup> *Cunningham*, 265 U.S. at 9. The Supreme Court's decision was couched in the ability to trace funds. According to the Court, a victim had to follow his actual deposits into and out of the fraudster's bank account. *Id.* at 11. Under the Bankruptcy Act, if the victim was unable to

(some of which constituted full refunds) depleted the available funds before satisfying all the investors.<sup>66</sup> The Court held that since fraud tainted all the funds, to allow some investors to stand behind the fiction that Ponzi had withdrawn money legitimately to pay them “would be carrying the fiction to a fantastic conclusion.”<sup>67</sup> That fantasy would have allowed some investors to reap full refunds of their money, while others received nothing. The Court rejected that result because it would violate the fundamental policy—and what should be the root of Ponzi law—that “*equality is equity*, which is the spirit of the bankrupt[cy] law.”<sup>68</sup>

Ponzi schemes sometimes originate from what arguably starts out as a legitimate investment opportunity. But Bernie Madoff administered the largest Ponzi scheme in history, without ever investing a dime.<sup>69</sup> He relied on his reputation for providing relatively modest, regular returns to his investors to attract newer and bigger investors.<sup>70</sup> The motto “Bigger, Better, Faster, More” epitomized Madoff’s investment house. Like other Ponzi scheme operators, Madoff created a sense of security—the impression that investing with him amounted to a special invitation into an exclusive club.<sup>71</sup> But Madoff never actually invested his clients’ money. True to Ponzi form, Madoff used new investors’ money to provide the positive and consistent returns that his early clients enjoyed. At his peak, Madoff’s clientele included celebrities, wealthy individuals, large investment houses, and charities that paid him for the privilege of his investment prowess.<sup>72</sup>

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identify his or her particular funds, then he or she was forced to participate as a general creditor in the bankrupt’s estate. *See, e.g., In re Kennedy & Cohen, Inc.*, 612 F.2d 963, 965 (5th Cir. 1980).

<sup>66</sup> *Cunningham*, 265 U.S. at 13. The Supreme Court recognized that the tracing rule could be avoided if abandoning the rule resulted in equal treatment of the defrauded customers. *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* (emphasis added).

<sup>69</sup> Alex Altman, *A Brief History of Ponzi Schemes*, TIME (Dec. 15, 2008), <http://www.time.com/time/business/article/0,8599,1866680,00>.

<sup>70</sup> SEC. & EXCH. COMM’N, *Ponzi Schemes—Frequently Asked Questions*, <http://www.sec.gov/answers/ponzi.htm#BernieMadoff>, (last visited Oct. 2, 2011).

<sup>71</sup> *See* Ronald A. Cass, *Madoff Exploited the Jews*, WALL ST. J., Dec. 18, 2008, at A19 (noting that Madoff’s power and connections allowed him to carry out his scheme).

<sup>72</sup> *See* Cass, *supra* note 71 (noting that Madoff’s clientele included Steven Spielberg and Yeshiva University). Madoff had a powerful résumé. In addition to running his investment company, Madoff had been a “prominent member of the securities industry throughout his career.” Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), *available at* <http://sec.gov/news/press/2008/2008-293.htm>. His stints included serving as vice chairman of the National Association of Securities Dealers (NASD), holding a position on the NASD board of governors, including chairman of its New York region. *Id.* In addition, Madoff was on the NASDAQ Stock Market’s board of

Ponzi schemes usually involve “too good to be true” investment opportunities. While the setup is rote, the execution can be creative. Ponzi scheme characters seem to go from humdrum (even respectable) investment gurus to notorious thugs overnight.<sup>73</sup>

Former boy-band promoter Lou Pearlman (who unleashed the likes of the Backstreet Boys and N'Sync on the unsuspecting parents of tweens and teenagers) pinched \$300 million in investor capital over nearly twenty years.<sup>74</sup> Bronx-born swindler Scott Rothstein promised his clients that he used great lawyering, investigation and intimidation to secure large settlements from defendants with sordid histories.<sup>75</sup> Rothstein effectively blackmailed defendants into agreeing to large annuity settlements, which he would assign to investors for a lump sum, and who were promised large returns as the money rolled in.<sup>76</sup> Or so investors thought. In the end it was not his New York savvy that brought in the lucre, but the power of his imagination. The “defendants” were fictitious and the settlements fanciful. Rothstein’s investments were wholly fraudulent.

Rothstein’s plot disintegrated in less than five years, spawning—as in most bankruptcy cases—a string of “clawback” proceedings initiated by the trustee of the firm’s bankruptcy estate to recover payments received by investors.<sup>77</sup> The clawbacks at issue in these cases evoke the question this paper intends to answer: are those lucky few investors who cash-out their stake in time liable to the unfortunate many who do not?

## II. THE CLAWBACK CROWD: IN PURSUIT OF PONZI PAYOUTS

Ponzi-scheme creditors are not the average supplier or service provider seeking payment on an invoice for a delivery made two or six months before bankruptcy. Rather, the Technicolor cast of creditors in a Ponzi scheme have varying degrees of interests and liabilities. Ponzi investors share one thing in common: they are all victims of an elaborate con. But any collective identity ends there.

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governors, its executive committee, and even served as the chairman of the NASDAQ trading committee. *Id.*

<sup>73</sup> See Altman, *supra*, note 69 (discussing various Ponzi schemes perpetrators).

<sup>74</sup> *Id.*

<sup>75</sup> Kevin McCoy, *Fla. Attorney Charged in Alleged Ponzi Case*, USA TODAY (Dec. 2, 2009), at 2B.

<sup>76</sup> *Id.*

<sup>77</sup> *In re Rothstein Rosenfeldt Adler, P.A.*, No. 09-34791-BKC-RBR, 2010 WL 3743885, at \*2 (Bankr. S.D. Fla. Sept. 22, 2010).

Ultimately, the time of their withdrawals separates the winners from the losers.

### *A. Ponzi Scheme Definition and Its Players*

To properly introduce the cast of characters, it is important to describe the legal definition of a Ponzi scheme, as opposed to the media depiction. The United States Court of Appeals for the Second Circuit defines a Ponzi scheme as a “fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability, thus attracting new investors.”<sup>78</sup> The United States Court of Appeals for the Ninth Circuit provides an arguably broader description: “any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors.”<sup>79</sup> Other courts add the criterion that the scheme failed to “conduct[] . . . legitimate business as represented to investors”<sup>80</sup>—a point that will become important later in this Article.

As this Article has mentioned, Ponzi investors fall into two broad categories. First, there are the “net losers”: investors’ whose funds are used to satisfy earlier investors’ redemptions. Net losers either fail to receive a full return on their principal investment,<sup>81</sup> or, in many instances, see no return of their principal at all. The other broad category of investors is the “net winners.” Net winners are the “lucky” investors who receive redemption payments that exceed the value of their principal investments.<sup>82</sup> Recoupment of fictitious profits may subject the net winners to disgorgement, and, in some instances, even disgorgement of principal.<sup>83</sup> Beyond the two broad categories, there are also “feeder funds,” which include various hedge funds, brokerage houses, and banks that steered large pools of investors into the Ponzi scheme.<sup>84</sup> A Ponzi scheme’s use of these

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<sup>78</sup> *Ades-Berg Investors v. Breeden (In re The Bennett Funding Grp., Inc.)*, 439 F.3d 155, 157 n.2 (2d Cir. 2006) (quoting BLACK’S LAW DICTIONARY 1198 (8th ed. 2004)).

<sup>79</sup> *Danning v. Bozck (In re Bullion Reserve of N. Am.)*, 836 F.2d 1214, 1219 n.8 (9th Cir. 1988) (emphasis added).

<sup>80</sup> *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 431 (Bankr. S.D. Tex. 1997).

<sup>81</sup> See, e.g., *In re Smith*, 132 B.R. 73, 74 (Bankr. M.D. Fla. 1991) (discussing the trustee’s attempt to recover money for the “net losers”).

<sup>82</sup> *Id.*

<sup>83</sup> McDermott, *supra* note 1, at 169.

<sup>84</sup> See Nick S. Dhcsi, Note, *The Conman and the Sheriff: SEC Jurisdiction and the Role of Offshore Financial Centers in Modern Securities Fraud*, 88 TEX. L. REV. 1345, 1366 (2010) (discussing Madoff’s choice of offshore centers to establish feeder funds).

feeder funds enables it to sweep in thousands of smaller investors to sustain the scam over a longer period of time.<sup>85</sup>

While Charles Ponzi's name became synonymous with investment schemes, Bernie Madoff achieved a new yardstick. The Madoff case typifies the struggle between the net winners and net losers. The Madoff net winners bitterly contested the Bernard L. Madoff Investment Securities L.L.C. (BLMIS) bankruptcy trustee Irving Picard's position that they should return part of their "profits" to achieve a more equitable distribution to later investors.<sup>86</sup> The net winners argued that they reasonably relied on BLMIS financial statements that showed that they had a comfortable nest egg on which to retire.<sup>87</sup> On the other hand, the net losers—whose principal investments funded payouts to the earlier investors—agreed with Picard's view that equity requires looking "solely to deposits and withdrawals that in reality occurred" (i.e., real principal instead of fictitious profits) in order to more evenly distribute any recovery among all investors.<sup>88</sup> A Ponzi scheme's bankruptcy trustee primarily relies on two vehicles to strike the more equitable balance between net winners and net losers: fraudulent transfers and preferential transfers.<sup>89</sup>

### *B. Ponzi Payouts: Fraudulent or Preferential?*

A trustee, or a debtor-in-possession,<sup>90</sup> has two crucial statutory tools that enable him to clawback funds from creditors, (or, investors

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<sup>85</sup> See *id.* (discussing how offshore feeder funds allow a fraudster to manipulate returns). Various groups—individual investors, state regulators, federal agencies, bankruptcy trustees—often target lawsuits and investigations at the feeder funds that invested customers' cash into Ponzi schemes. Lawrence J. Zweifach & Sophia N. Khan, *Recent Developments in Ponzi Scheme Litigation*, in AUDITOR LIABILITY IN THE CURRENT ENVIRONMENT: HOW TO PROTECT YOURSELF 99, 101 (2010). The actions carry varying degrees of success against financial firms, as most cases turn the question of what the investment house either knew or *should have known* about the legitimacy of the investment opportunity. See *id.* at 120–21 (discussing the claims and defenses asserted against the investment houses).

<sup>86</sup> See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (*In re Bernard L. Madoff Inv. Sec. LLC*), 424 B.R. 122, 136 (Bankr. S.D.N.Y. 2010) (discussing the Trustee's position that the transfers of fictitious profits are avoidable and the objective claimants' defenses), *aff'd*, 2011 WL 3568936, at \*1 (2d Cir. Aug. 16, 2011).

<sup>87</sup> See *id.* at 134–35 (discussing the net winners' contention that they reasonably relied on BLMIS financial statements).

<sup>88</sup> See *id.* at 142 ("To the extent possible, principal will rightly be returned to Net Losers rather than unjustly rewarded to Net Winners under the guise of profits. In this way, the Net Investment Method brings the greatest number of investors closest to their positions prior to Madoff's scheme in an effort to make them whole.").

<sup>89</sup> See generally 11 U.S.C. §§ 547, 548 (2006) (Section 547 of the Bankruptcy Code provides for the recovery of preferential transfers and section 548 provides for the recovery of fraudulent transfers).

<sup>90</sup> In bankruptcy cases, the power to recover property for the estate is vested in either the trustee or, in Chapter 11 cases, the debtor-in-possession. See generally *id.* (providing the trustee

in Ponzi schemes, who received disbursements prior to the bankruptcy.<sup>91</sup> Through the Bankruptcy Code, trustees can challenge and seek the return of transfers that were either (1) preferences, or (2) fraudulent transfers.<sup>92</sup> While the main thrust of this Article concerns the latter, I think it important to plumb the former for policy reasons that might suggest an overhaul of fraudulent transfer law in Ponzi schemes.

In Ponzi schemes, the trustee can avoid pre-bankruptcy transfers of funds, which the trustee can distribute for the benefit of all creditors. Accordingly, preference claims are often a trustee's weapon of choice.<sup>93</sup> A preference action's burden of proof is an easier hurdle than in fraudulent transfer actions because the trustee receives the benefit of a presumption that any funds, whether principal or profit, withdrawn within ninety days of the bankruptcy filing are an improper preference.<sup>94</sup> If the trustee satisfies the elements of a preference action, the burden shifts to the preferred investor to assert

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the ability to recover property). In Chapter 11 business bankruptcies, the bankrupt company is referred to the debtor-in-possession as it attempts to reorganize its debts. 11 U.S.C. § 1101(1). Consequently, the debtor-in-possession, as represented by counsel, may initiate an avoidance action. The debtor-in-possession is not omnipotent, however. If the debtor-in-possession exhibits "fraud, dishonesty, incompetence, or gross management," a trustee may be appointed to replace the debtor-in-possession. 11 U.S.C. § 1104(a)(1). The trustee then may pursue any avoidance actions that the debtor-in-possession would have the right to. While most bankruptcy Ponzi schemes are ultimately Chapter 7 liquidations because there is no legitimate business to salvage, some do begin in Chapter 11. In those cases, an appointment of a trustee is immediate and necessary given the nature of business. See Symposium, *The Business Bankruptcy Panel—Ponzi Schemes—Bankruptcy Court v. Federal Court Equity Receivership*, 26 EMORY BANKR. DEV. J. 207, 212 (2010) (explaining that most of the time, the trustee appointment comes almost immediately after a receiver). Notwithstanding a Chapter 11 filing, some practitioners and judges believe that Ponzi schemes should never be Chapter 11 cases since there is little to nothing to reorganize. See, e.g., *id.* at 214 (questioning the efficacy of having a ponzi scheme in a chapter 11).

<sup>91</sup> Some Ponzi schemes fall first into a receivership and may remain there or transition into bankruptcy. Appointed receivers can successfully pursue clawbacks of fraudulent transfers under state law. The drawback, however, is that receivers do not hold the bevy of powers a bankruptcy trustee does under the Bankruptcy Code. If a statutory or common law receivership of the enterprise is not in the best interests of the creditors or the estate, the receiver could initiate bankruptcy proceedings—such as happened in the *Madoff* and *Peters* cases. See, e.g., Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. (*In re Bernard L. Madoff*), No. 09-11893 (BRL), at \*3, (Bankr. S.D.N.Y. June 9, 2009), [http://www.madoff.com/documents/252\\_order.pdf](http://www.madoff.com/documents/252_order.pdf) (order appointing the SIPA trustee as the Chapter 7 trustee of the substantively consolidated estate).

<sup>92</sup> 11 U.S.C. §§ 547, 548.

<sup>93</sup> See, e.g., *Daly v. Simeone (In re Carrozzella & Richardson)*, 270 B.R. 325, 329 (Bankr. D. Conn. 2001) (finding that plaintiff-trustee of bankrupt estate established all elements of a preferential transfer); see generally *Jobin v. Matthews (In re M & L Bus. Mach. Co.)*, 184 B.R. 136, 139 (D. Colo. 1995) (discussing the policies served by allowing preference claims).

<sup>94</sup> 11 U.S.C. § 547(b).



what is perhaps the only available affirmative defense: that the transaction occurred in the “ordinary course of business.”<sup>95</sup>

The major obstacle to the preference action, however, is that most, if not all, of the transfers in a Ponzi scheme occur outside that ninety-day limit. By contrast, fraudulent transfers allow the trustee to avoid transfers beyond the ninety days. The trustee has the burden to prove one of the following two items. First, the trustee could show that the transferor’s actual or constructive intent was to “hinder, delay, or defraud” creditors.<sup>96</sup> Second, the trustee could show that the transferor made the transfer while the transferor was financially distressed and did not receive reasonably equivalent value for the transfer.<sup>97</sup>

### *1. Defining and Differentiating Fraudulent Transfers*

Fraudulent transfer law is rooted in the antiquated Statute of Elizabeth, first enacted in 1571.<sup>98</sup> As one of the oldest debt collection devices, it served as the model for the Uniform Fraudulent Transfer Act, enacted in many states, and section 548 of the Bankruptcy Code.<sup>99</sup> The Statute of Elizabeth and its progeny voided any conveyance or transfer made with the intent “to delay, hinder or defraud creditors and others of their just and lawful actions.”<sup>100</sup> The time-honored *Twyne’s Case* in 1601 broadened clawback capabilities by providing for various “badges of fraud” that could be used as circumstantial evidence of the debtor’s intent to defraud its creditors.<sup>101</sup> Consequently, Anglo-American law has long condemned

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<sup>95</sup> See 11 U.S.C. § 547(c)(2) (providing the elements of the ordinary course of business defense).

<sup>96</sup> See, e.g., *Bauman v. Blicse (In re McCarn’s Allstate Fin., Inc.)*, 326 B.R. 843, 848, 852 (Bankr. M.D. Fla. 2005) (finding that trustee successfully established debtor’s intent to defraud under section 548(a)(1)(A)).

<sup>97</sup> 11 U.S.C. § 548(a)(1)(B)(i)–(ii)(II).

<sup>98</sup> See, e.g., *In re Maxwell Sheraton, Inc.*, 46 F. Supp. 680, 681 (S.D.N.Y. 1942) (noting that New York adopted the Statute of Elizabeth prior to adopting a statute that modeled the Uniform Fraudulent Conveyance Act), *aff’d sub nom. City of New York v. Johnson*, 137 F.2d 163 (2d Cir. 1943).

<sup>99</sup> See *id.* at 682 (explaining that the Uniform Fraudulent Conveyance Act “is the modernized Statute of Elizabeth”); see also *Goveart v. Capital Bank (In re Miami Gen. Hosp., Inc.)*, 124 B.R. 383, 391 (Bankr. S.D. Fla. 1991) (reasoning that Florida statute that prohibited fraudulent transfers and conveyances “was basically a restatement of the law on fraudulent conveyances as declared by the Statute of Elizabeth” until the statute’s recent amendment).

<sup>100</sup> *Sexton v. Wheaton*, 21 U.S. (8 Wheat.) 229, 242 (1823); see also *Hovis v. Ducate (In re Ducate)*, 355 B.R. 536, 542 (Bankr. D.S.C. 2006) (restating the same language in South Carolina’s fraudulent transfers statute).

<sup>101</sup> See, e.g., *Warner v. Norton*, 61 U.S. (20 How.) 448, 456 (1857) (discussing secrecy as one of the signs or “badges of fraud”); *Colandrea v. Colandrea (In re Colandrea)*, 17 B.R. 568, 580 (Bankr. D. Md. 1982) (discussing Maryland’s application of the badges of fraud as set out “by the Star Chamber in *Twyne’s Case* . . . for the purpose of shifting the burden of proof to the

a debtor's attempts to hinder or defraud one's creditors by transferring assets.<sup>102</sup> But fraudulent transfers are not unique to Anglo-American law. The ancestors of the Statute of Elizabeth can be traced to the early Romans.<sup>103</sup>

Fraudulent transfer law's fundamental purpose is to protect creditors from debtors' actions that craft "last-minute diminutions in the pool of assets"<sup>104</sup> in an attempt to place property beyond the reach of their creditors.<sup>105</sup> The asset depletion often amounts to gratuitous transfers for little or no value on the eve of bankruptcy. The equitable purpose behind fraudulent transfer law recognizes "that any significant disparity between the value received and the value surrendered will significantly harm innocent creditors."<sup>106</sup>

Preference actions signify a later development in creditor protection. By definition, a preferential transfer is a payment that permits a creditor to receive a greater percentage of his claim against the debtor than he would have received if he had participated in the general distribution of assets with the other creditors.<sup>107</sup> The purpose of a preference action is two-fold. First, authorizing the trustee to avoid pre-bankruptcy transfers within a short period before bankruptcy discourages creditors from sprinting to the courthouse to "dismember the debtor during his slide into bankruptcy."<sup>108</sup> Second, the preference provisions facilitate the essential bankruptcy policy of leveling the playing field among creditors by providing for more equitable distributions of the debtor's assets.<sup>109</sup> Thus, any creditor that received a greater payment than other similarly situated creditors must disgorge that payment so that the whole may share equally.<sup>110</sup> In short, fraudulent transfers diminish assets of the estate without a corresponding reduction in debt or obligation; preferential transfers

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transferee").

<sup>102</sup> *Shapiro v. Wilgus*, 287 U.S. 348, 354 (1932) (declaring fraudulent transfers have "been condemned in Anglo-American law since the Statute of Elizabeth" in 1571).

<sup>103</sup> See *Glinka v. Bank of Vt. (In re Kelton Motors, Inc.)*, 130 B.R. 170, 176 (Bankr. D. Vt. 1991) ("[F]raudulent conveyance laws extend[] over two thousand years to at least early Roman law.").

<sup>104</sup> *Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (In re Consol. Pioneer Mortg. Entities)*, 211 B.R. 704, 717 (S.D. Cal. 1997) *aff'd in part, rev'd in part*, 166 F.3d 342 (9th Cir. 1999).

<sup>105</sup> *Id.*

<sup>106</sup> *Dayton Title Agency, Inc. v. White Family Cos. (In re Dayton Title Agency, Inc.)*, 292 B.R. 857, 874 (Bankr. S.D. Ohio 2003).

<sup>107</sup> *Union Bank v. Wolas*, 502 U.S. 151, 160 (1991).

<sup>108</sup> *Id.* at 161 (quoting H.R. REP. NO. 95-595, at 177-78 (1978), *reprinted in* 1978 U.S.C.A.N. 5963, 6138) (internal quotation marks omitted).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

deplete assets of the estate but also reduce an obligation owing to a creditor.

## 2. Ponzi Schemes: Fraud in the Making

Fraudulent transfer law has a flexible underpinning: it looks to the substance as opposed to the form of the transaction.<sup>111</sup> Thus, even though there may be no conspiratorial aspect to the payment of a Ponzi investor, at bottom the transaction is considered fraudulent because the amount of the payment was either imaginary or simply robbed from Peter to pay Paul.<sup>112</sup> Regardless of a Ponzi investor's status as a victim of the scheme, bankruptcy trustees routinely use section 548 to recover payments made to the investors and reallocate those monies recovered to the larger universe of defrauded investors.<sup>113</sup>

There are two theories under which a bankruptcy trustee may proceed under section 548: actual fraud<sup>114</sup> or constructive fraud.<sup>115</sup> The "actual fraud" theory requires that the trustee prove that the Ponzi operator (i.e., debtor) made the transfers to the investor "[w]ith actual intent to hinder, delay, or defraud" the creditors (i.e. the losing investors).<sup>116</sup> Unlike the garden variety fraudulent transfer action where proving actual intent can be a time-intensive process, "[t]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to defraud.<sup>117</sup> Ponzi scheme operators often admit, sometimes in a plea agreement, the "actual intent" element.<sup>118</sup> In other words, a Ponzi scheme provides a presumptive element of actual fraud.<sup>119</sup>

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<sup>111</sup> See, e.g., *Cooper v. Centar Inv. Ltd (In re TriGem Am. Corp.)*, 431 B.R. 855, 862 (Bankr. C.D. Cal. 2010) (reasoning that it was necessary to look at the entire substance of the transaction in evaluating whether earmarking doctrine applied to fraudulent transfer action).

<sup>112</sup> In a Ponzi scheme, "[t]he fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment." *Wyle v. C.H. Ridcr & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n.1 (9th Cir. 1991).

<sup>113</sup> See, e.g., *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 434 (Bankr. S.D. Tex. 1997) (applying section 548 to Ponzi investors).

<sup>114</sup> See 11 U.S.C. § 548(a)(1)(A) (2006) (providing for avoidance of transfer made with actual intent to defraud).

<sup>115</sup> See 11 U.S.C. § 548(a)(1)(B) (providing for avoidance of transfer for less than equivalent value).

<sup>116</sup> 11 U.S.C. § 548(a)(1)(A).

<sup>117</sup> *Barclay v. Mackenzic (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008) (internal quotations and citation omitted).

<sup>118</sup> See, e.g., *Floyd*, 209 B.R. at 433 ("[T]he criminal conviction of [the defendant] based on the debtors' operation of a Ponzi scheme conclusively establishes fraudulent intent. . .").

<sup>119</sup> See *Barclay*, 525 F.3d at 704 (explaining that a Ponzi scheme by itself is enough to establish transfers were made with actual fraudulent intent).

On the other hand, the “constructive fraud” theory is a two-pronged approach. First, it requires that the trustee demonstrate that the transfer to the investor occurred for less than the “reasonably equivalent value” in exchange for the payout.<sup>120</sup> As the “robbing Peter to pay Paul” principle holds, profits that the debtor disburses via collections from later investors cannot amount to a “reasonably equivalent” exchange for the winning investor’s principal investment.<sup>121</sup> To meet the second prong of “constructive” fraud, the trustee must demonstrate that one of four additional events occurred:

- (1) The debtor was insolvent on the date of the payout or was rendered insolvent because of it;
- (2) The debtor was engaged or about to engage in business for which the assets remaining after the transfer constituted “unreasonably small capital”;
- (3) The debtor intended to incur debts beyond its ability to pay them at maturity; or
- (4) The debtor made the transfer to or for the benefit of an insider under a separate agreement and not in the ordinary course of business.<sup>122</sup>

The insolvency component of constructive fraud<sup>123</sup> is somewhat straightforward; courts regularly hold Ponzi schemes to be insolvent from inception.<sup>124</sup> The constructive fraud theory may insulate a portion of, and in some cases all of, the net winner’s principal. For payouts less than or equal to the amount of the creditor’s principal investment, courts often conclude that creditor gave reasonably equivalent value.<sup>125</sup> That does not apply, however, in cases where the

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<sup>120</sup> *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec., LLC)*, 440 B.R. 243, 261 (Bankr. S.D.N.Y. 2010); *Stone v. Ottawa Plant Food, Inc. (In re Hennings Feed and Crop Care, Inc.)*, 365 B.R. 868, 874 (Bankr. C.D. Ill. 2007).

<sup>121</sup> See generally 11 U.S.C. § 548(a)(1)(B)(i) (providing for avoidance of transfer for less than reasonably equivalent value).

<sup>122</sup> 11 U.S.C. § 548(a)(1)(B)(ii)(I)–(IV).

<sup>123</sup> See 11 U.S.C. § 548(a)(1)(B)(ii)(I) (requiring that transferor was insolvent at time of transfer or became insolvent as a result).

<sup>124</sup> See, e.g., *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 650 (Bankr. S.D. Ohio 2006) (“[G]iven the undisputed evidence that Canyon was operating a Ponzi scheme from the time it commenced operations, the Court may find as a matter of law that the Debtor intended to incur debts beyond its ability to repay.”).

<sup>125</sup> *Fisher v. Sellis (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 872 (Bankr. N.D. Ill. 2000) (internal citations omitted) (“[T]o the extent of invested principal, payments from the debtor are deemed to be made in exchange for reasonably equivalent value. . . . Payments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity.”).

creditor receives distributions in excess of the investment.<sup>126</sup> Unless the trustee can establish that investor lacked good faith, some courts have held that the trustee is limited to recovering the profits paid to the investor under the constructive fraud theory.<sup>127</sup>

In practice, the distinction between constructive and actual fraud seems insignificant. Constructive fraud takes more legwork (i.e., discovery) to prove and the result is generally the same in either case: the innocent investor must return funds.<sup>128</sup> The difference, however, is that a constructive fraud case may insulate some, or all, of a victim's principal investment. But the actual fraud theory may be used to recover the entire amount paid to the investor. Recovery of principal under the actual fraud theory is, however, subject to a "good faith defense" that allows an innocent investor to keep funds up to the amount of the initial investment.<sup>129</sup> Where a transfer is avoided as a constructive fraud, the trustee's recovery is limited to the investor's profits he or she received over and above the principal investment.<sup>130</sup> Notwithstanding, if the trustee proves that the innocent investor was less than innocent (i.e., lacked good faith), the trustee may use constructive fraud to recover the investor's principal.<sup>131</sup> Interestingly, the law of preferences contains no corresponding good faith caveat.<sup>132</sup>

### 3. *The Displeasure of Preferences: Timing is Everything*

In business situations, many creditors will experience bankruptcy through the preference lens.<sup>133</sup> In *Central Virginia Community*

<sup>126</sup> See, e.g., *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.* (*In re Bayou Grp., LLC*), 396 B.R. 810, 843 (Bankr. S.D.N.Y. 2008) (finding that each transfer of fictitious profits was for less than a reasonably equivalent value in exchange) *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

<sup>127</sup> For an example of a court adopting this holding, see *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008).

<sup>128</sup> See *Daly v. Deptula* (*In re Carrozzella & Richardson*), 286 B.R. 480, 483 n.3 (Bankr. D. Conn. 2002) (discussing the two theories under which a trustee can pursue fraudulent transfers).

<sup>129</sup> 11 U.S.C. § 548(c) (2006); see also *Kapila v. TD Bank, N.A.* (*In re Pearlman*), 440 B.R. 900, 905–06 (Bankr. M.D. Fla. 2010) (stating an affirmative "good faith" defense is available to individuals in actual fraud cases); *Cuthill v. Greenmark, LLC* (*In re World Vision Entm't, Inc.*), 275 B.R. 641, 648 (Bankr. M.D. Fla. 2002) ("All recipients of avoidable transfers from a debtor operating a Ponzi scheme are entitled to raise good faith as a defense").

<sup>130</sup> See *Daly*, 286 B.R. at 483 (discussing the Trustee's attempt to recover interest payments under a constructive fraud theory).

<sup>131</sup> See, e.g., *Donell*, 533 F.3d at 771 ("Under the constructive fraud theory, the receiver may only recover 'profits' above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may also recover the amounts that could be considered return of principal").

<sup>132</sup> See 11 U.S.C. § 547 (allowing recovery of any transfer that provided the transferee with more than he would have recovered otherwise).

<sup>133</sup> Some companies may also face fraudulent transfer actions, but the average trade creditor for a bankrupt company usually finds itself on the defending end of a preference action.

*College v. Katz*,<sup>134</sup> the United States Supreme Court recognized that a core tenant of the Bankruptcy Code is a debtor's privilege to avoid fraudulent and preferential transfers.<sup>135</sup>

A preference is a payment made on the "eve" of bankruptcy to a creditor in order to extinguish a pre-existing debt.<sup>136</sup> The term derives from the legal presumption that by paying a specific creditor the debtor has preferred that creditor to the detriment of the larger pool of creditors.<sup>137</sup> A trustee must demonstrate that the payment qualifies as a preference under the criteria set out in section 547(b). Preferences are voidable transactions, meaning that the trustee can decide whether to bring an avoidance action and that the creditor has a statutory opportunity to defeat such an action.<sup>138</sup>

Preference law's approach to Ponzi schemes stands in sharp contrast to fraudulent transfer actions.<sup>139</sup> Preference defenses, including ordinary course of business, serve a simple purpose: cushioning creditors. The defenses encourage creditors to continue doing ongoing and regular business with the debtor when bankruptcy is a foregone conclusion. And preference defenses facilitate ongoing business relationships that will allow a debtor to operate its business during the days before and possibly after a bankruptcy.<sup>140</sup> But preference defenses lose their utility in the Ponzi scheme context because the very act of paying investors facilitates the fraud rather than legitimate business.<sup>141</sup>

*See* Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 371–72 (2006) (describing such a dynamic).

<sup>134</sup> 546 U.S. 356 (2006).

<sup>135</sup> *Id.* at 371–72.

<sup>136</sup> *Dean v. Davis*, 242 U.S. 438, 443 (1917) ("Preference implies paying or securing a pre-existing debt of the person preferred" on the eve of bankruptcy); *DuBay v. Williams*, 417 F.2d 1277, 1288 (9th Cir. 1969) (describing a preference as one that is made within four months of bankruptcy).

<sup>137</sup> *Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228, 232 (9th Cir. 1995) (explaining that one of the underlying policies of a preference action is to prevent "a debtor from benefitting a particular creditor on the eve of bankruptcy").

<sup>138</sup> *See* 11 U.S.C. § 547(c) (2006) (enumerating the defenses to a trustee's preference action); *see also Harstad v. First Am. Bank*, 39 F.3d 898, 901 (8th Cir. 1994) ("The bankruptcy trustee has the discretionary power to avoid and to recover preferential transfers."); *Buchwald Capital Advisors, LLC v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 338 (Bankr. S.D.N.Y. 2006) ("A creditor against whom a preference suit is sought has the burden of proving one of the defenses in § 547(c) by a preponderance of the evidence.").

<sup>139</sup> *See Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 164 B.R. 657, 662 (D. Co. 1994) (discussing the good-faith defense to a fraudulent transfer action).

<sup>140</sup> *See Union Bank v. Wolas*, 502 U.S. 151, 157 (1991) (stating that ordinary course of business defense provides insulation from preference attack against payments part of a bank's ordinary course of business).

<sup>141</sup> *See Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedge-Investment Assocs., Inc.)*, 48 F.3d 470, 476 (10th Cir. 1995) (holding that payments to investor were not to be considered part of "ordinary course of business" as they were part of an ongoing Ponzi

Section 547 does not grant a good faith defense to the transferee, and the section 550 good faith defense is not given to the initial transferee of a preferential transfer.<sup>142</sup> In Ponzi scheme proceedings to recover preferences, perhaps the only viable defense is that the withdrawal occurred within section 547(c)'s "ordinary course of business." This defense houses dual purposes. First, it permits, and even urges, creditors to engage in normal and customary business dealings with debtors on the brink of bankruptcy. Second, it discourages and rejects extraordinary debt collection actions or payment terms.<sup>143</sup>

But, despite the policy objectives, a creditor must clear several hurdles to establish the defense. The creditor defendant must show that debt arose in the ordinary course of business (e.g., an arm's length transaction that does not depart from the traditional or historic dealings between the parties).<sup>144</sup> Moreover, the creditor must establish that the payments were made in either: (a) the ordinary course of the parties' particular business relationship (a subjective test), or (b) the ordinary course of the business or industry in which the debtor or creditor operate (an objective test).<sup>145</sup>

Under this defense, payments made in the ordinary course of business or financial affairs of the debtor generally escape clawback under section 547, but may not be applicable in a Ponzi Scheme case.<sup>146</sup> In theory, section 547(c)(2) of the Code could provide net-winning Ponzi investors with one potent tool to fight a trustee's attempt to recover withdrawn funds. Theory and practice, however, do not always coincide. Indeed, some courts have adopted a blanket rule that the ordinary course of business defense is simply unavailable

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scheme).

<sup>142</sup> See 11 U.S.C. §§ 547; 550.

<sup>143</sup> See COLLIER ON BANKRUPTCY: CHAPTER 5 BANKRUPTCY CODE, CREDITORS, DEBTORS, AND THE ESTATE § 547.04[2][a] (Matthew Bender Co., Inc. ed., 15th ed. rev. 1996) (noting Congress's intent to discourage unusual action by creditors during a debtor's slide into bankruptcy).

<sup>144</sup> *Id.*

<sup>145</sup> 11 U.S.C. § 547(c)(2). The industry norm requires an examination of the relevant industry. The inquiry becomes whether the relevant industry is that of the debtor or creditor if they have merely a vendor/customer relationship. Since the defense is affirmatively asserted by the creditor, it would seem that the appropriate industry to consider is that of the creditor. Nonetheless, a trustee might challenge this and focus the test on the debtor's industry. Even assuming that the parties agree, proving the relevant industry practices require expert testimony. See *Finley v. Mr. T's Apparel (In re Wash. Mfg. Co.)*, 144 B.R. 376, 380 (Bankr. M.D. Tenn. 1992) (requiring expert testimony); see also *Morris v. Kan. Drywall Supply Co. (In re Classic Drywall, Inc.)*, 121 B.R. 69, 78–79 (D. Kan. 1990) (finding that testimony of officer of preferred creditor alone was sufficient).

<sup>146</sup> For consumer cases, "the paragraph uses the phrase 'financial affairs' to include such nonbusiness activities as payment of monthly utility bills." S. REP. No. 95–989, at 88 (1978).

to “any creditor being pursued by a trustee of a Ponzi scheme.”<sup>147</sup> And under section 547, the trustee “may recover both principal investments as well as fictitious profits earned despite any objective or subjective good faith defense raised by the investor.”<sup>148</sup> For those reasons, section 547 preference actions are often superior to fraudulent transfer actions.

Other courts are reluctant to enforce a wholesale ban of the defense. But the net-winning investor fails regardless because the courts rule that the “payments made to Ponzi investors cannot satisfy the requirement that payments must be ‘made according to ordinary business terms’ because ordinary businesses, among other things, do not pay fictitious profits.”<sup>149</sup> While preference law has a litany of defenses available to the transferee, courts rarely, if ever, permit investors to take advantage of them in Ponzi scheme cases, even when it comes to return of principal.<sup>150</sup> This tacit policy falls short of a bright-line rule, but the result is consistent and predictable. Nonetheless, the facts so fatal to a preference defense—a Ponzi scheme’s fraudulent purpose and lack of legitimate business operations—do not have the same effect on defenses to fraudulent transfer actions, leaving that body of law ripe with ambiguity.

### III. FRAUDULENT TRANSFERS IN PONZI SCHEMES: THE CHANGING FACE OF GOOD FAITH

In ordinary businesses, preferences stand apart from fraudulent transfers. Preferential transfers can be avoided, but the defense scheme under section 547(c) demonstrates that some transactions will be protected because they foster regular business activities that may well keep the pre-bankruptcy doors open for debtor and creditor

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<sup>147</sup> McDermott, *supra* note 1, at 185; *see also* Henderson v. Buchanan, 985 F.2d 1021, 1025 (9th Cir. 1993) (stating the United States Court of Appeals for the Ninth Circuit had previously held Ponzi schemes were not true businesses and thus any transfers related to such schemes cannot now be deemed within the “ordinary course of business”); *In re Taubman*, 160 B.R. 964, 991 (Bankr. S.D. Ohio 1993) (internal citation omitted) (“Ponzi schemes are not legitimate businesses which Congress intended to protect by enactment of § 547(c)(2).”)

<sup>148</sup> Jerry J. Campos, *Avoiding the Discretionary Function Rule in the Madoff Case*, 55 LOYOLA L.J. 587, 600 (2009) (discussing recourse for defrauded investors of Ponzi schemes during bankruptcy proceedings).

<sup>149</sup> McDermott, *supra* note 1, at 185; *see also* Jobin v. McKay (*In re M&L Bus. Mach. Co.*), 84 F.3d 1330, 1339–40 (10th Cir. 1996) (rejecting a bright-line rule that section 547(c)(2) should never apply in the context of Ponzi schemes, while holding that the payments were not in the ordinary course of business resulting from their fraudulence); *Inskip v. Grosso (In re Fin. Partners, Ltd.)*, 116 B.R. 629, 637–38 (Bankr. N.D. Ill. 1989) (holding that Ponzi investors were not protected by ordinary course of business defense).

<sup>150</sup> *See, e.g., Grosso*, 116 B.R. at 637–38 (holding that Ponzi investors were not protected by ordinary course of business defense).



alike.<sup>151</sup> Even the name “fraudulent transfers” connotes despicable conduct. Far from merely favoring a creditor, fraud permeates the transaction and frustrates legitimate creditor interests.<sup>152</sup> In Ponzi schemes, however, the distinction between preferences and fraudulent transfer actions as applied to investors blend into each other. Largely, the difference depends on timing rather than the nature of the transaction. And any distinction between the two in Ponzi scheme cases fails to strictly adhere to comparative norms of section 547 and 548.

If a fraudulent course of business by the debtor can torpedo the ordinary course of business defense in a Ponzi preference action, then perhaps the express good faith defense under section 548(c) also has no place in fraudulent transfer actions related to Ponzi schemes. Some courts have begun to agree that good faith is a futile gesture.

### *A. Into the Bayou and Beyond*

While 2008 and 2009 proved to be banner years for Ponzi schemes, one case struck an early tone in fraudulent transfer actions against investor-defendants.<sup>153</sup> Sam Israel, James Marquez, and Daniel Marino engineered the Bayou Fund in 1996.<sup>154</sup> Virtually from inception, the fund bled money.<sup>155</sup> In essence, the fund “cooked the books” by falsifying financial disclosures and doctoring investment returns.<sup>156</sup> The masquerade intensified when Marino removed the fund’s independent auditor, and created a fictitious accounting firm to

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<sup>151</sup> See, e.g., *Redmond v. Ellis Cnty. Abstract & Title Co. (In re Liberty Livestock Co.)*, 198 B.R. 365, 373 (Bankr. D. Kan. 1996) (noting that “[t]he purpose of the ordinary course of business defense is to encourage creditors to continue to do business with financially strapped debtors”); *Advo-Sys., Inc. v. Maxway Corp.*, 37 F.3d 1044, 1050 (4th Cir. 1994) (internal quotations and citation omitted) (stating subsection C grants creditors “considerable latitude in defining what the relevant industry is” and thus creditors can still find protection under subsection C even if they substantially deviated from industry norms); see also Terry M. Anderson, *In re Iowa Premium Service Co.: When is a Debt Incurred Under Section 547(c)(2) of the Bankruptcy Code*, 17 CREIGHTON L. REV. 1075, 1093–94 (1984) (presenting notion that part of the purpose behind section 547(c)(2) is to allow financially-strapped debtors the ability to continue ongoing business operations in the eve of bankruptcy). But see *Sacred Heart Hosp. v. E.B. O’Reilly Servicing Corp. (In re Sacred Heart Hosp.)*, 200 B.R. 114, 116 n.2 (Bankr. E.D. Pa. 1996) (finding that such public policy is not recognized in 547(c)(2)).

<sup>152</sup> The policy behind section 548 “is to prevent a debtor from diminishing, to detriment of some or all creditors, funds that are generally available for distribution to creditors. Consequently, any funds under control of debtor, regardless of source, are properly deemed the debtor’s property” and cannot be transferred if such transfer diminishes estate. *Nordberg v. Sanchez (In re Chase & Sanborn Corp.)*, 813 F.2d 1177, 1181 (11th Cir. 1987).

<sup>153</sup> *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp. LLC)*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part*, 439 B.R. 284 (S.D.N.Y. 2010).

<sup>154</sup> *Id.* at 822.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

manage the fraud in-house and assume the role of an independent auditor.<sup>157</sup> From 1999 through 2005, the imaginary accountants certified the fund's financial reports despite the absence of any profit.<sup>158</sup> True to Ponzi form, investor redemptions were funded by the investment of later-in-time investors.<sup>159</sup> When the scheme imploded in 2005, the unpaid balances totaled \$250 million.<sup>160</sup> As expected, the bankruptcy trustee initiated actions to recover the money from the redemption payments to investors who successfully "cashed out" up to one year before the scheme collapsed.<sup>161</sup>

*Bayou's* facts themselves are not remarkable in the context of Ponzi schemes. But a series of decisions in the resulting Bayou bankruptcy has created quite a stir with respect to the good faith defense. To date, there are four opinions regarding the fraudulent transfer actions against the redeeming investors.<sup>162</sup> In the first two cases (*Bayou I* and *Bayou II*), the trustee initiated fraudulent transfer actions against redeeming investors to recover the pre-petition payments that the fund made to investors within fourteen months of the bankruptcy filing.<sup>163</sup>

Bankruptcy Judge Adlai S. Harding, Jr. handed down *Bayou I* in February 2007.<sup>164</sup> The redeeming investors moved to dismiss the debtor-plaintiffs' adversary proceeding brought under section 548(a)(1)(A) to avoid the payments based on an actual fraud theory.<sup>165</sup> In *Bayou I*, the court denied the motion to dismiss, concluding that the debtors alleged a prima facie case that the redemption payments were made with "actual intent to hinder, delay, or defraud."<sup>166</sup> The court's finding of "actual intent" was premised on both the "intuitive and inescapable" presumption of fraudulent intent based on the facts and the broad definition of "Ponzi scheme."<sup>167</sup> The court defined the term Ponzi scheme as any "inherently fraudulent

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<sup>157</sup> *Id.*

<sup>158</sup> *Id.* at 822–23.

<sup>159</sup> *Id.* at 823–24.

<sup>160</sup> *Id.* at 823.

<sup>161</sup> *Id.* at 821.

<sup>162</sup> See *Christian Bros. High Sch. v. Bayou No Leverage Fund, LLC* (*In re Bayou Grp., LLC*), 439 B.R. 284 (S.D.N.Y. 2010) (referred to in the text as *Bayou IV*); *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.* (*In re Bayou Grp., LLC*), 396 B.R. 810 (Bankr. S.D.N.Y. 2008) (referred to in the text as *Bayou III*), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010); *In re Bayou Grp., LLC*, 372 B.R. 661 (Bankr. S.D.N.Y. 2007) (referred to in the text as *Bayou II*); *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P.* (*In re Bayou Grp., LLC*), 362 B.R. 624 (Bankr. S.D.N.Y. 2007) (referred to in the text as *Bayou I*).

<sup>163</sup> *In re Bayou Grp.*, 372 B.R. at 663; *Bayou Superfund*, 362 B.R. at 626.

<sup>164</sup> *Bayou Superfund*, 362 B.R. at 626.

<sup>165</sup> *Id.* at 633.

<sup>166</sup> *Id.* at 634.

<sup>167</sup> *Id.*

arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.”<sup>168</sup>

The court also held that section 548(a)(1)(A) avoids the *entire amount* of “any transfer” where the requisite intent to defraud exists.<sup>169</sup> Consequently, the redemption payments—in their entirety—could be avoided since they qualified as “fictitious profits.”<sup>170</sup> The court also noted that section 548(a)(1) does not compel the plaintiff to prove that the investor-defendants lacked good faith because lack of good faith is not an element of an avoidance claim.<sup>171</sup> Rather, the burden of pleading good faith rests with the investor as an affirmative defense.<sup>172</sup>

On the heels of *Bayou I*, *Bayou II* is considered a slightly different fraudulent transfer action. In *Bayou II*, the non-redeeming investors initiated their own avoidance action to recover the payments made to the redeeming investors.<sup>173</sup> The court concluded that the non-redeeming investors—despite their status as equity investors—could nonetheless pursue fraudulent transfer actions due to a contractual right of redemption.<sup>174</sup>

### *B. The Third Time's a Charm: Bayou III and the Good Faith Deviant*

While *Bayou I* and *Bayou II* addressed the more procedural issues of standing and statutory definitions, *Bayou III* brought the most controversial opinion in the case.<sup>175</sup> The debtors filed an adversary complaint against investors who redeemed their investments within one year.<sup>176</sup> As before, Bayou sought recovery of the transfers under section 548(a) and New York Debtor and Creditor Law.<sup>177</sup> The debtor wanted to claw back both principal and “fictitious profits” that had been redeemed by the investors.<sup>178</sup> As a threshold matter, the court set

<sup>168</sup> *Id.* at 633.

<sup>169</sup> *Id.* at 634–35.

<sup>170</sup> *Id.* at 634.

<sup>171</sup> *Id.* at 639.

<sup>172</sup> *Id.*

<sup>173</sup> *In re Bayou Grp., LLC*, 372 B.R. 661, 664 (Bankr. S.D.N.Y. 2007).

<sup>174</sup> *Id.* at 665, 667.

<sup>175</sup> See, e.g., Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, AM. BANKR. INST. J. Apr. 2009, at 16 (critiquing *Bayou III*'s treatment of the good-faith defense).

<sup>176</sup> *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 821 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at 825–28.

forth the operation of section 548.<sup>179</sup> In particular, the court emphasized that section 548(a)(1)(A):

- (1) applied to avoid the entire amount of “any transfer” made with the actual intent to hinder, delay or defraud creditors;
- (2) acknowledged that the debtor’s intent could be directed at either present or future creditors;
- (3) required that only the debtor’s intent is relevant;
- (4) did not consider the transferee’s intent, which was only relevant to the good faith defense; and
- (5) attempted to achieve a balance of equities by placing the transferee in the same position as other similarly situated creditors.<sup>180</sup>

The court then resolved larger issues relevant to, if not critical in, most Ponzi schemes. *Bayou III* took up three critical issues. First, when is a transfer made “with actual intent to hinder, delay, or defraud” present or future creditors?<sup>181</sup> Second, what is the role of good faith as an affirmative defense?<sup>182</sup> And third, what qualifies as “inquiry notice” and “diligent inquiry” for purposes of the good faith defense?<sup>183</sup>

### *1. An Easy Hunt for Intent*

In *Bayou III*, the court narrowed its iteration of “actual intent” from its pronouncement in *Bayou I*. In *Bayou I*, the court determined that actual intent in a Ponzi scheme is present if the facts demonstrate that the scheme used later-in-time investment to pay earlier investors and perpetuate the fraud.<sup>184</sup> In contrast, *Bayou III* tapered the focus to the intent of Bayou management when it knowingly authorized the redemption payments in excess of the contractual amounts that were the product of the cooked books.<sup>185</sup> Consequently, the court held that each redemption payment qualified as an intentional

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<sup>179</sup> *Id.* at 825–26.

<sup>180</sup> *Id.* at 825–27.

<sup>181</sup> *Id.* at 842–43.

<sup>182</sup> *Id.* at 843–45.

<sup>183</sup> *Id.* at 845–47.

<sup>184</sup> *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Grp., LLC)*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007).

<sup>185</sup> *Bayou Accredited Fund*, 396 B.R. at 843.

misrepresentation and deliberate concealment of the real accounts.<sup>186</sup> Accordingly, the court found that the payments were made with the “actual intent to hinder, delay, or defraud” because the redemptions constituted fraudulent payments that lacked any reason or purpose “and damaged the remaining investors.”<sup>187</sup>

## 2. *The Boundaries of Good Faith*

After the *Bayou* plaintiffs established that fraudulent transfers occurred under section 548(a), the burden shifted to the investor-defendants to prove their affirmative defense of good faith under section 548(c). Section 548(c) states:

[A] transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.<sup>188</sup>

Under section 548(c), a transferee may retain a transfer if the transferee (1) takes for value and (2) takes in good faith. Note that the defense encompasses the components of “good faith” and “value,” both of which the defendant must prove. In *Bayou III*, “value” was not at issue, but the court spent a considerable analysis on section 548(c)’s “good faith” prong.<sup>189</sup> The court observed that “good faith” is not defined in the Bankruptcy Code and lacks worthwhile legislative history.<sup>190</sup> Instead, the court reasoned that it must look to case law to extract both definition and application of “good faith.”<sup>191</sup>

According to *Bayou III*, the “good faith” element of section 548(c) is an objective inquiry, and a transferee’s subjective good faith is irrelevant.<sup>192</sup> This objective perspective asks what the transferee objectively knew or should have known in deciding whether that transferee accepted a payment in good faith.<sup>193</sup> Under the objective test, good faith does not exist if the surrounding circumstances would place a reasonable person on inquiry notice of debtor’s fraudulent

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<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> 11 U.S.C. § 548(c) (2006).

<sup>189</sup> *Bayou Accredited Fund*, 396 B.R. at 844.

<sup>190</sup> *Id.*

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* (citing *Bear Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund)*, 397 B.R. 1, 23 (Bankr. S.D.N.Y. 2007)).

<sup>193</sup> *Id.* at 845 (quoting *Hayes v. Palm Seedlings Partners (In re Agric. Research and Tech. Grp., Inc.)*, 916 F.2d 528, 535–36 (9th Cir. 1990)).

objective, *and* diligent inquiry would have revealed the fraud.<sup>194</sup> To analyze the defendant's good faith defense, the *Bayou III* court used the *Manhattan Fund* test, which "requires either that: (1) the transferee was not on 'inquiry notice'; or (2) if on notice, the transferee was 'diligent in its investigation' of the transferor."<sup>195</sup> Moreover, a redeeming investor transferee need not have knowledge of some underlying fraud to be on inquiry notice.<sup>196</sup>

*a. Inquiring Minds Need to Know*

Notwithstanding the good faith defense's objective nature, the *Bayou III* court recognized that it cannot exist in a vacuum: "[T]o disregard objective evidence of the transferee's subjective good faith intent would fundamentally distort the concept of good faith."<sup>197</sup> Still, an investor in a Ponzi scheme, is presumed to be on inquiry notice if she "knew or should know of information" or a "red flag" placing her "objectively 'on alert that there was a potential problem with the Fund' such that the transferee 'should have attempted to learn more.'"<sup>198</sup> Thus, as a matter of law, the transferee bears the burden of establishing that he or she was not on inquiry notice.<sup>199</sup>

The concept of good faith is an imprecise fixture in section 548. But the presence of certain factors helps to clear the inherent ambiguity. Many conditions clearly negate the good faith defense. For example, when: (1) the transferee knew the fraudulent purpose of the transfer; (2) there was underlying fraud; (3) the transferor had an unfavorable financial condition or was insolvent; (4) the nature of the transfer was improper; or (5) the transfer was voidable.<sup>200</sup> Despite the societal tendency to label Ponzi scheme investors "victims," courts have been reluctant to construe the inquiry notice prong broadly in a manner that parallels the concept of strict liability in tort law.<sup>201</sup>

*b. C.Y.A. Analysis*

Once the inquiry notice prong is satisfied, a transferee's failure to conduct a "diligent investigation" sinks the good faith defense. In

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<sup>194</sup> *Id.*

<sup>195</sup> *Id.* (citing *In re Manhattan Inv. Fund*, 397 B.R. at 22).

<sup>196</sup> *Id.*

<sup>197</sup> *Id.* at 849.

<sup>198</sup> *Id.* at 845 (quoting *In re Manhattan Inv. Fund*, 397 B.R. at 23).

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 845–46.

<sup>201</sup> See *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1335–36 (10th Cir. 1996) (internal citation omitted) (holding that the presence of any circumstance placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the transferee of the good-faith defense).

other words, an investor on inquiry notice must mitigate and cancel out his or her problem by performing a thorough investigation.<sup>202</sup> The “diligent investigation” prong of section 548(c) cannot be met simply by speaking with the Ponzi operator.<sup>203</sup> After all, those individuals have a tremendous incentive to obscure truth, and, in some cases, have perfected the art of placating investors.

Taking the ostrich head-in-the-sand approach (i.e., the “what you don’t know can’t hurt you” mentality) defeats the good faith defense.<sup>204</sup> *Bayou III* further held that an “inconclusive diligent investigation” which failed to uncover the fraud will not, on its own, prove good faith.<sup>205</sup> The investor must demonstrate that the reason for the withdrawal was “not because he had some information that there was some infirmity in the fund, but because of some other reason personal to him and extraneous to the well-being of the fund and its remaining investors.”<sup>206</sup> Consequently, in order to pass the *Bayou III* good faith hurdle, a Ponzi investor would need to show the following two items. First, an investor must establish that she made a diligent inquiry, the results of which signaled the “all clear.” Second, she has to show that the withdrawal was the product of some extraneous purpose, such as buying a house, wholly unrelated to red flags.<sup>207</sup>

### *c. Objectifying Good Faith*

To illustrate its view of permissible redemptions, *Bayou III* listed specific examples of extraneous circumstances that amounted to good faith, including:

- (1) A pension plan liquidating its Bayou investment (along with other investments) to comply with ERISA;
- (2) A trust withdrawing funds for the sole purpose of funding a home purchase;
- (3) A partnership requesting a redemption as part of a liquidation of assets in advance of a partner’s death;
- (4) A parent withdrawing funds to cover expenses of a newborn child and private school tuition expenses;

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<sup>202</sup> Bayou Accredited Fund, 369 B.R. at 846.

<sup>203</sup> *Id.*

<sup>204</sup> *Id.* at 847.

<sup>205</sup> *Id.* at 851.

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* at 850.

(5) Bayou returning an investment and closing an account after an investor's balance fell below the minimum levels accepted by Bayou; and

(6) A fund seeking a partial satisfaction of its Bayou investment to fulfill withdrawal requests from its own investors and to pay a bank loan.<sup>208</sup>

The court explained that all of the above redemptions met the objective good faith defense, which allowed the investors to retain the redemption payments attributable to the principal investment but required them to return any fictitious profits.<sup>209</sup>

### C. Battle over Bayou

*Bayou III* perhaps went further than other courts in denying the good faith defense.<sup>210</sup> But *Bayou III* also provided an arbitrary set of exceptions, which seem to drift back toward subjective motivations for withdrawing funds. For example, using withdrawals to fund the purchase of a home or the birth of a child are laudable, if not sympathetic, reasons. But the court also permitted a feeder fund to pay off its own bank loan. The court initially approached strict liability in Ponzi scheme redemptions, but then whipsawed, carving out exceptions for a select few withdrawals. While the court's gesture was an attempt to soften the hardship of losing money by inserting a scintilla of fairness, it still resulted in disparate treatment. The judgment merely realigned the "haves" and the "have-nots."

Several articles have harshly criticized *Bayou III* for placing restrictions on the good faith defense's applicability in Ponzi schemes.<sup>211</sup> Notably, the commentators object to what they perceive as *Bayou III*'s wholesale rejection of "decades of tradition

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<sup>208</sup> *Id.* at 853.

<sup>209</sup> *Id.*

<sup>210</sup> Although some courts have strayed in that direction. See *Smith v. Suarez (In re IFS Fin. Corp.)*, 417 B.R. 419, 427 (S.D. Tex. 2009) (holding that defendants were not good-faith transferees where evidence indicated that they knew or should have known of the illegitimacy of the subject investments and that board member acted as siblings' "agent" and thus under agency law his knowledge of fraud was imputed to the principal); see also Memorandum in Opposition to Defendants' Motion for Partial Summary Judgment at 16, *Wing v. Nathenson*, No. 2:09-cv-109-DB (D. Utah Sept. 4, 2009), 2009 WL 5129177 (arguing that the transferee must undertake a diligent investigation when put on inquiry notice of suspicious circumstances).

<sup>211</sup> For an example of that critique see Sinclair, *supra* note 178, at 16; see also Kathy L. Yeatter, *Investors Beware: Bankruptcy Court Decision Takes Narrow View of "Good Faith" Under § 548(C)*, AM. BANKR. INST. J. Feb. 2009, at 38, 49 (arguing that the facts of *Bayou III* supported the good-faith defense).



interpreting fraudulent transfer law since its inception in the Statute of Elizabeth.”<sup>212</sup>

*Bayou III*'s critics are more vocal than its defenders. I think, however, that *Bayou III* laid the foundation for eliminating the good faith defense under section 548(c) altogether. *Bayou III* got much of the analysis right, but it could have—and should have—gone further. Critics argue that the *Bayou III* configuration of the good faith defense causes investors to lose the defense if they fail to ask the right questions. But that is perhaps the best result, and one that unifies investors instead of creating factions. Indeed, a healthy dose of Schadenfreude<sup>213</sup> calms the maddening crowd by spreading shared blame and shared pain among all. Nor should the good faith defense be limited because of burden on the courts, which would have to adjudicate the massive amount of claw back actions. The good faith defense's elimination is fortified by the fact that it will achieve equity among all creditors.<sup>214</sup>

*Bayou III*'s influence on the good faith defense would be short-lived. The jilted investors appealed to the district court, and the result was *Bayou IV*.<sup>215</sup> While the district court affirmed many of the bankruptcy court's holdings, it categorically rejected the holding of good faith.<sup>216</sup> The district court held that when considering red flags of fraud in connection with the investor's related conduct, courts should evaluate the specific circumstances of each transfer.<sup>217</sup> Consequently, *Bayou IV* formulated the question as whether a transferee reasonably should have known of the fraudulent intent underlying the transfer.<sup>218</sup>

*Bayou IV* also concluded that the objective reasonable investor standard applies to both the inquiry notice and diligent investigation prongs of the good faith defense. The district court determined that the bankruptcy court's analysis of “red flags” that included “some infirmity in Bayou or the integrity of its management,” was overly broad and untenable.<sup>219</sup> Rather, it is “information suggesting

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<sup>212</sup> Sinclair, *supra* note 178, at 16.

<sup>213</sup> Schadenfreude is where pleasure is derived from the misfortune of others. OXFORD ONLINE DICTIONARY, <http://www.oxforddictionaries.com/definition/schadenfreude?view=uk> (last visited Sept. 18, 2011).

<sup>214</sup> Cf. *Pepper v. Litton* 308 U.S. 295, 304–05 (1939) (discussing the Bankruptcy Court's broad equitable powers).

<sup>215</sup> *Christian Bros. High Sch. v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).

<sup>216</sup> *Id.* at 316–17.

<sup>217</sup> *Id.* at 313.

<sup>218</sup> *Id.* at 311.

<sup>219</sup> *Id.* at 314 (quoting *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 848 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*,

insolvency or a fraudulent purpose in making a transfer that triggers inquiry notice.”<sup>220</sup>

Furthermore, *Bayou IV* rejected that bankruptcy court’s interpretation of the good faith defense’s diligent investigation prong.<sup>221</sup> The district court concluded that the good faith defense could not be forced into a strict box.<sup>222</sup> Insisting on such rigidity, according to the district court, ignores the good faith defense’s historical objectivity and would force judges to measure the transferee’s subjective motivations and intentions.<sup>223</sup> As a last nail in *Bayou III*’s coffin, the district court ruled that if “the transferee can meet its burden of demonstrating that a diligent investigation would not have led to discovery of the fraud, it may prevail on [the diligent investigation prong],” and defeat the specter of inquiry notice.<sup>224</sup> Despite the district court’s more generous construction of the good faith defense, the defendant-funds still lost once the issue proceeded to trial.<sup>225</sup> The jury found that the funds failed to make the required investigation, and thus ordered the return of the entire amount paid to the defendant investors.<sup>226</sup>

Unfortunately, the United States District Court for the Southern District of New York continues to upend the good faith defense as used in Ponzi schemes, including one that expands the defense to its widest berth yet. In another Madoff spinoff, *Picard v. Katz*,<sup>227</sup> the district court staunchly rejected the objective, or inquiry notice, approach, at least in the context of a Securities Investor Protection Act (“SIPA”) trusteeship.<sup>228</sup> The court noted that in cases involving

439 B.R. 284 (S.D.N.Y. 2010)).

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 315–17.

<sup>222</sup> *Id.* at 317.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.* There are other defenses available in fraudulent transfer actions aside from the good-faith defense embodied in section 548(c), including the *in pari delicto* doctrine, which is the common law notion that “a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim.” *Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 64, 78 (S.D.N.Y. 2008) (internal citation omitted). Growing in its success rate, it and any other defenses outside of good faith are beyond the scope of this article.

<sup>225</sup> Joel Rosenblatt, *Bayou Group Estate Wins \$13 Million from Hedge Funds for Fraud Investors*, BLOOMBERG (May 12, 2011, 9:08 PM), <http://www.bloomberg.com/news/2011-05-13/bayou-group-estate-wins-13-million-from-hedge-funds-for-fraud-investors.html>.

<sup>226</sup> *Id.*

<sup>227</sup> No. 11 CIV. 3605(JSR), 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011).

<sup>228</sup> *Id.* at \*5. When a brokerage firm fails, the Securities Investor Protection Corporation (“SIPC”) (discussed *infra* Part IV.A) transfers the failed brokerage’s accounts to a different securities brokerage firm. If the SIPC is unable to arrange the accounts’ transfer, the failed firm is liquidated. *See* 15 U.S.C. §§ 78aaa *et seq.* (2006) (detailing the procedure by which SIPC winds up a failed brokerage). In the Madoff case, the liquidation began under SIPA and flowed

bankrupt securities firms, bankruptcy law incorporates certain elements of securities law.<sup>229</sup> Consequently, the “safe harbor” provision of section 546(e) barred the trustee from pursuing any claims based upon either preference law or constructive fraud.<sup>230</sup> The trustee was only left with the actual fraud claims under section 548(a)(1)(A), which the court then narrowly construed.<sup>231</sup>

The court held where a SIPA trusteeship was involved, the trustee in bankruptcy had to prove the level of scienter required in a securities fraud case: “proof of more than negligent nonfeasance.”<sup>232</sup> Focusing on the plain language of the statute, the court rejected Picard’s argument that applying the safe harbor in the instant case ran counter to the legislative goals.<sup>233</sup> In addition to the plain language, the court also felt the aims of the legislation would be served because the recovery actions in the Madoff case threatened the sort of market upheaval SIPA was designed to avoid.<sup>234</sup> Addressing the good faith defense, the court reasoned that although securities law prohibited an investor from “willful blindness” to obvious fraud, “[a] securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty.”<sup>235</sup> According to the court’s formulation, the good faith defense remains available when an investor encounters “suspicious circumstances” and still fails to undertake any investigation.<sup>236</sup>

Although the result in *Katz* delighted fans of the New York Mets,<sup>237</sup> it directly conflicted with another Southern District of New York opinion in the Madoff case, *Picard v. Merkin*,<sup>238</sup> decided only a month earlier. In *Merkin*, the district court ruled that the complaint—

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into the bankruptcy court.

<sup>229</sup> *Katz*, 2011 WL 4448638, at \*2.

<sup>230</sup> *Id.*

<sup>231</sup> *Id.* at \*1.

<sup>232</sup> *Id.* at \*5 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 215 (1976)).

<sup>233</sup> *Id.* at \*2–\*3.

<sup>234</sup> *Id.* at \*3.

<sup>235</sup> *Id.* at \*5.

<sup>236</sup> *Id.* at \*6.

<sup>237</sup> The avoidance action sought to recover \$300 million worth of fictitious profits and \$700 million in principle from the owners of the New York Mets. Jonathan Stempel & Grant McCool, *UPDATE 3-Judge Narrows \$1 bln Madoff Case vs NY Mets Owners*, REUTERS (Sept. 27, 2011), <http://www.reuters.com/article/2011/09/27/madoff-mets-dUSS1E78Q1UA20110927>. The team owners motioned to dismiss the lawsuit arguing that they had no knowledge of the Ponzi scheme. *Id.* Picard’s suit further endangered the owners’ tenuous hold on the Mets, a team already facing substantial financial losses. *Id.* Judge Rakoff’s decision limits Picard’s potential recovery to the \$300 million payout of “profits”. *Id.*

<sup>238</sup> *Picard v. Merkin (In re Bernard L. Madoff Investment Securities, LLC)*, SIPA Liquidation Case No. 08–01789 (BRL), Adv. Proc. No. 09–1182 (BRL) (S.D.N.Y. Aug. 31, 2011).

which alleged fraudulent transfers based on both actual and constructive fraud—could survive the defendant’s motion to dismiss. In contrast to Judge Rakoff, Judge Wood determined that both the Bankruptcy Code and New York state law focus squarely on the intent of the debtor-transferor and *not* the intent of the transferee.<sup>239</sup> The court went on to conclude that the application of the section 546(e) safe harbor defense at this point in the case was premature, as the court had not yet crossed that bridge.

Given two wildly different interpretations of the good faith defense within the confines of the same case, the only thing that is clear is the unpredictability and inconsistency of the application of the good faith defense. A litigant attempting to ascertain the legal landscape of the good faith defense in Ponzi schemes would be no worse for the wear if he or she flipped a coin on read tea leaves at the bottom of a cup. And the last two Madoff cases examined the “good faith” prong of section 548(c) without touching upon the “for value” component of the defense.

#### *D. Calculating “Value” into the Good Faith Equation of Section 548(c)*

Last year, the United States Bankruptcy Court for the Northern District of Georgia decided whether equity-denominated investments that were repaid can be the bases of “value” for purposes of the section 548(c) defense. *In re International Management Associates, L.L.C.* (“IMA”)<sup>240</sup> illustrates the different notions and play of defenses in fraudulent transfer actions in Ponzi schemes. A seemingly routine fraudulent transfer case, *IMA* catapulted to the United States Court of Appeals for the Eleventh Circuit by route of the rarely used direct appeal.<sup>241</sup>

The facts are voluminous, but are neither remarkable nor complex. Kirk Wright formed the International Management Associates L.L.C. (“IMA”) and a string of related companies<sup>242</sup> to manage and operate as hedge funds. The corporate structure of each was either a limited liability company or a limited partnership.<sup>243</sup> True to the label

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<sup>239</sup> *Id.* at 8–13. In New York, however, the transferee’s intent (or lack thereof) can be considered an affirmative defense.

<sup>240</sup> No. A06–62966–PWB, 2009 WL 6506657 (Bankr. N.D. Ga. 2009), *aff’d*, No. 10–10683, 2011 WL 5103951 (Oct. 27, 2011).

<sup>241</sup> *In re Int. Mgmt. Assocs., LLC*, 2009 WL 6498191 (order certifying case for direct appeal to the United States Court of Appeals for the Eleventh Circuit).

<sup>242</sup> All of Wright’s companies entered bankruptcy in 2006; the cases were then substantively consolidated. *In re IMA*, 2009 WL 6506657, at \*5 n.4.

<sup>243</sup> *Id.* at \*8.

“Ponzi,” Wright pursued investors from whom he collected capital contributions. Funds from the next tier of investors were used to pay the earlier investors more than the value of their equity investments, including nonexistent principal and imaginary profits, to “perpetuate the illusion” that the IMA hedge funds were producing profits.<sup>244</sup> The gain margin served two purposes: (1) preventing the existing investors from seeking a return of their principal equity investments and (2) inducing prospective and existing investors to make new equity investments.

Wright’s investors were quickly herded into a bubble, and Wright himself moved into the big leagues. Among others, he targeted retired National Football League (“NFL”) players as investors.<sup>245</sup> In fact, the NFL and its affiliate the NFL Players Association placed Wright on a list of approved financial advisors for players.<sup>246</sup> Eventually the “too good to be true” investment vehicle collapsed. The SEC exposed the charade, and, in early 2006, a federal receiver took control of the companies.<sup>247</sup> In March 2006, the receiver filed the Chapter 11 bankruptcy for the IMA companies and was appointed the Chapter 11 trustee.<sup>248</sup> Two years later, a federal jury convicted Wright of fraud and money laundering.<sup>249</sup> Three days after the conviction, he committed suicide in jail.<sup>250</sup> But the case did not end there. A trail of lawsuits, beleaguered victims, and empty company coffers remained.

With the fraud in excess of \$150 million and a large pot to feed, the bankruptcy trustee sued certain “Investor Defendants” who received transfers from IMA during the operation of the Ponzi scheme.<sup>251</sup> The bankruptcy court consolidated the 108 adversary proceedings.<sup>252</sup> The consolidation effort was for one purpose: to answer the question of “whether an Investor Defendant, as a holder of an equity interest (as opposed to a claim based on a debt) in a Debtor, can establish that the Investor Defendant tendered ‘value’ to the

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<sup>244</sup> *Id.*

<sup>245</sup> See *Atwater v. Nat’l Football League Players Ass’n*, No. 1:06-CV-1510-JEC, 2009 WL 3254925, at \*2, 189 L.R.R.M. (BNA) 2812 (N.D. Ga. March 27, 2009), *aff’d*, 626 F.3d 1170 (11th Cir. 2010) (discussing the former NFL players’ suit against the association for negligently performing background checks on Wright and other financial advisors).

<sup>246</sup> *Id.* at \*1–2.

<sup>247</sup> *In re IMA*, 2009 WL 6506657, at \*5.

<sup>248</sup> *Id.*

<sup>249</sup> DOJ Press Release, <http://www.justice.gov/usao/gan/press/2008/05-21-08.pdf>

<sup>250</sup> See Dorie Turner, *Man Convicted of Hedge Fund Fraud Commits Suicide in Jail*, USATODAY.COM (May 25, 2008, 6:19 PM), available at [http://www.usatoday.com/money/economy/2008-05-25-1668624117\\_x.htm](http://www.usatoday.com/money/economy/2008-05-25-1668624117_x.htm).

<sup>251</sup> *In re IMA*, 2009 WL 6506657, at \*5.

<sup>252</sup> *Id.* at \*5 n.1.

transferor-Debtor in exchange for the cash transfer that the Investor Defendant received from the Debtor.”<sup>253</sup>

To limit its focus to the pure question of law, the court assumed that that trustee had established his *prima facie* avoidance case under federal and state law fraudulent transfer statutes.<sup>254</sup> For a trustee to avoid a transfer under section 548(a)(1)(B) as constructively fraudulent, the trustee must show that the “debtor voluntarily or involuntarily . . . received less than a reasonably equivalent value in exchange for the transfer.”<sup>255</sup> Under section 548(a)(1)(A) (i.e., actual fraud), the reasonably equivalent value issue is inapposite because the transfer is actually fraudulent.<sup>256</sup> The transferee, however, is entitled to keep the transfer if she can prove that she acted in “good faith” and that she provided the transferor “value” in exchange for the transfer.<sup>257</sup>

By the language of section 548(c), the average fraudulent transfer defendant can establish an affirmative defense to a trustee’s avoidance action by showing that it provided “value” in exchange for any transfer made for the Debtor’s interest. The “value” inquiry exists independently of the question of “good faith.”<sup>258</sup> In Ponzi schemes, however, Investor Defendants are not your average ilk. The transfer is made on account of the Investor Defendant’s equity interest, an interest that arguably never had any value to begin with. Consequently, the availability of the section 548(c) defense is in doubt in Ponzi schemes because any cognizable value disappears to the inescapable bottom of a black hole. The bankruptcy court in *IMA* was right to question whether an exchange for value in equity interests is even possible in a Ponzi scheme.<sup>259</sup>

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<sup>253</sup> *In re Int. Mgmt. Assocs. LLC*, No. A06-62966-PWB, 2009 WL 6498191, at \*2 (Bankr. N.D. Ga. Dec. 1, 2009).

<sup>254</sup> The relevant facts included: (a) that the Investor Defendant tendered an essentially worthless equity interest to the Debtor in exchange for the transfer; and (b) that the Investor Defendant held an unasserted claim against the Debtor that arose at the time the Investor Defendant originally invested as an equity holder in the Debtor. *In re IMA*, 2009 WL 6506657, at \*8–\*9.

<sup>255</sup> 11 U.S.C. § 548(a)(1)(B)(i) (2006).

<sup>256</sup> 11 U.S.C. § 548(a)(1)(A).

<sup>257</sup> 11 U.S.C. § 548(c).

<sup>258</sup> See *In re IMA*, 2009 WL 6506657, at \*8 (stating that an adverse ruling on trustee’s motion for partial summary judgment, seeking a ruling “that, as a matter of law, an investor who made an equity investment in the debtors and received payments did not receive the payments ‘for value,’” did not “fully negate the Trustee’s ability to defeat the [section 548(c)] defense, because the defense also requires that the transfer be in ‘good faith’”).

<sup>259</sup> See *id.* at \*9 (acknowledging the trustee’s argument that the general rule “that the victim of a Ponzi scheme has a claim for the return of the principal it invested based on fraud and that payments up to the amount of the invested principal are made in exchange for ‘value’” does not apply in situations where the “victim’s investment takes the form of an equity investment,” but concluding “that interpretation of the fraudulent transfer laws has made no

In *IMA*, the court adopted the well-established money in/money out principal that a “defrauded Ponzi scheme investor has a claim for the return of its principal investment based on fraud and that the satisfaction of this fraud claim through transfers, at least up to the amount of principal, constitutes ‘value’ for purposes of the defense to a fraudulent transfer claim under section 548(c) and equivalent state laws.”<sup>260</sup> But the trustee sought an exception to the general rule when the victim’s principal investment is in the form of equity. The trustee argued that in a Ponzi scheme, a transfer on account of an equity interest cannot be an exchange for value: the distinction between *IMA* and the “run of the mill” Ponzi being the equity nature of the fraudulent investments that the Debtors offered in their capital contribution structure.<sup>261</sup>

The trustee’s argument has some attractive features, especially its promotion of the equality of distribution. Ponzi victims would be placed in a one-size-fits-all box without regard to the strategic positioning of who got out and when. The bankruptcy court found the trustee’s foothold persuasive but not authoritative. Ultimately, the court had to decide between equal application (principal Ponzi payments constitute value) and equal distribution (Ponzi equity, participation, and debt receive identical treatment) under the law.<sup>262</sup> The court held that the former rule prevailed, and that the debtors received “value” to the extent of the invested principal.<sup>263</sup> Despite its conclusion, the court made an effort to point out that the rule should be equal distribution regardless of whether the investments took the form of debt or equity.<sup>264</sup> The court found no authority, however, to support that proposition. In fact, only one United States Court of Appeals had ever discussed the question, and the bankruptcy court in *IMA* followed its lead.<sup>265</sup>

Despite being hamstrung by law and practice, the bankruptcy court recognized the importance of the issue, and certified the question for direct appeal to the Eleventh Circuit.<sup>266</sup> The bankruptcy court noted

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distinction based on the form of the investment”).

<sup>260</sup> *Id.* at \*10.

<sup>261</sup> *Id.* at \*9.

<sup>262</sup> “[T]he Court concludes that no principled basis exists for a different result depending on the technical form of the fraudulent investment” *Id.* at \*10.

<sup>263</sup> *Id.*

<sup>264</sup> *Id.* at \*9.

<sup>265</sup> See *Barclay v. Mackenzic (In re AFI Holding, Inc.)*, 525 F.3d 700, 706–707 (9th Cir. 2008) (discussing “reasonably equivalent value”).

<sup>266</sup> *In re Int. Mgmt. Assocs.*, No. A06–62966–PWB, 2009 WL 6498191, at \*1 (Bankr. N.D. Ga. Dec. 1, 2009).

that the glut of Ponzi schemes in the United States merits a closer look at the question.<sup>267</sup> The court indicated that numerous judges, trustees, receivers, and parties need guidance and a definitive rule.<sup>268</sup> The bankruptcy court expressly pointed out that current case law leaves only a default rule to apply: that “investors who held equity interests in the fraudulent scheme from the outset could assert the ‘value’ defense.”<sup>269</sup> In other words, the bankruptcy court thought it necessary that a court of appeals establish the rules of play for the equity interests in Ponzi schemes.<sup>270</sup> Whether the equity holders constitute a special team, the *IMA* court believed that every investor should get equal play time and distributions.

In *IMA*, the parties fundamentally disagreed about whether equity interest should be analyzed differently than debt-based claims.<sup>271</sup> The Eleventh Circuit affirmed the bankruptcy court’s ruling.<sup>272</sup> Reiterating adherence to the substance over form rule, the appeals court held that an equity interest did constitute value.<sup>273</sup> The appeals court also agreed that purchasing an equity interest from a Ponzi scheme established a claim for fraud or restitution, the debtor’s subsequent withdrawals amounted to a release of those claims, and were therefore “for value.”<sup>274</sup> Not surprisingly, given the specificity of the issue, the court did not opine upon whether section 548(c) should be unavailable to the universe of Ponzi scheme investment clawbacks, irrespective of equity status. Given the expanding universe of Ponzi schemes and defrauded investors, the “value” component is as much a recurring issue as good faith.<sup>275</sup> Current practice applies fraudulent transfer law uniformly in an effort to reallocate losses among all Ponzi victims. As the *IMA* opinion pointed out, substance governs over the transaction’s form so that Ponzi victims can retain payment of and submit claims for funds up to the amount of the principal.<sup>276</sup>

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<sup>267</sup> *Id.* at \*3.

<sup>268</sup> *Id.*

<sup>269</sup> *Id.*

<sup>270</sup> *Id.*

<sup>271</sup> *In re Int. Mgmt. Assocs. LLC*, No. A06-62966-PWB, 2009 WL 6506657, \*9-10 (Bankr. N.D. Ga. Dec. 1, 2009), *aff’d*, No. 10-10683, 2011 WL 5103951 (Oct. 27, 2011).

<sup>272</sup> *Perkins v. Haines*, No. 10-10683, 2011 WL 5103951, at \*4 (11th Cir. Oct. 27, 2011).

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> See, e.g., Karen E. Nelson, Note, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1480-89 (2011) (arguing that courts should expand the definition of value to account for both the time value and opportunity costs of withdrawals in order to arrive at a more equitable solution for winning investors).

<sup>276</sup> *In re IMA*, 2009 WL 6506657, at \*10; see *Pepper v. Litton* 308 U.S. 295, 305 (1939) (noting that bankruptcy courts “have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial



Notions of equity and fairness may, counter-intuitively, dictate disparate treatment for equity investments. But an equally compelling argument is that investors should not be penalized for the manner in which a Ponzi fraudster perpetrated the scheme.

Either way, the general rule—that the repayment of principal constitutes value in exchange for the transfer irrespective of whether the investment was debt or equity—may be running into overtime. Judicial discontent from *Bayou* to *IMA* has generated some congressional conversations about rulemaking in Ponzi cases. But given the number of jurisdictions and the growth in the Ponzi scheme largesse, there is a “potential for inconsistent results, delayed adjudication, and skyrocketing costs.”<sup>277</sup>

#### IV. DIMINISHING RETURNS OF GOOD FAITH

The demolition of the good faith defense for investors in cash-in, cash-out Ponzi schemes (where “debts were incurred as part of an extraordinary and unlawful enterprise and payments came from other people’s money”)<sup>278</sup> leaves a sour taste in the mouth. Yet, to effect a primary purpose of the Bankruptcy Code (i.e., equality of the distribution), it is a necessary evil. And it would ensure that all creditors—not just the most friendly, necessary, lucky and/or aggressive creditors—recover at least part of their claims.

The key question is often, in the case of innocent investor-victims: were the investors expecting a commercially reasonable rate of return, for “equivalent value and good faith,” or were they relying on promises that were, in essence, “too good to be true”?<sup>279</sup> In *In re Carrozzella & Richardson*, the Court found that guaranteed fifteen percent interest payments were reasonable and treated the payments as favorably as any other trade creditor, like the utility company.<sup>280</sup> On the other hand, another court found returns of twelve to twenty-four percent to be an unreasonable rate of return in the context of a Ponzi scheme.<sup>281</sup> This split between the courts further perpetuates inconsistency and unpredictability. For some, section 548(c) provides

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justice from being done”).

<sup>277</sup> Tally M. Weiner, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 236 (2009) (discussing clawbacks, preferences, and fraudulent transfers in the Madoff Ponzi scheme).

<sup>278</sup> *Id.* at 224.

<sup>279</sup> *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 491 (D. Conn. 2002).

<sup>280</sup> *Id.* at 483–84, 484 n.7, 490–91.

<sup>281</sup> See *In re Taubman*, 160 B.R. 964, 972, 985–86 (Bankr. S.D. Ohio 1993) (finding that the investors did not give reasonably equivalent value).

a total shield from a clawback action, but for others the defense is more of a brass ring hanging just out of reach.

In other cases, courts assign different levels of fiduciary responsibility depending on the role the investor plays in the overall scheme.<sup>282</sup> Sometimes, courts view innocent investors as partially responsible for perpetuating a Ponzi fraud, justifying their susceptibility to a clawback.<sup>283</sup> Courts raise the bar of responsibility even higher for brokers that feed hungry investors into Ponzi schemes. While many brokers are unknowing co-conspirators, they do earn commissions for placing customers with the fraudulent funds. The commissions they receive from Ponzi funds are prone to avoidance actions, and some courts reject a good faith defense as applied to their role of steering investors to Ponzi funds.<sup>284</sup> In *World Vision*, not only did the court reject the brokers' good faith defense, but it also deemed their actions of soliciting new investors, which perpetuated the illegal Ponzi scheme, to be fraudulent.<sup>285</sup>

As *IMA*, *World Vision*, *Bayou III*, and *Bayou IV* demonstrate, the applicability and even definition of good faith is in flux. Additionally, the iterations of good faith from these cases fail to address the reality that early investors benefit from the misfortunes of subsequent investors. Holding fast to the antediluvian concepts of good faith effectively slaps a tiny Band-Aid on a gaping wound. The status quo contributes to drawn-out litigation over the standards, customs, practices, sophistication, and experience generally possessed by the individual investors—and that is just to establish inquiry notice. Once the investor is on inquiry notice, there is still another layer of litigation remaining that considers whether a “diligent investigation” would have discovered the fraudulent purpose of the transfer. The *Bayou* good faith litigation boiled down to a question over the investors' knowledge or suspicions about “some potential infirmity” that would trigger an investigation into their investment.<sup>286</sup> But questioning what a “reasonably prudent institutional hedge fund

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<sup>282</sup> See, e.g., *In re Int. Mgmt. Assocs. LLC*, No. A06-62966-PWB, 2009 WL 6498191, at \*3-4 (Bankr. N.D. Ga. Dec. 1, 2009) (discussing the potential different levels of responsibility of debt and equity investors).

<sup>283</sup> E.g., *In re Carrozzella & Richardson*, 286 B.R. at 488 (“Further, by helping the debtor perpetuate his illegal scheme, the transfers between the debtor and investors only exacerbated the harm to the debtor's creditors by increasing the amount of claims, while diminishing the debtor's estate.”).

<sup>284</sup> See *Cuthill v. Greenmark, LLC (In re World Vision Entm't, Inc.)*, 275 B.R. 641, 658-61 (Bankr. M.D. Fla. 2002) (rejecting such a defense).

<sup>285</sup> *Id.* at 657.

<sup>286</sup> *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 848 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

investor” would do diminishes an already starved estate. In contrast, eliminating the good faith defense focuses on the real problem of maximizing those assets for the benefit of all investors. The Madoff case typifies how the bacteria of good faith can infect even the fundamental chore of calculating loss.

*A. Picking the Carcass: Madoff Math*

As explained above, Ponzi scheme investors fall into two categories: “net winners” and “net losers.” Net winners received payments from the Ponzi scheme greater than they originally invested. On the other hand, net losers withdrew less than the original investment.<sup>287</sup> Ponzi investors largely fall into the latter category, and often come closer to financial devastation when the scheme unravels.<sup>288</sup> Compounding the misery felt after investors realize their retirement, income, and investments are worthless, the trustee sends the dreaded clawback letter that demands a turnover of any and all money withdrawn from the scheme in the past two (and sometimes as high as six) years or face legal action.<sup>289</sup>

In the Madoff case, the trustee, Irving H. Picard, stated that the letters were not intended to affect “net losers,” those who lost and only received part, if any, of their principal investment back from the perpetrator(s) of the Ponzi fraud.<sup>290</sup> Nonetheless, the demand letters insisted on the return of 100 percent of the funds withdrawn from Madoff accounts—principals and profits—within the maximum allowed statutory period of six years.<sup>291</sup> Picard’s demand included charitable institutions and was not, in that regard, unprecedented.<sup>292</sup>

The Madoff trustee and some investors, like those in *Bayou II*, championed the “net equity” method and demanded that the “net winners” return their “profits” to insure a more equitable distribution

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<sup>287</sup>See McDermott, *supra* note 1, at 164–69 (discussing the reasonably equivalent value test for constructive fraud).

<sup>288</sup>*Id.*

<sup>289</sup>See, e.g., Christopher Scinta et al., *Madoff Trustee Demands Investors Return \$735 Million*, BLOOMBERG (Apr. 23, 2009, 5:47 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apnVhVcUN7O8>.

Under 11 U.S.C. § 544, the trustee may bootstrap state fraudulent transfer law onto a section 548 claim. Doing so expands the look back window to the time period provided by state law. In the Madoff case, New York law provided that transactions up to six years prior to a bankruptcy could be avoided. *Id.* Thus, the possible defendants increased exponentially with the expanded window of opportunity.

<sup>290</sup>*Id.*

<sup>291</sup>*Id.*

<sup>292</sup>See *Scholes v. Lehmann*, 56 F.3d 750, 759–61 (7th Cir. 1995) (describing a similar attempt to clawback funds from charitable institutions).

of funds.<sup>293</sup> Under net equity, a court determines the investors' losses based on their actual losses in investing with Madoff.<sup>294</sup> The opponents of this method, on the other hand, wanted a "last statement balance" method to determine losses. Under this method, even the "net winners" would have a claim for loss against the Ponzi debtor based on the balances reflected on their last statements before Madoff's scheme collapsed.

The bankruptcy court settled the debate over the scope of Madoff investors' liability to the Securities Investors Protection Corporation ("SIPC").<sup>295</sup> The ruling granted Picard's request to apply the "net equity" method.<sup>296</sup> As mentioned previously, Madoff's investment house was liquidated under SIPA, and the decision precluded retention of withdrawals for many of the Madoff investors.<sup>297</sup> Investors' claims against the Madoff Ponzi scheme equaled the difference between the cash paid into a "Madoff-Ponzi" account and the amount withdrawn prior to the collapse of the scheme.<sup>298</sup> In other words, the "net equity" calculation prevailed. Under this calculation, early investors, the so-called "net winners," will be both subject to avoidance of their profits and ineligible for publically-funded SIPC investment insurance payments of up to half a million dollars.<sup>299</sup> The ruling reflects judges' general historical unwillingness to base losses on the fantasy worlds concocted by Madoff and his predecessors. Or, as Judge Lifland eloquently stated: "It would be simply absurd to credit the fraud and legitimize the phantom world created by Madoff. . . ."<sup>300</sup>

To a large extent, under both SIPA and bankruptcy law, the debtor's assets—in the form of cash and securities—get lumped together and distributed pro rata among the investors, based on the

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<sup>293</sup> Secs. Investor Prot. Corp. v. Bernard L. Madoff Inv. Secs., LLC (*In re Bernard L. Madoff Inv. Secs. LLC*), 424 B.R. 122, 125 (Bankr. S.D.N.Y. 2010). The Trustee defines Net Equity as the amount of cash deposited by the customer into his BLMIS customer account less any amounts already withdrawn by him (the "Net Investment Method"). *Id.*

<sup>294</sup> *Id.*

<sup>295</sup> *Id.* "The Securities Investor Protection Corporation either acts as trustee or works with an independent court-appointed trustee in a missing asset case to recover funds. The statute that created SIPC provides that customers of a failed brokerage firm receive all non-negotiable securities that are already registered in their names or in the process of being registered." *Who Are We*, SECS. INVESTOR PROT. CORP., <http://www.sipc.org/who/who.cfm> (last visited Sept. 4, 2011).

<sup>296</sup> *Bernard L. Madoff Inv. Secs.*, 424 B.R. at 125.

<sup>297</sup> 15 U.S.C. §§ 78aaa *et seq.* (2006).

<sup>298</sup> Diana B. Henriques, *Madoff Judge Endorses Trustee's Rule on Losses*, N.Y. TIMES, Mar. 2, 2010, at B1.

<sup>299</sup> *Id.*

<sup>300</sup> *Bernard L. Madoff Inv. Secs.*, 424 B.R. at 140.

theory of “net equity.”<sup>301</sup> Section 7811(11) of SIPA defines “net equity” to be:

[T]he dollar amount of the account or accounts of a customer,<sup>302</sup> to be determined by—

(A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all *securities positions* of such customer (other than customer name securities reclaimed by such customer); minus

(B) any indebtedness of such customer to the debtor on the filing date; plus

(C) any payment by such customer of such indebtedness to the debtor which is made with the approval of the trustee and within such period as the trustee may determine. . . .<sup>303</sup>

If the assets fail to satisfy the investors’ claims in full, then the investors may be entitled to an advance from the SIPC up to \$500,000 for securities claims and \$100,000 for cash claims.<sup>304</sup>

The Madoff case—a mess from the beginning—boiled over when the trustee calculated that the amount of each Madoff investor’s net equity equaled the amount of cash deposited by the investor into its BLMIS account, without interest, less any cash withdrawals (the “Net Investment Method”).<sup>305</sup> As a result of this approach, any Madoff victims who withdrew more cash than deposited (i.e., the “net winners”) could not receive an SIPC advance, regardless of whether the investor relied upon the phony BLMIS account statements in good faith.<sup>306</sup>

Understandably, investors decried what they believed to be just one more level of victimization perpetrated by the Madoff scam. As opposed to the Net Investment Method, a large portion of the investors, especially the early ones, argued that the investors’ expectations, which were based on their most recent BLMIS account

<sup>301</sup> 15 U.S.C. § 7811(11).

<sup>302</sup> SIPA and cases like *Madoff* use the term “customer.” For purposes of this Article, the term “investor” will be used generally to include “customer.”

<sup>303</sup> 15 U.S.C. § 7811(11) (emphasis added).

<sup>304</sup> *Bernard L. Madoff Inv. Secs.*, 424 B.R. at 137–38.

<sup>305</sup> *Id.* at 124.

<sup>306</sup> *Id.* at 132.

statement, should control the determination of net equity (“Last Statement Method”).<sup>307</sup> The bankruptcy court sided with the trustee on the Net Investment Method.<sup>308</sup> The bankruptcy court focused on the term “securities positions” in the definition of “net equity” under SIPA, and held that an investor’s position could only be determined by examining the debtor’s books and records to verify the actual securities positions held.<sup>309</sup> BLMIS’s records exposed the hard truth that Madoff never purchased any securities. And the only verifiable amounts in an investor’s account constituted hard cash in and hard cash out.<sup>310</sup>

In its decision, the bankruptcy court used two Second Circuit opinions from *In re New Times Securities Services, Inc.* litigation to support the Madoff math.<sup>311</sup> *New Times* had some parallel facts—including a broker who managed to purchase not a single investment for any of the scheme’s customers.<sup>312</sup> Likewise, the *New Times* opinions rejected investors’ “expectations” as the proper measurement of securities positions.<sup>313</sup> Unlike *Madoff*, however, the *New Times* trustee differentiated between investors whose accounts demonstrated actual securities that had never been purchased, and consequently applied the Last Statement Method to those investors.<sup>314</sup> *Madoff*, however, held that the imaginary trading prices of “real” securities propounded by Madoff matched his fabrication of wholly nonexistent securities. In other words, the bankruptcy court in *Madoff* departed from the *New Times* method of attributing some “legitimate expectations” to the loss and instead spread the loss more evenly by equivocating false trading prices to false investments.<sup>315</sup>

That result makes sense. Because Madoff used fictional prices and investments, the entire scheme reeked of fraud. Investors’ net equity could not be apportioned under the *New Times* method.<sup>316</sup> Had the bankruptcy court followed the “Last Statement” approach, then the net winners could have received a recovery windfall at the expense of the net losers.<sup>317</sup> Moreover, the definition of “net equity” in SIPA

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<sup>307</sup> *Id.* at 135.

<sup>308</sup> *Id.* at 141.

<sup>309</sup> *Id.* at 135.

<sup>310</sup> *Id.*

<sup>311</sup> *Stafford v. Giddens (In re New Times Secs. Servs., Inc.)*, 463 F.3d 125 (2d Cir. 2006); *In re New Times Secs. Servs., Inc.*, 371 F.3d 68 (2d Cir. 2004).

<sup>312</sup> *New Times Secs. Servs.*, 371 F.3d at 71–2.

<sup>313</sup> *See, e.g., id.* at 87–8 (rejecting the district court’s calculation which was based on legitimate expectations).

<sup>314</sup> *See Bernard L. Madoff Inv. Secs.*, 424 B.R. at 139 (discussing the difference).

<sup>315</sup> *Id.* at 140.

<sup>316</sup> *Id.*

<sup>317</sup> *Id.* at 139.

does not include “legitimate expectations.” SIPA in its entirety lacks the phrase “legitimate expectations.”<sup>318</sup> The profits reflected on the final account statements in *Madoff* were “arbitrary[,] . . . divorced from market reality[,] . . . unbounded by the limitations of real-market trading, [and] entirely engineered by a con man.”<sup>319</sup> Legitimate expectations cannot supplant the fantasy world that Madoff created. Nonetheless, Madoff math is something the bankruptcy court left with a question mark, much like the *IMA* decision on “for value.” Recognizing the forthcoming hullabaloo, the bankruptcy court certified a direct appeal to the Second Circuit Court of Appeals.<sup>320</sup> On August 16, 2011, the Second Circuit affirmed the bankruptcy court’s use of the net investment method as the proper calculation of the investors’ net equity.<sup>321</sup>

The math is tricky, but so is the risk. The investors argue that it should not matter whether their loss was the product of fraud or just bad business investment and market upheaval. Some critics have assailed the bankruptcy court for shifting the risk from the SIPC to the Madoff investors.<sup>322</sup> But the other side of the coin is also true: investments bring a certain amount of risk to anyone—from the 401K contributor to the savviest on Wall Street—and risk is apportioned between all the players, whether the SIPC, the market, or the individual investors. With risk comes liability, and investors can be held liable when they receive what is not theirs.<sup>323</sup>

### *B. Supersizing SIPA and Section 548(c)*

Cases like *Bayou*, *IMA*, and *Madoff* have curtailed investors’ abilities to retain their withdrawals. But the voices of the net winners are powerful. And Congress is listening. As the 111th Congress came to a close, New Jersey Representative Scott Garrett, the chairman of

<sup>318</sup> 15 U.S.C. §§ 7811(11), 78fff-2(b).

<sup>319</sup> Brief for Trustee-Appellee Irving H. Picard at 33 *In re Bernard L. Madoff Investment Securities LLC*, 10-2378-bk(L), 2011 WL 3568936 (2d. Cir. Aug. 16, 2011) (No. 10-2378-bk(L)), 2010 WL 3736776, available at [http://www.madoff-help.com/wp-content/uploads/2010/09/picard\\_appeal\\_brief.pdf](http://www.madoff-help.com/wp-content/uploads/2010/09/picard_appeal_brief.pdf).

<sup>320</sup> *Id.* at 3-4.

<sup>321</sup> *In re Bernard L. Madoff Investment Securities LLC*, No. 10-2378-bk(L), 2011 WL 3568936 (2d Cir. Aug. 16, 2011).

<sup>322</sup> Kaja Whitchose, *Madoff Winners Go for ‘Losers’ Pennant*, NEW YORK POST (March 2011), [http://www.nypost.com/p/news/business/court\\_gestures\\_3BMq6Mr9x2BzuGWHfXfwN](http://www.nypost.com/p/news/business/court_gestures_3BMq6Mr9x2BzuGWHfXfwN).

<sup>323</sup> A trustee has authority under SIPA to recover property constituting a fraudulent transfer when there are not sufficient funds to pay in full the claims of investors. 15 U.S.C. § 78fff-2(c)(3); see also *Picard v. Taylor (In re Park South Sec., LLC)*, 326 B.R. 505, 512 (Bankr. S.D.N.Y. 2005) (holding that a SIPA trustee has standing to avoid fraudulent transfers); *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 273-75 (Bankr. S.D.N.Y. 1996) (discussing the SIPA trustee’s role in a brokerage house’s liquidation).

the House Financial Services Capital Markets and Government Sponsored Enterprises subcommittee, introduced House Bill 6531. The legislation would restrict court-appointed trustees' power to initiate clawback suits against the net winners.<sup>324</sup>

The Equitable Treatment of Investors Act, if enacted, would amend the 1970 Securities Investor Protection Act to require that trustees apportion claims of loss according to final account statements, except where the investor knew that the failed broker-dealer was involved in fraud.<sup>325</sup> SIPA currently provides that investors may recover their "net equity," but it does not specify the formula for calculating that amount.<sup>326</sup> The revision's proponents' concern is that Madoff investors are in the position of owing rather than recovering from the bankruptcy estate.

Unfortunately, that concern belies the true import of House Bill 6531, which in practice would place the interests of net winners at the top of the food chain to feed off the net losers. In addition, it would nearly preempt a bankruptcy trustee's ability to clawback fictitious profits from the net winners.<sup>327</sup> By contrast, if a trustee is permitted to recover fictitious profits from the investors, they get pooled into a fund where all investors will receive a share of the monies based upon a pro-rata distribution. A pro-rata distribution is a more equitable scheme than House Bill 6531's proposal. Excluding the good faith defense from Ponzi scheme cases would further streamline difficult Ponzi cases. And it would create a more equitable distribution that aligns investors, the law, and policy rather than producing the favoritism inherent in House Bill 6531.

The absolute removal of the good faith defense works for three reasons. First, a Ponzi scheme has no actual "profits," just money stolen from new participants:

If a person invests money with the understanding that he will share in the profits produced by his investment, and it turns out that there are no profits, it is difficult to see how that person can make a claim to receive any more than the return of his principal investment.<sup>328</sup>

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<sup>324</sup> H.R. Res. 6531, 111th Cong. (2011). This bill was again revived in May 2011 by Congressman Gary Ackerman, a Senior Member of the House Financial Services Committee. *Ackerman Introduces Legislation to Provide Relief for Victims of Bernard Madoff & All Investors Defrauded by Ponzi Schemes*, CONGRESSMAN GARY ACKERMAN (May 31, 2011), <http://ackerman.house.gov/index.cfm?sectionid=253&itemid=1644>.

<sup>325</sup> H.R. Res. 6531.

<sup>326</sup> 15 U.S.C. § 78III(11).

<sup>327</sup> H.R. Res. 6531.

<sup>328</sup> *Lustig v. Weisz & Assocs., Inc. (In re Unified Comm. Capital)*, No. 01-MBK-6004L,



Words cannot produce cash, so the “false representation by the Ponzi schemer that he is paying the investor his share of the profits, which are in fact nothing more than funds invested by other victims, cannot alter the fact that there are no profits to share.”<sup>329</sup>

Second, investors cannot have a legitimate expectation in distributions—or in account statements reflecting “profits”—that act to perpetuate a fraud. Payments of fictitious profits, and account statements showing additional fictitious profits, are used to bait and trap new investors and continue the Ponzi scheme for as long as possible.<sup>330</sup> These “profits” are subsidized by later investors who are left with an empty pot when the scheme collapses.<sup>331</sup> The good faith defense might give credence to investor’s innocent assumption that her profits were real, but it cannot, nor should it, change the fact that her profits were make-believe.

Third, an investor cannot have a legitimate expectation of actual value in excess of the principal investment because such transfers lack reasonably equivalent value. Courts have routinely held that investors have no legitimate claim to the “profits” of a Ponzi scheme where they transferred nothing in exchange for those ill-gotten gains.<sup>332</sup> Ponzi schemes are not like collapsed financial companies, which SIPA and SIPC were designed to manage. Had the investments been genuine, the investors would have actually paid for the securities, which promised a set rate of return. If that company tanks due to fraud or mismanagement, then investors can and have a right to recover securities they had paid for, and would have had in their accounts.<sup>333</sup>

In those cases, the “legitimate expectation” would be supported by the contents of the books and records. In Ponzi schemes, and the *Madoff* case in particular, investors deposit funds insufficient to obtain the fictitious securities listed on their account statements. The funds then used to “purchase” the securities were the fictitious “profits” of earlier bogus transactions. Furthermore, investors could

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2002 WL 32500567, at \*8 (W.D.N.Y. June 21, 2002).

<sup>329</sup> *Id.*

<sup>330</sup> See, e.g., *SEC v. Credit Bancorp, Ltd.*, No. 99 CIV.11395 RWS, 2000 WL 1752979, at \*40 (S.D.N.Y. Nov. 29, 2000) (“[R]ecognizing claims to profits from an illegal financial scheme is contrary to public policy because it serves to legitimate the scheme.”).

<sup>331</sup> *Id.*

<sup>332</sup> See *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995) (Ponzi scheme investor “is entitled to his profit only if the payment of that profit to him, which reduced the net assets of the estate now administered by the receiver, was offset by an equivalent benefit to the estate.”)

<sup>333</sup> For such an example, see *Stafford v. Giddens (In re New Times Sec. Servs., Inc.)*, 463 F.3d 125 (2d Cir. 2006).

not have obtained those returns because the trades themselves ultimately turned out to be manufactured. Consequently, calculating net equity in a Ponzi scheme to reflect the final account statements would effectively credit the fictional proceeds of the fraud.<sup>334</sup> Thus, the confluence of the good faith defense, House Bill 6531, and the impracticable net equity calculation would create a perfect storm where the net losers inevitably live up to their label and suffer to prop up the net winners.<sup>335</sup>

While House Bill 6531 is by no means a free pass for the net winners; it will reduce the settlements and ultimately the recoveries that Ponzi scheme trustees will be able to negotiate in these cases.<sup>336</sup> Avoidance actions are often vehicles of settlement. Since the bankruptcy estate has little money to spare, the expense and time of the additional litigation imposed by the good faith defense and House Bill 6531, if enacted, directly affects the size of the estate that benefits all creditors.<sup>337</sup> The overt expanse of SIPA coupled with the more clandestine advance of the good faith defense may protect the net winners. But it will also further entomb the net losers under the morass of Ponzi litigation. While some net winners are the most innocent of investors, there are also the “feeder funds” that were—by Bernie Madoff’s own self-serving admission—“complicit” in the fraud by turning a blind eye to suspicious returns.<sup>338</sup> Yet these feeder funds have powerful lobbyists and litigators at their disposal.

The proposed revisions to the SIPA fail to adequately or realistically take into account the overall impact that the proposed amendments would have on the SIPC’s trustee’s ability to effectively mitigate the damages left after the storm, or how such new legislation would affect innocent investors that become a part of the Ponzi

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<sup>334</sup> The “winners” in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to “enjoy an advantage over later investors sucked into the Ponzi scheme who were not so lucky.” *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 596 (9th Cir. 1991).

<sup>335</sup> See Dick Carozza, *Balancing Act: An Interview with Irving H. Picard, Madoff Trustee*, FRAUD MAGAZINE, July/August 2010, at 36–41 (discussing the Madoff liquidation’s winners and losers), available at <http://www.fraud-magazine.com/article.aspx?id=4294967939>.

<sup>336</sup> See, e.g., Bob Van Voris, *Madoff Trustee Says he Found \$1.5 B for Fraud Victims*, BLOOMBERG NEWS, April 10, 2010 (discussing the settlements in the Madoff case), available at CHRON BUSINESS, <http://www.chron.com/dispatch/story.mpl/business/6953339.html> (last visited Sept. 17, 2011).

<sup>337</sup> Cf. *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 648 (S.D.N.Y. 2004) (discussing the similar due-diligence defense in securities litigation).

<sup>338</sup> See Diana Henriques, *Madoff Says From Prison That Banks “Had to Know”*, N.Y. TIMES, Feb. 16, 2011, at A1 (reporting Madoff as saying that banks had to know of his scheme based on returns); Karen Freifeld, *Madoff Feeder Fund Adviser Merkin Accused in Lawsuit of Breaching Duty*, BLOOMBERG NEWS (Sept. 17, 2010, 4:54 PM), <http://www.bloomberg.com/news/2010-09-17/czra-merkin-sued-by-fraud-negligence-by-receiver-for-madoff-feeder-funds.html>.

scheme later in the game.<sup>339</sup> The proposed amendments would shift focus to the time at which an investor entered the scheme.<sup>340</sup> The general idea behind the changes praises the impulse of “the earlier the better.” Net winners would be able to realize funds that were withdrawn in excess of their original investment because of the time at which they entered the scheme.<sup>341</sup>

The proposed revisions to the SIPA fail to recognize that the net winners would be rewarded for perpetuating and funding the Ponzi scheme, albeit unknowingly.<sup>342</sup> This notion turns to the question of why the amended SIPC does not employ a strict liability standard.<sup>343</sup> The term “net winner” is inapposite with the term Ponzi scheme. The amendments should allow the trustee to recover any withdrawals made up to two years before the bankruptcy—whether amounting to principle or fictitious profit—for the benefit of all the Ponzi scheme’s victims.<sup>344</sup> The proposed amendments do precisely the opposite. The amendments base priority only on the time that a particular investor entered the scheme,<sup>345</sup> which thwarts a premier policy goal of the Bankruptcy Code: equality of distribution.

Remunerating early investors at the expense of later investors hardly comports with the equitable nature of the Bankruptcy Code. Distinguishing between equally culpable parties on the basis of timing thwarts the very fairness that bankruptcy attempts to achieve. The amount of money and the number of players involved in such schemes makes the utilization of a strict liability regime even more attractive. And it is the most just and efficient way to unweave the tangled web of financial lies that Ponzi schemes create. Without the so-called net winners, there could not be a category of net losers.

If either faction of investors is more culpable, it is the net winners. Their investments funded the scheme; their returns induced the net losers to enter the scheme. But the proposed amendments to the SIPA effectively say that the investors that entered the scheme later, i.e., the net losers, are more gullible and thus should bear the brunt end of the stick.

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<sup>339</sup> See H.R. Res. 6531, 111th Cong. (2010) (proposing revisions to SIPA).

<sup>340</sup> *Id.*

<sup>341</sup> *Id.*

<sup>342</sup> See *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008) (discussing net winners and losers in Ponzi schemes).

<sup>343</sup> But see H.R. Res. 6531, Sec. 2(d), 111th Cong. (2010) (proposing that courts should use the last statement, even if fabricated, to determine investor equity).

<sup>344</sup> Cf. *Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215, 221 (1941) (holding that a creditor of bankrupt’s corporation was entitled only to *pari passu* participation with bankrupt’s individual creditors).

<sup>345</sup> H.R. Res. 6531, 111th Cong. (2010).

Professor Coffee at Columbia University, illustrating the pitfalls of the possible SIPA amendments, argued before the House Financial Services Committee that Congress should not, as House Bill 6531's predecessor would, "subordinate the interests of net losers to those of net winners" or "limit[] the powers of the SIPC trustee to sue the net winners in a Ponzi scheme."<sup>346</sup> A Ponzi scheme's fraudulent nature blurs the role that net winners play in perpetuating the fraud. Despite that role, House Bill 6531 would ultimately guarantee advantageous gains for the net winners.<sup>347</sup>

Professor Coffee also points out—rightly so—that amending SIPA only deals with cases pursued under that statute. In actuality, SIPA cannot be applied "to the vast majority of Ponzi schemes, which are typically carried out by persons other than brokers and dealers, because SIPA only applies to the insolvency of a brokerage firm."<sup>348</sup> An illustration demonstrates this:

[I]f a traditional con man takes money from investors, telling them that he is investing in real estate, diamonds, currency transactions or whatever, the trustee in this proceeding will be able to bring avoidance actions against the Net Winners on behalf of the Net Losers, because this trustee is not governed by SIPA.<sup>349</sup>

Amending SIPA would limit the trustee's ability to make the victims whole, or as close to whole as possible given the circumstances. And it would provide no incentive for investors to exercise due diligence when making investment decisions of the sort seen in recent Ponzi schemes.

The most effective way to ensure that the innocent victims of Ponzi schemes are made as close to whole as possible would be to implement a strict liability framework. The proposed amendments, as they currently stand, allow arguably the most culpable investors, the net winners, to become mega-winners by allowing them to take more than their initial investments. Any excess recoveries obtained by the SIPA trustee should be distributed on a pro-rata basis, not based on the time that investors entered the scheme. Removing the good faith

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<sup>346</sup> *Assessing the Limitations of the Securities Investor Protection Act: Hearing Before the Subcomm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 111th Cong. 12–13 (2010) (testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University), available at <http://financialservices.house.gov/Media/file/hearings/111/Coffec092310.pdf>.

<sup>347</sup> See *id.* at 64–77 (written testimony of Professor Coffee) (discussing H.R. 5032, H.R. 6531's predecessor and arguing against its adoption).

<sup>348</sup> *Id.* at 68.

<sup>349</sup> *Id.*

defense from the equation not only puts net winners and net losers on a level playing field, but also reduces the disproportionate treatment that results from the caste-like system of classifying investors as winners and losers.

### *C. Criminal Competition*

Recovery by a trustee presupposes two things: (a) that the Ponzi schemer has not transferred, hid, sold, or given away assets never to be found; and (b) that the federal government did not get the first bite at the apple. By the time Scott Rothstein was charged with racketeering, money laundering, and fraud stemming from his cleverly orchestrated cash-on-settlement Ponzi scheme, his white Lamborghini, 304 pieces of jewelry, eighty-seven-foot yacht and other assets were already in the hands of the federal government.<sup>350</sup> While bankruptcy is a powerful tool for finding and allocating assets, it is not the only tool.<sup>351</sup> Increasingly, civil and criminal forfeiture have entered the formerly exclusive sphere of bankruptcy, taking and dispersing assets without the strict statutory rules of priority, preference, and fraudulent transfer that make bankruptcy, at its best, an organized and predictable process.

Creditors of Scott Rothstein found themselves floundering when the Federal government stepped in and seized all of Rothstein's assets before an involuntary bankruptcy proceeding could get underway.<sup>352</sup> Rothstein, a prominent Ponzi schemer who sold fictitious settlement annuities in exchange for lump sums, built a \$1.2 billion empire, only to watch it crumble as the bubble burst and investors worldwide came to their senses. Investors and creditors who had hoped for some slight return of their principle, even at pennies on the dollar, were disappointed when federal prosecutors swooped in to grab the pot.<sup>353</sup>

Naturally, this is troubling. Forfeiture laws were initially created as a way of dealing with large racketeering organizations, such as drug cartels. By attacking assets directly, prosecutors could weaken organizations broadly, easing the process of going after individuals and leaders within those organizations.<sup>354</sup> Forfeiture of this nature is tailor-made for crimes with no clear victims. By contrast, Ponzi schemes leave a clear and well-defined trail of victims, and seizing

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<sup>350</sup> Jacqueline Palank, *Prosecutors, Trustees Fight for Dominance In Ponzi Bankruptcies*, WALL ST. J. (Jan. 3, 2011), <http://online.wsj.com/article/SB10001424052748704111504576059613947208394.html>.

<sup>351</sup> See 21 U.S.C. § 853 (2006) (providing for forfeiture of criminal property).

<sup>352</sup> Palank, *supra* note 353.

<sup>353</sup> *Id.*

<sup>354</sup> *Id.*

assets for distribution at the government's whim makes no more sense than keeping a stolen car from its rightful owner because it is now tainted as the "proceeds of a crime."<sup>355</sup> Naturally, a lot of the money forfeited is returned to creditors and investors, but there are no guarantees to ensure that this happens. And creditors have few avenues for complaint if the money is not returned.

This has led to some bitterness between federal prosecutors and bankruptcy trustees, both of whom are fulfilling public duties with conflicting mandates. Judges have proven unpredictable on the issue of just where the assets should remain, resulting in what looks like a zero sum game between trustees and prosecutors in many cases.<sup>356</sup> Prosecutors cite the expense of bankruptcy proceedings as a reason to deal with stolen assets directly, while bankruptcy trustees argue that what that expense buys is a fair process shaped by decades of case law and judicial experience.<sup>357</sup> Even when compromises are reached, there is no shortage of bitterness.

A resolution must be reached to allow bankruptcy courts to function properly in large-scale fraud cases.<sup>358</sup> Without the assurance of a clearly defined set of preference rules, investors may rush to grab their money before the government can get a hold of it. Interested parties are bound to incur additional and unnecessary administrative costs due to the lack of clear boundaries and jurisdictional rules between prosecutors and bankruptcy courts. These costs will only further the need for more forfeiture money to keep the wheels greased. Until then, too many cooks spoil the soup.

#### *D. Clawback Chaos: Striking a Balance Between Cause and Effect*

Victims of Ponzi schemes, whether blue-collar workers, doctors, lawyers, financiers or captains of industry, all make the same mistake. They make a leap of faith for a friend or a confident salesman who seems to have all the answers, and they pay dearly. Generally, people have a certain amount of sympathy; we all make decisions sometimes without doing the necessary research, or act on a hunch, or even make a loan to a friend without the possibility of repayment. The

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<sup>355</sup> See Michael S. Linscott, *Asset Forfeiture (Modern Anti-Drug Weapon): Is Bankruptcy a "Defense"?*, 25 TULSA L.J. 617, 619 (1990) (discussing the origin and use of criminal forfeiture statutes).

<sup>356</sup> See *id.* at 623–35 (outlining the zero sum nature of the proceedings between trustees and prosecutors).

<sup>357</sup> See generally Myron M. Sheinfeld, Teresa L. Maines, & Mark W. Wege, *Civil Forfeiture and Bankruptcy: The Conflicting Interests of the Debtor, Its Creditors and the Government*, 69 AM. BANKR. L.J. 87 (1995) (highlighting the differences of opinion).

<sup>358</sup> See, e.g., *id.* at 88 (urging bankruptcy courts to exercise their jurisdiction over forfeited property).

Bankruptcy Code reflects this sympathy in section 548(c). Because good faith *should* be an objective inquiry, its applicability should not depend upon the status of the transferee. But the cases demonstrate the opposite effect. Courts often allow a creditor to keep a transfer that might normally be avoidable if he withdrew his money in good faith.

### *1. Ponzi Policy*

At bottom, the good faith defense is intuitively equitable: Parties who do not know why they are withdrawing are not punished. Further, the good faith defense might encourage investors to report a Ponzi scheme immediately, not simply make a run for the money. But, on the other hand, the good faith defense might encourage investors to withdraw their investments and attempt to create the appearance of good faith.

The good faith defense is already quite weak. First, it consumes court resources. Second, it is not well defined in Ponzi cases—somewhat counter intuitively given the label of objectivity.

In the Bankruptcy Code, sections 547 and 548 demonstrate the conflicting results based upon the same set of facts. Preferences are avoided if transferred to third parties in the ninety days before bankruptcy. Fraudulent transfers have a two-year reach-back period. Why is it that under section 547, the Ponzi scheme investor largely has, by virtue of case law, no defense to an avoidance action? On the other hand, section 548 provides a good faith defense to the same types of transactions—the only difference being *when* the transfer took place. While the Code embodies a good faith defense regardless of circumstance, it does not define good faith in terms of knowledge and does not expressly exclude nor include the consideration of negligence. In Ponzi schemes the need for a good faith standard fails to reach the paramount significance it attains in non-Ponzi cases.<sup>359</sup>

Federal and state fraudulent conveyance statutes implement a policy of preventing the diminution of a debtor's estate.<sup>360</sup> In an effort to force the “square peg facts of a ‘Ponzi’ scheme into the round holes of the fraudulent conveyance statutes,”<sup>361</sup> the law is subpar. The case law regarding the applicability of the good faith defense in Ponzi

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<sup>359</sup> See *Gill v. Winn (In re Perma Pac. Props., Inc.)*, 983 F.2d 964, 968 (10th Cir. 1992) (finding “no impediment to allowing the bankruptcy court to look at the nature of the transaction and the relationship among the parties”).

<sup>360</sup> *Lustig v. Weisz & Assocs., Inc. (In re Unified Commercial Capital, Inc.)*, 260 B.R. 343, 352 (Bankr. W.D.N.Y. 2001).

<sup>361</sup> *Id.* at 350.

schemes is inconsistent. Courts are unpredictable and decisions are vulnerable to reversal.

Congress should specify that a transfer of funds for a period of time prior to bankruptcy, preferably one year instead of the two provided by the statute, cannot be considered value or to be made in good faith when the bankrupt entity was engaged in a pure Ponzi scheme. That would be far more tenable than the current system; under which courts are accused of ignoring “what is clearly value and fair consideration under the applicable fraudulent conveyance statutes.”<sup>362</sup> Eliminating the good faith defense would level the imbalance between net winners and net losers in Ponzi schemes. It would also correct the myopic situation that sometimes results in investors recouping “profits” ahead of those who have yet to recover principal.<sup>363</sup>

Ponzi schemes are different from the garden variety fraudulent transfer case. The good faith defense is an accepted fundamental commercial principal that when one loans money to an entity for a period of time in good faith, that person has given value and is entitled to a reasonable return.<sup>364</sup> Furthermore, the Bankruptcy Code must be mindful not to step on the toes of the state-law equivalents of section 548, largely based on either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act.<sup>365</sup> It must also stay within the bounds of the two-year look-back window or—if more palatable—be limited to one year prior to the filing of a bankruptcy.<sup>366</sup>

Investors accept a series of risks when they deposit substantial sums into a Ponzi scheme (or the feeder funds that push them there). They understand that their principal might be lost, partially or completely, and that recovery of their contractual interest may be

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<sup>362</sup> *Id.*

<sup>363</sup> *See, e.g.,* Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 856–62 (D. Utah 1987) (addressing such a situation). Numerous injustices flow from courts’ allowing net-winning investors to retain fictitious profits. For example, it (1) diminishes the debtor’s estate, so that there is less available for other innocent investors; (2) does not come from profits or even independent cash flow generated by the debtor, but is paid from the funds of other innocent investors; (3) unjustly enriches that innocent investor victim at the expense of other innocent investors who did not recover all of their principal; and (4) furthers the fraudulent scheme. *Id.*

<sup>364</sup> *Id.* at 861 (construing 11 U.S.C. § 548(c)).

<sup>365</sup> First Nat’l Bank of Barnesville v. Rafoth (*In re* Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 716–17 (6th Cir. 1992) (analyzing both state statutes and the uniform code provisions); Wyle v. C.H. Rider & Family (*In re* United Energy Corp.), 944 F.2d 589, 593–97 (9th Cir. 1991) (analyzing “the state statutes and the Code provisions contemporaneously”).

<sup>366</sup> Prior to 2006, fraudulent transfer actions were limited to a one-year look back period. *See* 11 U.S.C. § 548 (Comment on Amendments and n.1, 2009 Collier Pamphlet Edition) (stating that the pre-2005 Amendment avoidance period of one year remains applicable with respect to cases filed before April 21, 2006).



impossible. Those risks include the risk that the investment might later turn out to be part of a Ponzi scheme.<sup>367</sup>

To be sure, the notion of eliminating the good faith defense will make many cringe. Some may argue that the same result should then hold true to the scheme's payment of day-to-day operation costs like utility, office supplies, and other expenses. That argument, however, is beyond the scope of this article. Good faith is generally a question of fact, but for Ponzi scheme cases its application should be one of law. Much like a statute of limitations operates on a fraudulent transfer action itself, so too should it dictate the reach of the good faith defense.

Congress should amend section 548(c) for Ponzi schemes to reallocate the risks and redistribute the losses occasioned by a bankrupt entity that engaged in a Ponzi scheme. To act, Congress must believe that the result is a fair and equitable solution. But if Congress does nothing, inconsistent case law will continue to skew cases in varied directions. That variation will result in both a one-sided solution and partial injustice.

On the other hand, Congress should carefully craft any amendment so that section 548 does not become a fraudulent transfer statute on steroids. Indeed, the window of foreclosure on the good faith defense should be limited to one, or, at most, two years. And it should only apply in pure Ponzi schemes.<sup>368</sup> Anything less has the effect of trampling on the investors already at the bottom of barrel. Anything more creates an invincible beast.

## 2. *Innocent Investor v. Hungry Financier*

A shift in a substantive portion of Bankruptcy Code to reflect what already exists in bankruptcy policy and practice protects the interests

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<sup>367</sup> See *Sender v. Buchanan (In re Hedged-Inv. Assocs.)*, 84 F.3d 1286, 1290 (10th Cir. 1996) (holding that the contractual interest portion of a Ponzi investment is recoverable as fraudulent transfer); *In re Taubman*, 160 B.R. 964, 985–86 (Bankr. S.D. Ohio 1993) (same); *Abbott*, 77 B.R. at 886 (same).

<sup>368</sup> The term Ponzi scheme derives from the original Ponzi scheme case, and what Chief Justice Taft described as “the remarkable criminal financial career of Charles Ponzi.” *Cunningham v. Brown*, 265 U.S. 1, 7 (1924). In its most pure form, a Ponzi scheme consists of:

[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 funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.

*Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n.1 (9th Cir. 1991) (citing *Cunningham*, 265 U.S. at 7–8).

of all investors in Ponzi schemes. Investors will continue to suffer from the “too-good-to-be-true” reality of a Ponzi scheme. But at the end of the day, equity should be shared instead of tilted to one side. Ponzi schemes have a number of special statuses both in and out of bankruptcy courts. They are presumed insolvent from the moment of their inception, any transfers made to investors are fraudulent, and good faith is the sole viable defense to avoidance. In order to establish a good faith defense, an investor must show that he neither knew nor should have known about the existence of the scheme when he withdrew his profits. This objective test of good faith places a high, and often inconsistent, hurdle before transferees which varies from court to court.

But why present good faith as a defense at all? Courts have already recognized that Ponzi schemes are simply a means of convincingly rearranging money while the scammer skims off the top. In one sense, letting investors keep their winnings from a Ponzi scheme is like hosting a key party where everyone gets to keep the car they pull out of the bowl. And yet, there are many supporters of the good faith defense. Defenders assert that the good faith defense avoids punishing blameless investors for their normal activity, encourages those who discover a Ponzi scheme to report it quickly, and conforms to our gut instincts about equity in bankruptcy.

These points are not entirely persuasive. Allowing those who win out by withdrawing their investments early reduces the total size of the estate, ensuring that other equally blameless creditors get an even smaller pro-rata share than they normally would. And an informed investor has no more of an interest in maintaining the existence of a Ponzi scheme without good faith protection than with it. In either case reporting the scheme will lead to a swift involuntary bankruptcy and a small slice of the pie, with no incentive for future investment. Finally, there is the argument about basic fairness, which I take a moment to address.

Trustees can fashion hardship exemptions where an individual's return of a Ponzi scheme withdrawal would effectively precipitate individual bankruptcies. Thus, the hardship exemption arguably addresses concerns of fairness. For example, Irving Picard has received ninety-five applications for hardship exemptions from returning fictitious profits, and has granted some of them.<sup>369</sup> The availability of a hardship exemption avoids unnecessary litigation and promotes judicial efficiency. More importantly, the bankruptcy

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<sup>369</sup> Stewart Ain, *Picard: 'Hardship' Cases Will Be Exempt*, THE JEWISH WEEK, (March 8, 2011), [http://www.thejewishweek.com/news/new\\_york/picard\\_hardship\\_cases\\_will\\_be\\_exempt](http://www.thejewishweek.com/news/new_york/picard_hardship_cases_will_be_exempt).

system can accommodate an exemption for a devastated retiree with little income as opposed to a wealthy individual fighting to keep a drop in the bucket.<sup>370</sup> The Bankruptcy Code incorporates such social values in its pages—and it can do so in Ponzi scheme cases without resorting to expensive and time consuming good faith litigation. The Bankruptcy Code's purpose is to promote a "fresh start" to debtors.<sup>371</sup> In Ponzi schemes, this purpose is frustrated since the product of fraud cannot achieve a fresh start. To ameliorate this dead end, however, the bankruptcy system can avoid the brick wall being thrust upon the most financially vulnerable.

Perceptions about fairness and morality vary wildly from example to example, even with only subtle differences. Take, for instance, the famous case of the trolley problem. Barreling down the street at fifty miles an hour is a trolley, which will eventually hit a group of ten people.<sup>372</sup> Diverting the track will cause the train to swerve and instead hit only one person. Over ninety percent of people surveyed respond that they would pull the lever in that situation, killing one to save ten, while virtually no one would be willing to push someone into the path of the train to stop it, which would also kill one and save ten.<sup>373</sup>

Similarly, our moral intuitions about the good faith defense vary based on whether we view a Ponzi scheme from the perspective of the individual or the collective. The individual investor might be struck by how deeply unfair it is for funds that he acquired in good faith to be "clawed back" from him in the eleventh hour. Like a statute of limitations or the ninety-day preference window, the good faith defense gives that investor a period of time after which he can feel confident in his financial security. But from the perspective of investors as a whole, the reticent transferee begins to look like someone who upon discovering the money he has obtained has been stolen, refuses to return it to its rightful owner. The defense in that case, that the unwitting thief felt so secure in his newfound wealth

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<sup>370</sup> For example, Nelson, *supra* note 278, focuses on the "value" prong of the affirmative defense, and argues the narrow definition of value, which fails to consider opportunity costs or time value of a creditor's money, visits overly harsh results upon winning investors. That argument, however, ignores both the brevity of the window in which clawback actions may be brought, as well as the existence of available hardship exemptions.

<sup>371</sup> See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (discussing the purpose of providing a fresh start for the debtor).

<sup>372</sup> See Philippa Foot, *The Problem of Abortion and the Doctrine of the Double Effect*, in *VIRTUES AND VICES AND OTHER ESSAYS IN MORAL PHILOSOPHY* 19, 23 (Oxford Univ. Press 2002) (1978) (discussing this and other scenarios giving rise to moral dilemmas).

<sup>373</sup> John Mikhail, *Universal Moral Grammar: Theory, Evidence, and the Future*, *TRENDS IN COGNITIVE SCIENCES*, Apr. 2007, at 143, 146.

that it is wrong to take it from him, would fall on deaf ears in most courts.<sup>374</sup>

Eliminating the good faith defense would produce a simple, bright-line rule that would result in increased predictability and administrative efficiency of the bankruptcy courts. The mish-mash of precedent has produced a definition of “good faith” that has strayed far from the likely legislative meaning, or at least the ordinary usage of the word. Narrowing the good faith defense to those who could not have discovered the insolvent and fraudulent status of the scheme without some extreme new level of due diligence, the courts have ended up ignoring exactly those people most likely to possess subjective good faith, the financially uninformed.<sup>375</sup>

Small investors who might be bought off by sandwiches and coffee are rarely going to understand how to do due diligence before entering into a financial transaction. By contrast, large institutions which are capable of thoroughly investigating an investment beforehand are more likely to either avoid Ponzi schemes or take advantage of them with an early investment and pull-out. In short, the good faith defense fails mechanically as a way to get money to creditors. It fails administratively as a way to make the courts run smoothly. Most importantly, it fails morally by controverting our vested expectation that the Bankruptcy Code should protect while simultaneously promoting a “finders keepers” mentality for Ponzi winners. The Supreme Court said it best in the original Ponzi case: “Those who were successful in the race of diligence violated not only [bankruptcy’s] spirit, but its letter, and secured an unlawful preference.”<sup>376</sup> The same is true of the fraudulent transfer.

There is no shortage of Ponzi schemes. In the first six months of 2011 alone, forty-five possible Ponzi schemes have been reported.<sup>377</sup> A change to the Bankruptcy Code to measure and sensibly apply the good faith defense is necessary. Some might argue that as it stands the Code permits the trustee to recover “fictitious profits” and that no more should be reached.<sup>378</sup> And Congress could, if it so desires, undo

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<sup>374</sup> See Annotation, *Modern Status of Rules as to Ownership of Treasure Trove as Between Finder and Owner of Property on Which Found*, 61 A.L.R.4th 1180 (1988) (outlining the judicial tendency to not accept this defense).

<sup>375</sup> See 1 GARY M. LAWRENCE, *DUE DILIGENCE IN BUSINESS TRANSACTIONS* § 2.01 (2010) (outlining the judicial tendency to ignore the financially uninformed).

<sup>376</sup> *Cunningham v. Brown*, 265 U.S. 1, 13 (1924).

<sup>377</sup> DILIGENTIA GROUP, *2011 Ponzi Schemes By the Numbers*, <http://www.diligentiagroup.com/duc-diligence/2011-ponzi-schemes-by-the-numbers/> (last visited Aug. 28, 2011).

<sup>378</sup> *Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (“But the theme of the Bankruptcy Act is equality of distribution.”).

that effect. Currently, fraudulent transfer law protects only those who managed to make net profits in the Madoff scandal.<sup>379</sup> If antiquated fraudulent transfer provisions work against the policy, then Congress must be heavy handed rather than fragmenting the changes in and out of bankruptcy. What might do justice in one case (Madoff) may not necessarily do the same in another (Rothstein).<sup>380</sup>

Moral luck is a concept first mentioned by Bernard Williams and expanded on by Thomas Nagel.<sup>381</sup> It considers a common bias, and we dispense blame to those whose conduct runs afoul of our logic. How then, do we assign moral blame or praise on those people who believe they are making legitimate investments when they are, in fact, prolonging a fraud on the public? Clawback suits, as found in the Madoff and Rothstein cases, presume that no one is entitled to profit from such a fraud while others suffer.<sup>382</sup> But could we really apply this principle broadly? Imagine the savvy investor who, without inside information, pulled his money out of Enron months before its collapse so he could invest in more profitable ventures. Should he be liable to other investors, who, lacking his intuition or expertise or pure blind luck, saw their investments dwindle into nothing? Why then, make such a rule for Ponzi schemes?

### CONCLUSION

Will losers write the history of bankruptcy? Someone who generates extraordinary rates of return is either a financial genius or a bad-faith creditor, due to reasons beyond his knowledge or control. Should we punish someone acting under subjective good faith after the fact? Should we not treat differently the party that deliberately, and in bad faith, invests in a Ponzi scheme for the specific purpose of pulling out before it collapses? An investor might have been morally in the right up to the very moment it discovered that the money it had received was acquired fraudulently from others. At that point, the investor has a new legal duty to rectify the situation to whatever

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<sup>379</sup> See Robert Schmidt & Jesse Westbrook, *Madoff, Stanford Victims Unite*, BLOOMBERG BUSINESSWEEK (March 10, 2010 8:09 PM), [http://www.businessweek.com/magazine/content/10\\_12/b4171065645872.htm](http://www.businessweek.com/magazine/content/10_12/b4171065645872.htm) (discussing victims' efforts to recover money lost in the Madoff Ponzi scheme).

<sup>380</sup> Carozza, *supra* note 335.

<sup>381</sup> See generally B.A. O. Williams & T. Nagel, *Moral Luck*, 50 PROC. ARISTOTELIAN SOC'Y 115 (1976) (describing the two philosophers' thoughts on the topic).

<sup>382</sup> Morality in bankruptcy is not new. The seven year limit enacted on bankruptcies was in fact, directly suggested by the Old Testament. "At the end of every seven years you shall grant a remission of debts. 2. And this is the manner of remission: every creditor shall release what he has loaned to his neighbor; he shall not exact it of his neighbor and his brother, because the LORD's remission has been proclaimed." *Deuteronomy* 15:1-2 (New American Standard Bible).

extent possible. Historical analogues include Nazi art and Native American artifacts.

The Bankruptcy Code is a set of policy agreements in pursuit of two seemingly simple goals. The code seeks to grant debtors a fresh start and relief from life-long debts. At the same time, it attempts an equitable distribution of assets among creditors. Each time a court grants a winning investor the full extent of his winnings, every other investor is pushed further away from the full return of his or her principal. The good faith defense takes into account the innocence of one investor while ignoring that factor for every other creditor left to scabble for their pro rata share regardless of culpability.

As courts have come to realize this, they have narrowed the good faith exception ever further, limiting it to those whose best intelligent efforts are stymied by persuasive and sophisticated schemers. Maintaining this ever-shrinking exception fails to serve either fairness or administrative efficiency, especially as courts have come to ever less consistent conclusions about who should be protected. The good faith defense remains a rare misstep within the Bankruptcy Code. By elevating the interests of one sympathetic party above those of many others, it creates wide disparities in a system that otherwise attempts to create a strict hierarchy or priority to ensure equally situated creditors are treated equally. As a relic whose time has come, the good faith defense should be eliminated with all deliberate speed.

