

Con: Section 548(c)'s Good Faith Defense Should be Unavailable in Ponzi Scheme Cases

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Resolved: Section 548(c)'s Good Faith Defense Should be Unavailable in Ponzi Scheme Cases

Response: For the reasons stated, Section 548(c)'s good faith defense should **not be** Unavailable in Ponzi Scheme Cases, and in fact, the Bankruptcy Code's policy mandates that such a defense be available.

Summary

Making the good faith defense available to defendants in Ponzi scheme cases is sound bankruptcy policy. Chapter 5 avoidance actions, especially actions under Sections 547 and 548, serve the fundamental purpose of making funds available to pay creditors. More importantly, these causes of action prevent third parties from taking advantage of the debtor prior to bankruptcy at the debtor's expense and to the detriment of other creditors. Preference actions prevent a prepetition run on the bank. Similarly, constructive fraudulent transfer cases remedy transactions in which the debtor does not receive reasonably equivalent value. In both instances, parties who take advantage of the debtor's condition at the creditors' expense, whether or not there is an actual intent to harm the debtor, must reimburse the bankruptcy estate.

The Section 548(c) defense implements the bankruptcy policy of Chapter 5 causes of action in Ponzi scheme cases in two ways. First, the defense protects those who are truly defrauded after giving value and redeeming their investments in objective good faith without knowledge that they have invested in a Ponzi scheme. These investors deserve protection because they have not redeemed in an effort to make a run on the bank. Second, those investors who discover the fraud or should have discovered the fraud are prevented from making a run on the bank to their own advantage at the expense of estate creditors. Furthermore, the investors with knowledge of the Ponzi scheme (and consequently who are not acting in good faith) are incentivized to quickly report the Ponzi scheme and see that it is terminated in order to prevent future redemptions and to

preserve value. The preservation of value makes recovery to the potential transferee and other investors more likely, and has the added benefit of creating an environment in which Ponzi schemes are more likely to be reported and stopped, and thus protects potential future investors from being duped in the same way.

Stated differently, if a transferee redeems without knowledge of the debtor's weakened financial condition or the actual fraud underlying the Ponzi scheme, the transferee is not intentionally taking advantage of the debtor's weakened position and is entitled to protection. This is intuitively equitable. If, however, a transferee's discovery of the Ponzi scheme hastens the investor's redemption, it operates to harm the debtor, its creditors, and other investors. In such cases, the 548(c) good faith defense should not be available. While the transferee discovering the debtor's fraud may be required to return distributions, the same transferee will be incentivized to immediately report the fraudulent scheme to see that the Ponzi scheme is stopped and that assets are preserved to pay the transferee's resulting claim. This will stop the Ponzi scheme more quickly and protect future investors, and is a sound policy justification for making the Section 548(c) defense available in Ponzi cases.

The Section 548(c) defense succeeds only where the transferee proves that it received the transfer in good faith. Good faith is judged on a case by case basis. Ponzi scheme investors who redeem their investment based upon knowledge of one or more red flags receive more than others similarly situated and are required to return such transfers. This result is similar to preference law where the savviest creditors obtain prepetition payments that must later be returned in order to prevent a run on the bank and a race to the courthouse. The same policy holds true in Ponzi schemes. One party's diligence that discovers a Ponzi scheme and allows the party to redeem in advance of others does not make that party inherently bad. However, the redemption does skew the

recovery in the investors' favor unfairly when compared to those who do not realize the fraud as quickly. Creditors who redeem in good faith for reasons other than red flags that may indicate the existence of a Ponzi scheme are innocent bystanders who not be penalized by the fraud. Finally, by requiring those with inquiry notice to pursue reasonable diligence (and not put their head in the sand) in order to preserve the 548(c) defense, potential Ponzi investors are more likely to seriously investigate operators that promise huge returns or have woefully inadequate business plans.

What is a Ponzi Scheme

The treatises and case law concerning Section 548 over the past few decades provide the common definition of a Ponzi scheme, which can be summarized as follows:

A “Ponzi” scheme is a term generally used to describe an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The person who runs this scheme typically uses some of the money invested for personal use. Usually, this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments¹

The key ingredient of a Ponzi scheme in most cases is the perceived existence of a “business” or “enterprise” that entices the potential investor. Along with elaborate business plans, handsome returns are promised to potential investors. Many of the original investors in a Ponzi scheme do in fact reap the returns promised. The last investors, however, get caught “holding the bag” when the music stops. Generally, investors that did receive distributions are left diving into the Bankruptcy Code to find defenses such as the good faith defense provided by Section 548(c) in order to avoid liability to a bankruptcy trustee.

¹ *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 Am. Bankr. L.J. 157 (1998), citing *Martino v. Edison Worldwide Capital (In re Randy)*, 189 B.R. 425, 437 n.17 (Bankr. N.D. Ill. 1995).

What is the 548(c) Good Faith Defense?

The good faith defense under Section 548(c) is set forth in the Bankruptcy Code as follows:

Except to the extent that a transfer or obligation voidable under this section is voidable under Section 544, 545, or 547 of this title, 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

The defense in Section 548(c) applies to actual fraud cases under Section 548(a)(1)(A) of the Bankruptcy Code and those asserted for constructive fraud under Section 548(a)(1)(B). In constructive fraud, the debtor must have received less than reasonably equivalent value. In actual fraud cases, the debtor must make a transfer with an actual intent to hinder, delay, or defraud creditors. In a Ponzi case, payments to investors are violations of Section 548(a)(1)(A) and are, therefore, calculated to hinder, delay or defraud other investors.²

If Ponzi schemes are analyzed solely as constructive fraud cases then investors who receive a return on their investment (the antecedent debt) would have a lien on funds received for the value of their initial principal investment. If the Ponzi scheme is analyzed as an actual fraud, then even the principal becomes “at risk” and subject to return to the Debtor’s bankruptcy estate or trustee. The concept of value is rarely the focus of litigation involving Ponzi cases because the principal investment is usually money. Value becomes an issue in those cases where the trustee seeks to recover, for example, commission payments made to employees of the Ponzi operator. In those cases, the value must be determined based upon the transaction.³

² *In re Bayou Group LLC*, 396 B.R. 810, 843 (Bankr. S.D.N.Y. 2008).

³ *Balaber-Strauss v. Lawrence (In re Churchill Mortgage Investment Corp.)*, 264 B.R. 303 (S.D.N.Y. 2001) (holding that the focus of the court’s inquiry is the value of the goods and services provided rather than the impact that the goods and services had on the bankruptcy enterprise or the fact that it facilitated what later turned out to be a Ponzi scheme. Where the

Application of the 548(c) Defense Element of “Good Faith”

Good Faith

The United States Bankruptcy Court for the Southern District of New York recognized that courts have had difficulty defining good faith, which is inherently a case by case analysis. The Court’s general observations include that whatever good faith may mean, it does not ordinarily refer to the transferee’s knowledge of the source of the debtor’s monies which the debtor obtained at the expense of other creditors. The Court also notes that the legislative history related to Section 548(c) never defines good faith.⁴ An important point noted by the Court, is that federal courts have reached a consensus that “good faith” as used in Section 548(c) must be determined according to an “objective” or “reasonable person” standard, and not on the subjective knowledge or belief of the transferee.⁵ According to the Court, under this standard subjective assertions of good faith are not important. The only important fact is what the transferee objectively knew or should have known that there were red flags concerning the Ponzi operator’s business.

The standard for good faith under the *In re Bayou* decision can vary from party to party. The Court noted that “good faith” 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.⁶ Certain evidence that may serve to put a party on inquiry notice includes knowledge of: the purpose of the transfer,

brokers were hired and compensated to initiate mortgages and solicit investors, they did so with no knowledge of any wrongdoing).

⁴ *In re Bayou Group LLC*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008).

⁵ *In re Independent Clearing House Co.*, 77 B.R. 843, 861 (D. Utah 1987); *Plotkin v. Pomona Valley Imports (In re Cohen)*, 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996).

⁶ *Id.*, citing *In re Manhattan Inv. Fund Ltd.*, 2007 WL 440360, at *17.

the underlying fraud of the Ponzi scheme, the unfavorable financial condition of the transferor, the insolvency of the transferor, the improper nature of a transaction, or the voidability of the transfer.⁷

Once on inquiry notice, the transferee must conduct a diligent investigation according to most authorities.⁸ A diligent investigation may or may not result in the demolition of the good faith defense depending on the “quality” of the Ponzi operator’s response. The better the sleight of hand employed by the operator, the less likely a diligent investigation is to uncover the fraud and spoil the good faith defense. Thus, when attempting to preserve the good faith defense, defendants should do their best to bolster the quality of the operator’s salesmanship. For example, one Court has stated 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 former of any claim to good faith unless investigation actually disclosed no reason to suspect financial embarrassment.”⁹

The courts have generally not condoned putting ones head in the sand to preserve a good faith defense. Taking no steps at all other than speaking to the Ponzi scheme operator would amount to willful ignorance, which is not allowed. And the mere failure to make inquiry in the face of unusual circumstances may preclude a good faith defense.¹⁰ The Second Circuit Court of

⁷ *Id.*

⁸ Some courts have declined to apply this standard in the Uniform Fraudulent Conveyance contexts. *See In re Sharp International Corp.*, 403 F.3d 43 (2nd Cir. 2005) (holding that the defendant’s knowledge of the fraud, without more, does not allow an inference that defendant received payments in bad faith). The court in *In re Sharp* further held that “a company in a position to thwart or expose a breach of fiduciary duty may protect its interests by doing neither, sitting tight and being quiet” so long as the company does not assist the fraud affirmatively. *Id.* at 52; *The Sad Tale of Fraudulent Transfers*, Paul Sinclair, *ABI Journal* (April 2009).

⁹ *Jobin v. McKay (In re McE’s L. Bus. Machine Co. Inc.)*, 84 F.3d 1330, 1335-36 (10th Cir. 1996).

¹⁰ *Development Specialists, Inc. v. Hamilton Bank, N.A. (In re Model Imperial, Inc.)*, 250 B.R. 776, 798 (Bankr. S.D. Fla. 2000).

Appeals, however, has found in the context of the Uniform Fraudulent Conveyance Act that a good faith defense can be maintained even with knowledge of the fraud, which is in sharp contrast to *In re Bayou Group* for example.¹¹

Good faith for Section 548(c) purposes is not the traditional notion of good faith employed by laymen according to the Court in *In re Bayou*. To this point, the Court stated as follows:

Where the rule of law holds that an investor may not be able to establish his statutory good faith defense because he requested redemption of his investment after becoming aware of a “red flag” putting him on “inquiry notice of possible infirmity in his investment, that does not necessarily entail a finding or carry an imputation that he was guilty of any sort of *mala fides* or otherwise deserving of opprobrium. To the contrary, any rational investor or financial advisor, on inquiry notice of a warning signal respecting an investment, would be entirely justified in requesting or recommending redemption and could not be criticized for doing so. Indeed, it would be quite reasonable for an investor to decide to redeem solely on the basis of the red flag without making any inquiry, since the investor has not obligation to any third party to make any inquiry. **But if he does so, the courts have held that he cannot invoke the good faith defense under Section 548(c).**¹²

Good faith is accorded a legal definition in this case, which is different from what one might refer to as a good faith attempt. It is something more than that, and would require that where inquiry notice is present, diligence is required. If that diligence is successful, and the Ponzi investor discovers a fraud, the next step is the critical piece. If the investor immediately demands a redemption or return of money that is honored, the resulting transfer is not in good faith even though it is not the result of a bad act. In fact, from the investor’s perspective, it is a good act – namely it embodies the following thought process: “This is a Ponzi scheme, let’s get our money out before the music stops”.

¹¹ *In re Sharp International Corp.*, 403 F.3d 43 (2nd Cir. 2005). For an excellent discussion of *In re Bayou* and *In re Sharp*, please see: *The Sad Tale of Fraudulent Transfers*, Paul Sinclair, *ABI Journal* (April 2009).

¹² *In re Bayou LLC*, 396 B.R. at 845.

Obtaining your money before the music stops when inquiry notice demands due diligence that turns up a red flag ultimately hurts those that do get caught holding the bag. This is no different than accepting a transfer that is ultimately deemed preferential. And when many people analyze preferences, the common advice to someone that may be preparing to accept a preference is that the only thing worse than receiving a preference is not receiving one. That advice results in less funds available for creditor payments, and consequently, renders the preferential payment avoidable. The same should hold true under Section 548(c). If the transferee's acts generate a redemption that it knows or should know will harm creditors or the estate, then the defense should not be available.

Burden of Proof

One final issue that cannot be overlooked is that under Section 548(c), the defendant bears the burden of proof to establish good faith. It is an affirmative defense. Thus, courts have held that an inconclusive diligent investigation can negate the good faith defense if the redeeming investor was on objective notice of some infirmity in the Ponzi scheme that triggered the redemption.¹³ It is possible that the transferee may be left attempting to prove a negative, and therefore, it is helpful to justify a redemption or other transfer with a basis other than the creditworthiness of the Ponzi operator. Thus, some reasons that may justify good faith would be redemption for: planned liquidation, purchase of a home, transition of investment management, funding expenses of a newborn child or the payment of private school tuition.¹⁴

¹³ *In re Bayou LLC*, 396 B.R. at 843.

¹⁴ *Id.*

Conclusion

The good faith defense under Section 548(c), when appropriately applied, protects innocent investors in Ponzi schemes. At the same time, it promotes solid bankruptcy policy to protect creditor repayment and to avoid the ability of investors to harm creditors and other investors. Accordingly, the resolution should not be adopted and instead should be replaced with the following:

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