



AMERICAN BANKRUPTCY INSTITUTE

**Fraudulent Transfer Claims and Defenses  
In  
Ponzi Schemes**



Kathy Bazoian Phelps  
Danning, Gill, Diamond & Kollitz, LLP  
2029 Century Park East, Third Floor  
Los Angeles, CA 90067  
kphelps@dgd.com  
310-277-0077  
www.dgd.com

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### I. Introduction

As more and more Ponzi scheme cases are seen in bankruptcy court or receivership proceedings, courts are continuing to refine the rules which arise in unwinding these tangled financial webs. In particular, the law regarding fraudulent transfer claims to recover funds paid by the Ponzi debtor to investors as a return of principal or payment of fictitious profits and defenses which can be asserted to those claims continue to evolve. Trustees and receivers of Ponzi debtors can use 11 U.S.C. 548(a) or state fraudulent transfer statutes to recover transfers made to investors as a return of their investment in some circumstances and to recover any profits paid in excess of the original investment amount in other circumstances. However, those target investors have available defenses, and much litigation has been generated defining the claims that can be brought and the defenses that can be asserted to those fraudulent transfer claims.

### II. Ponzi Scheme Defined

A "Ponzi scheme" is defined as:

[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. *See, Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424 (1924); *see also, Hayes v. Palm Seedlings Partners (In re Agric. Research and Tech Group, Inc.)*, 916 F.2d 528, 536 (9th Cir. 1990).

*Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 933 F.2d 589, 590 (9th Cir. 1991).

### III. Fraudulent Transfer Claims; The Statutes Used To Recover Ponzi Transfers

The primary method to recover transfers to investors is a fraudulent transfer claim, based either on actual fraudulent intent or a constructive fraud as set forth in 11 U.S.C. § 548(a) or applicable state fraudulent transfer law.<sup>1</sup> Section 548(a) provides as follows:

(a) (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily--

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

There are two theories under which a trustee or receiver may therefore seek to recover transfers made by the Ponzi debtor -- actual fraud or constructive fraud. Under actual fraud, it is

<sup>1</sup> Either the Uniform Fraudulent Transfer Act (UFTA), which was written to replace the Uniform Fraudulent Conveyance Act (UFCA), or UFCA have been adopted by almost all states, and there are few substantive differences between these statutes and section 548(a). Since the Bankruptcy Code specifically authorizes a trustee to bring suit under both the terms of section 548 and applicable state law, this article will refer only to section 548 for purposes of simplifying the discussion.

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alleged that the Ponzi scheme operator made transfers to the transferee with “actual intent to hinder, delay or defraud” the creditors of the debtor. Under constructive fraud, it is alleged that the transfer is made without receiving “a reasonably equivalent value in exchange for the transfer.”

### **IV. The First Inquiry Is Whether the Debtor Had an Interest in the Transferred Property**

Whether a trustee uses an actual fraud or constructive fraud theory to pursue a fraudulent transfer cause of action to recover funds returned to an investor in a Ponzi scheme, the first inquiry is whether the property transferred to the investor was property of the debtor. Section 548(a) specifically requires that the transfer be “of an interest of the debtor in property.” Generally speaking, there is not much controversy surrounding this issue, and the property transferred to investors is deemed to constitute the debtor’s property.

However, in a few Ponzi scheme cases, some investors have asserted that the property transferred to them was obtained through fraud where the debtor knowingly took funds from other investors to pay them and, therefore, the debtor did not rightfully acquire title to the property subsequently transferred to them. *See, e.g., Jobin v. Youth Benefits Unlimited, Inc. (In re M&L Bus. Mach. Co.)*, 59 F.3d 1078, 1081 (10th Cir. 1995). The constructive trust theory defense argues that transfers made in connection with a Ponzi scheme do not constitute a “transfer of an interest of the debtor in property” because the debtor never acquired title to the property it transferred due to the debtor’s wrongful conduct resulting in unjust enrichment. Courts, however, have largely rejected constructive trust arguments, finding that the debtor continues to hold title to the funds that have not otherwise previously been determined to be held in a constructive trust. A constructive trust is remedial in nature and does not arise until a court

has found the existence of one. *Berger, Shapiro & Davis, P.A. v. Haeling (In re Foos)*, 183 B.R. 149, 159 (Bankr. N.D. Ill. 1995).

A few courts have found that an investor can establish that the property it received is not property of the estate if it can trace the funds it received to the same funds it invested with the debtor – a nearly impossible task in a Ponzi scheme. *See, Youth Benefits*, 59 F.3d at 1081-82; *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214, 1217 (9th Cir. 1988).

An additional justification given for rejection of the constructive trust argument has distinguished ‘title’ to property from “an interest in” property. While some courts may find that a debtor cannot acquire title to property acquired through fraud, courts dealing with Ponzi scheme cases have found that, although the debtor may not acquire title, it may have an interest in the property transferred. *Jobin v. Lalan (In re M&L Bus. Mach. Co.)*, 160 B.R. 851, 857 (Bankr. D. Colo. 1993), *aff’d* 167 B.R. 219 (D. Colo. 1994).

## V. Actual Fraud Claims

Section 548(a) authorizes a trustee to avoid a transfer of the debtor’s property made with the actual intent to hinder, delay or defraud any current or future creditor made during the two-year period preceding the bankruptcy.<sup>2</sup>

### A. Proof of Fraudulent Intent

#### 1. Intent Inferred from Operation of Ponzi Scheme

In the case of an established Ponzi scheme, actual intent to defraud may be inferred simply from the operation of a Ponzi scheme itself, rather than proof of fraud through

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<sup>2</sup> The 2005 amendments to section 548(a) extend the reachback period from one to two years for cases commenced on or after April 20, 2006, although the one-year reachback period still applies for cases commenced before April 20, 2006.

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circumstantial evidence and a badges of fraud analysis. *See, e.g., Agric. Research*, 916 F.2d 528, 534 (9th Cir. 1990); *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 860 (D. Utah 1987); *Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund, Ltd.)*, 359 B.R. 510, 517-18 (Bankr. S.D.N.Y. 2007), *rev'd in part*, 397 B.R. 1 (S.D.N.Y. 2007). Factors that would weigh in favor of application of a presumption of fraud in a Ponzi case would be the following: (1) the debtor does not have any legitimate business operation to which its alleged investment program is connected; (2) the debtor's business operations are very small in comparison to the amount of the debt incurred by the debtor; (3) the investors are made unrealistic promises of returns on their investments; and (4) the debtor incurs substantial debt in a very short period of time.

### 2. Circumstantial Evidence of Fraudulent Intent

Absent a presumption of fraud arising from a finding of a Ponzi scheme, a plaintiff will have the burden of proof and will have to rely upon circumstantial evidence of fraudulent intent. *Jobin v. McKay (In re M&L Bus. Mach. Co.)*, 155 B.R. 531, 539-40 (Bankr. D. Colo. 1993); *Bowers & Merena Auctions, LLC v. Lull (In re Lull)*, 386 B.R. 261, 270 (Bankr. D. Haw. 2008) (actual intent may be established where transfer wears a sufficient number of badges of fraud).

### 3. Use of Criminal Plea or Conviction

One final possible other mechanism by which a trustee could establish fraudulent intent is by relying on an admission of the debtor, usually in a criminal plea agreement, or if the debtor is found criminally liable for fraud. *See, e.g., Scholes v. Lehmann*, 56 F. 3d 750, 762 (7th Cir. 1995).

**B. Entirety of Transfer Avoided**

Pursuant to section 548(a)(1)(A), the entire amount of any transfer which was made by the transferor with actual intent to hinder, delay or defraud creditors is avoided, whether or not the debtor received value in exchange, and a trustee need not prove that the transfer was for less than fair value if actual intent is proven. *See Bayou Superfund LLC v. WAM Long/Short Fund II L.P. (In re Bayou Group, LLC)*, 362 B.R. 624 (Bankr. S.D.N.Y. 2007); *see also, Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 56 (2d Cir. 2005). The transferee's lack of knowledge of the Ponzi scheme is irrelevant to a finding of actual fraudulent intent. *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006).

**VI. Constructive Fraud Claims**

Section 548(a)(1)(B) provides an alternative theory for recovery of funds transferred to investors as returns in a Ponzi scheme without the necessity of showing actual fraudulent intent. Unlike an actual fraud theory, most courts find that a plaintiff may only recover the profits paid to the investor, and not the return to the investor of the original investment amount, unless the plaintiff can establish the investor's lack of good faith. *See, e.g., Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008).

On a constructive fraud basis, the first element that must be established is that the transfer was made for less than reasonably equivalent value<sup>3</sup> during the applicable time period pre-petition. The next element that must be established is that the lower value received by the debtor in exchange for the transfer actually harmed the creditors of the debtor by leaving insufficient assets available for creditors, on one of the following three bases: (1) if the debtor was either

<sup>3</sup> UFCA uses the terminology "fair consideration" rather than reasonably equivalent value", but they have been found to be the functional equivalent.

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insolvent at the time of, or rendered insolvent as a result of, the transfer; (2) if the debtor was engaged or was about to engage in a business or transaction while inadequately capitalized; (3) if the debtor intended to or believed it would incur debts beyond its ability to pay as they matured.

### **A. Less Than Reasonably Equivalent Value**

As a preliminary matter, a plaintiff must show that the transfer was made for less than reasonably equivalent value. Section 548(d)(2)(A) defines value as follows: “property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor”.

In the context of a Ponzi scheme, there are two types of payments an investor might have received which could be subject to avoidance by a trustee or receiver: (1) a return of the principal investment made; and (2) the fictitious profits on that investment.

#### **1. Fictitious Profits Not for Reasonably Equivalent Value**

There is a sharp split of authority over the issue of whether the payment to an investor of “interest” or “profits” on its investment was made in exchange for reasonably equivalent value. Many courts follow *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 871 (D. Utah 1987) and its progeny, which conclude that no reasonably equivalent value is provided in exchange for the payment of profits and, therefore, the transfer of profits is recoverable as a public policy matter, so as not to permit earlier investors to profit at the expense of later investors who received substantially less on their investments. *See Indep. Clearing House*, 77 B.R. at 858; *see also, Lehmann*, 56 F.3d at 757 (“A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits . . . conferred no benefit on the [debtors] but merely depleted their resources faster.”).

On the other hand, some courts have placed their focus not on public policy or an analysis of equity, but rather on the contractual relationship between the investor and the debtor. See *Lustig v. Weisz & Assoc., Inc. (In re Unified Commercial Capital, Inc.)*, 260 B.R. 343 (Bankr. W.D.N.Y. 2001), *aff'd*, 2002 WL 32500567 (W.D.N.Y. 2002); *Balaber-Strauss v. Lawrence*, 264 B.R. 303, 308 (S.D.N.Y. 2001), *aff'g*, *In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000) (court must evaluate the consideration exchanged by the debtor and transferee in the specific transaction which the trustee seeks to avoid, not the transaction's impact on the debtor's overall business).

The debate turns to whether "value" can be provided for profits. The *Independent Clearing House* line of cases finds that the only value was to perpetuate the Ponzi scheme, and no value can be provided if the contract underlying the transaction is illegal. The *Unified Commercial* line of cases looks at the discrete transaction, concluding that the court must measure what was given against what was received in that particular transaction, concluding in some instances that the debtor's use of the investor's funds for a period of time supported the payment of reasonable contractual interest. *Unified Commercial Capital*, 260 B.R. at 351.

## **2. Return of Investment Principal is Reasonably Equivalent Value**

### **a. Restitution Claim Theory**

With respect to amounts transferred to investors that constitute a return of their principal, and therefore release of their corresponding claim for the return of that principal, courts have found that reasonably equivalent value is exchanged by the investor where the investor is deemed to have acquired a restitution claim at the time of the investment, which claim is arguably exchanged when the investor received a transfer of funds. *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700 (9th Cir. 2008); *Indep. Clearing House*, 77 B.R. at 857.

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However, it is important to note that this reasoning does not apply where investors received more from the debtor than the amounts of their respective total investments and it is limited to the amount of principal transferred, not profits. *Indep. Clearing House Co.*, 77 B.R. at 857.

### b. Limits on Restitution Claim Theory

However, courts have limited the use of the restitution claim theory to situations where the investor acted in good faith regarding the investments made in the Ponzi scheme. *See, e.g., United Energy*, 944 F.2d at 596 n. 7 (“In recognizing these claims for rescission and restitution, we assume that the investors had no knowledge of the fraud the debtors were perpetrating.”). An investor’s good faith in this context is measured by a subjective standard so that a court can determine what the investor actually knew. *Jobin v. McKay (In re M&L Bus. Mach. Co.)*, 84 F.3d 1330, 1340-41 (10th Cir. 1996). This measurement of good faith should be the plaintiff’s burden since the plaintiff has the burden of establishing a lack of reasonably equivalent value. *See Ransier v. Public Employees Ret. Sys. (In re Cottrill)*, 118 B.R. 535, 537 (Bankr. S.D. Ohio 1990).

### c. Accounting Allocating Transfers to Principal or Profits

A question may arise as to whether the transfers paid to the investor should be applied first to the principal investment, or whether the payments should be applied first to the profits that the investor was promised. In calculating whether an investor is liable to return funds in connection with a fraudulent transfer claim, courts in Ponzi scheme cases have applied a netting rule by looking at the transfers in the aggregate to determine whether an investor is a net-winner (i.e., received profits in addition to the return of all principal invested) or a net-loser (i.e., only received a portion of the principal invested). It is, therefore, not necessary in a Ponzi scheme case to analyze each payment, transfer by transfer, to characterize the payments as either

principal or profit. *See, Donell v. Kowell*, 533 F.3d at 771. *But see, Scholes v. Ames*, 850 F. Supp. 707, 713-15 (N.D. Ill. 1994), *aff'd*, *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995) (investor was a net loser, yet still subject to liability on the facts of that case where setoff was not permitted against portion of investment that came from a separate investor).

### 3. Value in Exchange for Commissions Paid to Brokers

A particular category of transfers subject to avoidance claims in Ponzi scheme cases are the transfers made by the debtor to its brokers as commissions in order to solicit new investments. Some courts have found that, because a Ponzi enterprise has no legitimate purpose, there can be no value provided by a broker in furthering or assisting the debtor in perpetrating the fraud. *See Warfield*, 436 F.3d at 560; *Martino v. Edison Worldwide Capital (In re Randy)*, 189 B.R. 425 (Bankr. N.D. Ill. 1995); *Dicello v. Jenkins (In re Int'l Loan Network, Inc.)*, 160 B.R. 1, 16 (Bankr. D.D.C. 1993); *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 434 (Bankr. S.D. Tex. 1997). These cases are based on the underlying premise that profits and commissions should be treated the same, and that no valuable consideration is paid in exchange, so commission transfers are avoidable.

Other courts have looked more narrowly at the relationship between the debtor and the broker and measure “what was given and received” by the debtor and the broker, looking at the market commission rates versus what was paid and acknowledging that “Money is valuable even when used for illegal purposes.” *Solow v. Reinhardt (In re First Commercial Mgmt. Group, Inc.)*, 279 B.R. 230, 238 (Bankr. N.D. Ill. 2002); *In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664 (Bankr. S.D.N.Y. 2000): *see also, Orlick v. Kozyak (In re Fin. Federated Title & Trust Inc.)*, 309 F.3d 1325, 1332 (11th Cir. 2002) (“a determination of whether value was given under

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section 548 should focus on the value of the goods and services provided rather than on the impact that the goods and services had on the bankrupt enterprise”).

### **B. Insufficient Remaining Assets for Creditors**

Once the element of reasonably equivalent value has been established, then the trustee must establish one of the three elements under section 548(a)(1)(B) regarding insufficient value being received by the debtor: (1) the debtor was either insolvent on the date the transfer was made, or became insolvent as a result of the transfer; (2) the transfer left the debtor with unreasonably small capital to continue its business or transaction; or (3) the debtor intended or believed that it would incur debts beyond its ability to pay as such debts matured.

Insolvency of the debtor is established when the debtor is operating a Ponzi scheme. *Cuthill v. Kime (In re Evergreen Sec., Ltd.)*, 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003); *Ramirez Rodriguez*, 209 B.R. at 432. In a Ponzi scheme case, the question becomes whether a presumption of insolvency should apply for the entire period of operation of the debtor since the debtor had no legitimate business operations from the beginning, or whether a trustee will need to prove insolvency for the date of each and every transfer made. Some courts have found that a presumption of insolvency may apply from inception of the Ponzi scheme. *See, e.g., Independent Clearing House*, 77 B.R. at 871. However, where there is some ambiguity as to when the Ponzi scheme began or whether there was an ongoing legitimate business operation, the presumption may not be applied. *See McKay*, 155 B.R. at 535 n. 7.

The same presumption that may apply to prove insolvency in a Ponzi scheme case might apply to demonstrate either of the other two elements, with the same possible pitfalls if there are questions about the establishment of a Ponzi scheme in the first instance. *In re Taubman*, 160 B.R. 964, 986 (Bankr. S.D. Ohio 1993) (“The court determines, in the circumstances of this

bankruptcy case, that insolvency constitutes unreasonably small capital per se.”). If there is any question about whether a Ponzi scheme existed, then no presumption will apply and the facts required to establish these elements will need to be proven. Regarding unreasonably small capital, one court found that the presumption did apply and stated that “the fact that the debtor operated primarily if not exclusively on fraudulently obtained funds establishes that the debtor had little if any legitimate operating capital. It would seem axiomatic that the debtor was operating its business with unreasonably small capital.” *Emerson v. Maples (In re Mark Benskin Co, Inc.)*, 161 B.R. 644, 650 (Bankr. W.D. Tenn. 1993). Regarding the debtor’s intent to incur debts beyond its ability to repay, the *Taubman* court refused to apply a presumption and made inquiry into the debtor’s subjective intent. *Taubman*, 160 B.R. at 987.

## VII. Defenses To Ponzi Fraudulent Transfer Claims

The defenses of a target defendant from whom a trustee is seeking to recover monies paid may depend on whether such target defendant was the initial transferee or a subsequent transferee. Section 548(c) carves out an exception for the initial recipient of the alleged fraudulent transfer to the claim to avoid fraudulent transfers. Section 548(c) provides:

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 . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

An otherwise avoidable transfer to an initial transferee under section 548(a), not subject to the defenses available under section 548(c), is then recoverable by a trustee pursuant to section 550(a). However, additional defenses may be available to a subsequent transferee pursuant to section 550(b) that are not otherwise available to an initial transferee. Section 550(b) provides

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that an otherwise avoidable transfer may not be recovered from a subsequent transferee if said transferee took in good faith and for value, which may be subject to different burdens and standards than the good faith value defense under section 548(c).

### A. The Initial Transferee

#### 1. The Good Faith Defense

The knowledge and intent of a transferee are not factors in a trustee's prima facie fraudulent transfer action, whether based on actual or constructive fraud. Section 548(c) creates an exception for the transferee or obligee who takes the property or promise in good faith and for value. Assuming the defense can be established, it does not prevent avoidance of the transfer; it merely protects the good faith transferee from liability to the extent of the value given. *See Plokin v. Pomona Valley Imports, Inc. (In re Cohen)*, 199 B.R. 709, 718-20 (B.A.P. 9th Cir. 1996).

The transferee bears the burden of showing that it is entitled to protection under section 548(c). *Agric. Research*, 916 F.2d at 536. The good faith defense must be established by an objective standard, not merely subjective proof that the investors did not have knowledge of the fraud. *See Manhattan Inv. Fund*, 359 B.R. 510; *McKay*, 84 F.3d at 1338; *Agric. Research*, 916 F.2d at 535.

To establish the good faith defense, the investor must demonstrate that he exercised a duty of care of that of a reasonable person. "Good faith" in the context of section 548(c) means not only a lack of knowledge of the fraud, but also "a lack of knowledge of such facts as would put the reasonably prudent person on inquiry." *Practical Inv. Corp. v. Rellen (In re Practical Inv. Corp.)*, 95 B.R. 935, 941 (Bankr. E.D. Va. 1989); *Meeks v. Red River Entm't (In re Armstrong)*, 285 F.3d 1092, 1096 (8th Cir. 2002) (held, gambling casino failed to act in "good

faith” when it extended credit to debtor and received payment on debt: “. . . ‘a transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor’s possible insolvency.’”), quoting *Brown v. Third Nat’l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995) (transferees lacked good faith under 548(c) of the Code when they “were aware of sufficient facts concerning the debtors’ precarious financial situation to place [them] on inquiry notice of debtor’s insolvency and looming bankruptcy.”); *Warfield*, 436 F.3d at 559-60; *Lehmann*, 56 F.3d at 759.

Several Ponzi scheme cases have expressly discussed the elements necessary to establish the good faith defense of an initial transferee under section 548(c). The focus of the courts’ inquiry centers around the state of mind of the transferee -- whether the transferee has knowledge of the debtor’s insolvency or fraudulent activity; whether that knowledge is actual or constructive, and whether the transferee should have been placed on inquiry notice. Factors considered in Ponzi scheme cases are described generally as follows:

**a. Exorbitant Returns: Disparity in Market Rates and Promised Rates of Return**

A promise of very high or exorbitant returns should put an investor on inquiry notice. See, e.g., *Lalan*, 160 B.R. at 859; *Lehmann*, 56 F.3d at 760; *McKay*, 164 B.R. 657. But see, *Levey v. Razez (In re Mary S. Pate)*, No. 95 A 985, slip op. at 14 (Bankr. N.D. Ill. 1997) (“The mere fact that the debtors promised exorbitant returns on a defendant’s investment . . . does not, without more, mean that the defendant lacked good faith”); *Indep. Clearing House*, 77 B.R. at 862.

**b. The Investor’s Level of Business Knowledge and Experience**

An investor’s education and experience can preclude a finding of good faith. See, e.g., *Fisher v. Sellis (In re Lake States Commodities, Inc.)*, 253 B.R. 866 (Bankr. N.D. Ill. 2000);

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*Lalan*, 160 B.R. at 858-59; *Jobin v. Ripley (In re M&L Bus. Mach. Co., Inc.)*, 198 B.R. 800, 810 (D. Colo. 1996); *McKay*, 84 F.3d at 1333.

### c. Suspicious Circumstances and Inquiry Notice

If the circumstances would place a reasonable person on inquiry notice and a diligent inquiry would have uncovered the fraud, then a finding of a lack of good faith will likely be made. *Agric. Research*, 916 F.2d at 539; *Hays v. Jimmy Swaggart Ministries*, 263 B.R. 203, 212 (M.D. La. 1999); *Ripley*, 198 B.R. at 810.

### d. The Type of Due Diligence Made by the Investor

If insufficient due diligence was done by the investor, then good faith may not be found. *See, e.g., Lalan*, 160 B.R. 851; *Evergreen Sec.*, 319 B.R. 245; *Warfield*, 436 F.3d at 560.

### e. What the Investor Actually Knew About Investment Scheme

If the investor had actual knowledge of the fraudulent scheme, a finding of good faith will be precluded. *Cuthill v. Greenmark, LLC (In re World Vision Entm't, Inc.)*, 275 B.R. 641, 658 (Bankr. M.D. Fla. 2002); *Stevenson v. J.C. Bradford & Co (In re Cannon)*, 230 B.R. 546, 592 (Bankr. W.D. Tenn. 1999), *rev'd on other grounds, In re Cannon*, 277 F.3d 838 (6th Cir. 2002); *Rafoth v. First Nat. Bank of Barnsville (In re Baker & Getty Fin. Servs, Inc.)*, 98 B.R. 300 (Bankr. N.D. Ohio 1989), *aff'd*, 974 F.2d 712 (6th Cir. 1992). *But see, In re Sharp Int'l. Corp.*, 302 B.R. 760, 780, (E.D. N.Y. 2003), *aff'd*, 403 F.3d 43 (2d Cir. 2005) (preferring one creditor over another is not a fraudulent transfer, notwithstanding that the paid creditor had knowledge of the debtor's fraudulent scheme; the creditor did not owe a duty to the debtor, or its creditors and its silence did not constitute participation in the fraud).

**f. Whether Transaction Had the Earmarks of an Arms-Length Transaction**

The transaction must have been an arms-length transaction in order for the good faith exception to apply. *Indep. Clearing House*, 77 B.R. 843; *In re Hannover Corp.*, 310 F.3d 796 (5th Cir. 2002).

**2. The Value Defense**

Even if the transferee can establish good faith under section 548(c), it must also establish that it gave value to meet the criteria under section 548(c). For purposes of section 548, “value” is defined in section 548(d)(2)(A) as “property, or satisfaction or securing of a present or antecedent debt of the debtor . . .” The defendant’s assertion of “value” for purposes of section 548(c) is essentially the flip side of the plaintiff’s showing of “reasonably equivalent value” under section 548(a)(1)(B). The former looks at value from the perspective of the transferor (i.e., did the debtor receive enough value in exchange for the transfer), while the latter looks at value from the perspective of the transferee (i.e., how much did the transferee give?). *AFI Holding*, 525 F.3d at 707.

The courts have taken essentially two differing views in evaluating whether value was given: (1) Value must be assessed “on a case-by-case basis, looking at surrounding circumstances and by focusing on the precise nature of the transfer.” *Fin. Federated*, 309 F.3d at 1332 (“focus on the value of the goods and services provided rather than on the impact the goods and services had on the bankrupt enterprise”); or (2) Value should be evaluated by consideration of whether the reasonably equivalent value confers an economic benefit upon the debtor. *Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 991 (2d Cir. 1981) (“the debtor’s net worth has been preserved” and the interests of creditors have not been harmed by the transfer).

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Some examples of analysis of the value defense under section 548(c) in Ponzi scheme cases are as follows: *Hannover*, 310 F.3d 796 (Short-term call options which defendant provided in exchange for cash payments from debtor had value since, at that time, there was a chance that the investment could generate a positive return); *Cohen*, 199 B.R. 709 (Where Ponzi debtor provided \$114,500 automobiles to persons paying \$80,000, using subsequent buyers' monies to cover shortfall, dealers who sold vehicles took the debtor's money in good faith and value given was equal to full retail value of each vehicle); *Noland v. Morefield (In re Nat'l Liquidators, Inc.)*, 232 B.R. 915 (Bankr. S.D. Ohio 1999) (While fraudulent transfer defendant may have acted in good faith in investing in debtor's Ponzi scheme, she did not give value for any payments that she received from debtor in excess of amount of her initial investment, and accordingly could not utilize good-faith-for-value defense to prevent trustee from recovering these excess payments); *Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993) (section 548(c) does not provide defense to investors in debtor's Ponzi scheme where what these investors gave debtor in exchange for transfers to them was not "value" within meaning of § 548(c)); *First Commercial*, 279 B.R. 230 (defendant gave value where it entered into contract with debtor to pay commissions for finding investors for the debtor's enterprise; the debtor incurred the obligation to pay the defendant for recruiting investors); *Ramirez Rodriguez*, 209 B.R. 424 (Investor did not give, and Ponzi debtors did not receive, value in exchange for transfers to investor under base participation contracts, subcontracts, and guaranties that exceeded principal amount of investor's investments with debtors, so as to allow investor to retain fraudulent transfers).

### 3. The Mere Conduit and the Dominion and Control Defenses

Another possible defense of an initial transferee is to assert that it is not a transferee in the first instance as contemplated by the Bankruptcy Code. Pursuant to section 550(a), a fraudulent transfer may be recovered from an initial transferee. Section 550(a) provides:

- a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from-
- 1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
  - 2) any immediate or mediate transferee of such initial transferee.

Section 550(a) does not define the phrase “initial transferee.” Two lines of “initial transferee” cases exist – the “mere conduit” cases and the “dominion and control” cases. Courts have widely accepted the “dominion or control” test set forth in *Bonded*, 838 F.2d at 893, to evaluate whether the defendant is the initial transferee. *But see, In re Incomnet, Inc.*, 463 F.3d 1064 (9th Cir. 2006) (court distinguishes between two separate tests – the “dominion test” and the “control test”). The *Bonded* court explained, “we think the minimum requirement of status as a ‘transferee’ is dominion over the money or other asset, the right to put the money to one’s own purposes. When A gives a check to B as agent for C, then C is the ‘initial transferee’; the agent can be disregarded.” *Bonded*, 838 F.2d at 893.

As an extension of the dominion and control test, the “mere conduit” test, was established to find that a party is not an initial transferee if was a “mere conduit” of the funds. *See Christy v. Alexander & Alexander of New York (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52 (2d Cir. 1997). In essence, a party who acts as a conduit and simply facilitates the transfer of funds from the debtor to a third party is not deemed an initial

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transferee. See *Poonja v. Charles Schwab & Co., Inc. (In re Dominion Corp.)*, 199 B.R. 410, 413 (B.A.P. 9th Cir. 1996); *In re U.S. Interactive, Inc.*, 321 B.R. 388, 395-96 (Bankr. D. Del. 2005).

However, “just because a party is not a ‘mere conduit’ in the prototypical sense of the term – i.e., a party that receives the money merely to pass it on to a third party – does not mean that the party has the requisite ‘dominion and control’ over the funds.” *Manhattan Inv. Fund*, 397 B.R. at 15. A party must be able to put the funds at issue to his own purposes, even if he is not a mere conduit. *Id.* Therefore, courts have limited a plaintiff’s recovery of transfers to banks, law firms, and clearinghouses when these types of organizations acted solely as custodians or intermediaries.

### **B. A Subsequent Transferee**

While section 550(a)(1) provides that either an “initial transferee” or “the entity for whose benefit such transfer was made” is liable for an avoided transfer, section 550(b)(1) provides additional defenses for a mediate or immediate transferee (a subsequent transferee) that would not be available to an initial transferee. A plaintiff, however, is only entitled to a single satisfaction. See e.g., *Dzikowski v. N. Trust Bank of Fla. N.A. (In re Prudential Lines of Fla Leasing, Inc.)*, 478 F.3d 1291, 1301 (11th Cir. 2007).

Section 550(b) provides:

- b) The trustee may not recover under section (a)(2) of this section from-
- 1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
  - 2) any immediate or mediate good faith transferee of such transferee.

Under 11 U.S.C. § 550(b)(2), mediate transferees also have a shelter defense; if a mediate transferee takes in good faith from another mediate transferee who had the protection of section 550(b)(1), then each subsequent transferee who takes in good faith is sheltered by its transferor's status, even if the transferee did not take for value or took with knowledge that the initial transfer was voidable. *Leonard v. Optimal Payments, Ltd. (In re Nat'l Audit Defense Network, Inc.)*, 332 B.R. 896, 915 (Bankr. D. Nev. 2005).

A trustee may pursue recovery against a subsequent transferee even if the trustee has not yet obtained judgment avoiding the initial transfer. *Woods & Erickson, LLP v. Leonard (In re AVI, Inc.)*, 389 B.R. 721 (B.A.P. 9th Cir. 2008); *Kendall v. Sorani (In re Richmond Produce, Inc.)*, 195 B.R. 455, 463 (N.D. Cal. 1996).

A subsequent transferee will be protected from avoidance of the transfer to it under section 550(b)(1) if the subsequent transferee: (1) takes for value; (2) in good faith; and (3) without knowledge of the voidability of the transfers.

### 1. Good Faith vs. Knowledge

Courts have noted the distinction between “good faith” and “without knowledge”, finding that “knowledge” is a stronger term than “notice” and that, “A transferee that lacks information necessary to support an inference of knowledge need not start investigating on his own.” *Bonded*, 838 F.2d at 898 (failure to make inquiry did not permit court to attribute to transferee knowledge of voidability of transaction); *see also, CCEC Asset Mgmt. Corp. v. Chem. Bank (In re Consol. Capital Equities Corp.)*, 175 B.R. 629, 637-38 (Bankr. N.D. Tex. 1994) (distinguishing between “good faith” and “without knowledge” requirements of 550(b)(1)). The good faith standard is measured using an objective standard, i.e., a transferee acts in good faith if it had no facts before it that would cause a reasonable person to investigate whether the transfer

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would be avoidable. *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D. N.Y. 2005). The policy underlying the “good-faith” defense is to either (a) protect certain innocent purchasers from challenges to the underlying transfer; or (b) to prevent a transferee from whom a plaintiff could recover from transferring the recoverable property to an innocent transferee, and then later receiving a re-transfer of that same property, that is essentially “washing” the transaction through an innocent third party. *Id.*

### 2. Value from a Subsequent Transferee

A subsequent transferee may retain the funds transferred if it can prove that the transfer was made for value. The “value” required to be paid by the subsequent transferee to be eligible for the defense under section 550(b) is merely consideration sufficient to support a simple contract; there is no requirement that the value given by the transferee be a reasonable or fair equivalent. *Id.* Additionally, there is no requirement that the initial transferee must have given value to the debtor before a subsequent transferee is protected. *See, Bonded* 838 F.2d at 896-97 (noting the difference in “value” in section 550(b) and “value to the debtor” in section 548(c)). This exception, therefore, applies regardless of whether the initial transferee gave any value to the debtor.

### 3. Scope of the § 550(b) Defense

One additional distinction between the section 548(c) defense for the initial transferee and the section 550(b) defense for the subsequent transferee is that the initial transferee who has demonstrated a good faith value defense under section 548(c) must return the property to the estate, but retains a lien on the property transferred, but a subsequent transferee may assert its own defense, prohibiting the plaintiff from recovering anything from the subsequent transferee. *See, e.g., Wasserman v. Bressman (In re Bressman)*, 327 F.3d 229 (3d Cir. 2003).

**VIII. Conclusion**

A plaintiff in a Ponzi scheme case has actual and constructive fraudulent transfer theories to recover funds paid by a Ponzi scheme operator to its investors, brokers or others. Several presumptions are available to a plaintiff once a Ponzi scheme has been established, often simplifying the process of proof of actual intent and insolvency. In the absence of the presumptions, the plaintiff has the burden of proof regarding fraudulent intent, on the one hand, or reasonably equivalent value and insolvency on the other hand for constructive fraud claims. The law continues to develop as the split solidifies regarding recovery of principal versus profits.

An initial transferee has several possible defenses, including: (1) that the debtor has no interest in the property transferred, and (2) the good faith-value defense under section 548(c); and (3) the mere conduit defense under section 550(a). A transferee bears the burden of proof on issues of good faith and value under these defenses. A subsequent transferee has yet an additional defense under section 550(b), which gives an opportunity to demonstrate its own good faith and lack of knowledge, along with value, which need not have been given to the debtor.

The fraudulent transfer laws as applied in Ponzi scheme cases have largely viewed the transactions from the investors' perspective, analyzing what they knew or should have known, with an eye toward striving to accomplish equity and ratable distribution among earlier and later investors in a Ponzi scheme. There are, however, a growing number of courts taking a narrower approach, choosing to look at the transfer transaction in isolation to evaluate the merits of the fraudulent transfer claim, rather than viewing the impact of the transaction on the entire case. A plaintiff's success in pursuing fraudulent transfer claims may, therefore, depend on the precedential authority in the jurisdiction or the views of the judge presiding over their case, as



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the struggle between the public policy equitable viewpoint and the transactional viewpoint can significantly change the outcome of the case.