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I. INTRODUCTION

Ponzi schemes are not new, and they have been present within the financial community for many years, even before the case of Charles Ponzi, which gave us the name "Ponzi Scheme." However, the frequency and magnitude of these schemes that have been revealed in the last few years is staggering.

Since the onset of the global economic meltdown in 2008, many such schemes have had a light shown on them, which revealed

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Prior to becoming a Bankruptcy Judge, she was a member of the Committee on Character & Fitness, Appellate Division, Second Department from 1983 until taking the bench. She had been a Panel Trustee for the United States Bankruptcy Court for the Eastern and Southern Districts of New York. She is a fellow of the American Bar Foundation, a member of the American Bar Association, National Association of Women Judges, Women's Bar Association of the State of New York, American Bankruptcy Institute, New York State Bar Association, Member, Advisory Committee of Federal Bar Council at Central Islip, New York, former President of the Nassau County Women's Bar, former President of The Theodore Roosevelt American Inn of Court, and a member of the Bar Association of Nassau County, having previously served on its Board of Directors and chair of several bankruptcy law committees. She previously served as a member of the National Committee for Court Administration of the United States in regard to case administration and electronic case filing for Bankruptcy Courts. Currently, she is a member of the Advisory Committee for the New York State and Federal Judicial Council.

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these problems in areas which were unexpected and surprising to all of us, including the rise and fall of the Bernard Madoff enterprise.[1] These schemes have been perpetrated by people who appeared to be knowledgeable, even recognized professionals such as law firms and substantial business men or women.

In reviewing what happens when Ponzi schemes inevitably fail, many enterprises wind up in bankruptcy, or some similar form of orderly liquidation (such as a receivership, or a criminal restitution proceeding conducted by the U.S. Attorney's Offices). Ponzi schemes cannot generally be reorganized, because they usually have no actual business to rehabilitate, only some assets that can be liquidated and distributed amongst various competing claimants. This state of affairs makes the sort of orderly liquidation that is available in bankruptcy an ideal mechanism to put the financial affairs of the Ponzi scheme to rest.

We hope to illustrate this point by contrasting what takes place in bankruptcy liquidation with what would happen if each Ponzi victim/investor were essentially left to his or her own devices. In the former case, there is a structured mechanism designed to produce both the equitable distribution of assets and the maximum recovery for each claimant. In the latter case, the resulting cannibalization of the Ponzi scheme's assets would see some victims obtaining large sums, and others (situated in the same equitable position) getting little or nothing.

In the usual case where a Ponzi scheme is liquidated in bankruptcy, a "trustee" will be appointed to take ownership and control of the enterprise's assets, in the name of a bankruptcy estate created for the benefit of creditors. The trustee's job is to seek out and recover any assets which were held in the name of the debtor, or in which the debtor had any interest. Once all the assets are marshaled together, the trustee's job is to distribute them to the legitimate claimants, in accordance with the priority scheme put in place by the U.S. Bank-

[1] Recent bankruptcy cases involving Ponzi schemes include: In re Bernard L. Madoff Inv. Secs., Case No. 08-01789 (Bankr. S.D.N.Y. 2008); In re Petters Co., et al., Case No. 08-45257 (Bankr. D. Minn. 2008); In re Rothstein Rosenfeldt Adler, P.A., Case No. 09–34791 (Bankr. S.D. Fla. 2009); In re Capitol Invs., Inc., Case No. 09–36408 (Bankr. S.D. Fla. 2009); In re Bayou Grp., LLC, et al., Case No. 06–22306 (Bankr. S.D.N.Y. 2006); In re Janitorial Close-Out City Corp., Case No. 09–72982 (Bankr. E.D.N.Y. 2009); In re Agape World, Inc., Case No. 09-70660 (Bankr. E.D.N.Y. 2009); In re Dreier, LLP, Case No. 09–15051 (Bankr. S.D.N.Y. 2009); In re Laing, et al., Case No. 04–bk–03621 (Bankr. M.D. Fla. 2004); In re Am. Pac. Fin. Corp., Case No. 10-72855 (Bankr. D. Nev. 2010).

ruptcy Code.

The trustee's role is often a thankless one, as it usually puts him or her in an adversarial posture to the very claimants for whose benefit s/he has been charged to act. The earlier investors in a Ponzi scheme tend to realize a significant return, while those who invest in the scheme at a later point in time tend to be left with little payment. Since one of the aims of the Bankruptcy Code is equitable distribution amongst similarly-situated creditors, the trustee will usually commence litigation against the investors who realized the greatest returns from the scheme. The aim here is to "claw back" those excess payments, so that they may be distributed ratably.

We note that the bankruptcy process is rife with pitfalls, both for the trustee on the one hand, and for the claimants whose payments s/he seeks to recapture on the other. The trustee has a formidable arsenal of "avoidance actions" that s/he can commence against Ponzi investors who received more than their equitable share from the scheme. Due in part to the inherently-fraudulent nature of a Ponzi scheme, the Trustee is aided by certain evidentiary presumptions that ease his/her burden of proof in claw-back litigation. On the other hand, claimants also have multiple defenses that they can invoke in order to keep at least some portion of their returns.

II. CHARLES PONZI

The criminal enterprise of Charles Ponzi provides a good illustration of both the general characteristics of Ponzi schemes and the reasons why they inevitably fail. Mr. Ponzi convinced people to lend money to him by falsely claiming that he was in the business of purchasing international postal coupons and selling them at 100% profit (when, in fact, he had no such business).[2] Mr. Ponzi promised his investors a return of $150 for every $100 contributed, payable within 90 days.[3] Mr. Ponzi fulfilled his fantastic promises for a while, because of the seemingly everlasting influx of new investors.[4] He took these new investors' money and, with it, turned around and paid the covenanted returns to earlier investors, while of course keeping a healthy percentage for himself.[5]

[2] Cunningham v. Brown, 265 U.S. 1, 7 (1924).
[3] *Id.*
[4] *Id.* at 8.
[5] *Id.* at 7-8.

In June of 1920, Mr. Ponzi was raking in $1 million per week[6]—the equivalent of over $12.33 million per week in 2014 dollars[7]—from new contributions. However, public authorities soon began investigating Mr. Ponzi, whereupon he stopped soliciting investments.[8] Once this was reported to the public, Mr. Ponzi's investors began demanding their principal back *en masse*, creating a "run" on his operation.[9]

Mr. Ponzi had enough money put aside to satisfy his investors' claims for a while, but not for long, because his operation had become ever-more insolvent the longer it continued.[10] He had promised his investors a 50% profit.[11] Moreover, Mr. Ponzi paid the "salesmen," who helped him lure his victims, a 10% commission.[12] Accordingly, for every dollar Mr. Ponzi brought in, he incurred $1.60 in liabilities—without any real economic output from legitimate business activity to make up the difference. Thus, when the scheme ground to a halt and Mr. Ponzi's victims began demanding payment, he could not possibly satisfy all claims. The money eventually ran out, with many claims unpaid.[13] This left Mr. Ponzi with little choice but to seek the protection of bankruptcy, which he did.[14]

III. WHAT IS A PONZI SCHEME?

Ponzi schemes have no exact definition, since they manifest a kaleidoscopic variety of configurations. Thus, "courts look for a general pattern, rather than specific requirements."[15]

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6 *Id.* at 8.

7 Inflation Calculator, DOLLARTIMES, http://www.dollartimes.com/calculators/inflation.htm (last visited May 2, 2014).

8 *Cunningham*, 265 U.S. at 8.

9 *Id.*

10 *Id.*

11 *Id.* at 7-8.

12 *Id.* at 8.

13 *Cunningham*, U.S. 265 at 9.

14 *Id.*

15 *See* Manhattan Inv. Fund, Ltd. v. Gredd (In re Manhattan Inv. Fund, Ltd.), 397 B.R. 1, 12 (S.D.N.Y. 2007) (stating there is no precise ponzi scheme definition). Black's Law Dictionary defines a Ponzi scheme as follows:

> A fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other

A Ponzi scheme is born of deceit.[16] Generally, the operator ensnares investors by falsely claiming to have found an unusually lucrative investment opportunity. Once the operator accumulates enough contributions, he uses those funds to pay handsome "profits" to his earliest investors. This appears to lend credence to his claims and, in turn, beguiles more investors into contributing. Even so, any Ponzi profits are necessarily fictitious; without any substantial, real business activity, the scheme is incapable of generating true value in excess of contributions.[17]

Indeed, as Mr. Ponzi's scheme illustrated, the ultimate downfall of any Ponzi scheme is that it is insolvent *ab initio*, and becomes ever-more so as it persists.[18] Each investor is, of course, promised a percentage return. Additionally, many schemes employ "salesmen" to lure potential victims; these agents are promised a percentage commission on the funds they bring in. Accordingly, for every dollar the scheme takes in, it incurs much more than a dollar of corresponding indebtedness. This forces the operator perpetually to obtain new contributions in order to pay promised investor returns, which perpetually increases the scheme's ratio of liabilities to assets. This cycle continues until the operator can no longer obtain enough "new money" to sustain the promised dividends, at which point the scheme collapses.[19]

The following excerpt from the Journal of Financial Planning

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than the continual [deposit] of new funds.

BLACK'S LAW DICTIONARY 1278 (9th ed. 2009).

[16] This undercuts the contention that the Social Security system is a Ponzi scheme. It is true that the Social Security system uses funds acquired from later "investors" in order to pay earlier "investors," but the Social Security Administration and the United States Treasury do not deceive anyone with an eye towards inducing them to pay into the system. Accordingly, it is a misnomer to refer to the Social Security system as a "Ponzi scheme." *Compare* Surendranath R. Jory & Mark J. Perry, *Ponzi Schemes: A Critical Analysis*, J. FIN. PLAN. (July 24, 2011), http://www.onefpa.org/journal/Pages/Ponzi%20Schemes%20A%20Critical%20Analysis.aspx (calling various Ponzi-like government means of fundraising without deception "rational Ponzi scheme[s]").

[17] *See, e.g.*, *Cunningham*, 265 U.S. at 7-8. *See also Manhattan*, 397 B.R. at 12; Jory & Perry, *supra* note 16.

[18] *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent Transfers*, 72 AM. BANKR. L.J. 157, 170-73 (1998) (noting that this is the "only reasonable inference" where the scheme has "little or no legitimate business operations" aside from operating the Ponzi scheme itself); Jory & Perry, *supra* note 16.

[19] *See* Jory & Perry, *supra* note 16. The foregoing discussion of Charles Ponzi's scheme also provides a good example of this phenomenon. As discussed, he incurred at least $1.60 of debt and expense for every $1.00 his scheme brought in.

is informative:

> A Ponzi scheme is structured as a pyramid wherein more money is needed in each round to make payments to existing participants. For example, a Ponzi perpetrator approaches an investor for a one-year investment that pays a return of 20 percent. The investor invests $100,000, expecting $120,000 in a year. At the end of the year the Ponzi perpetrator approaches another investor, promising the same results, but demanding an initial investment of $120,000 this time. Assuming that the second investor accepts the proposal, the perpetrator takes the money and pays off the first investor. The cycle continues the third year (funds needed are now $144,000), the fourth year (funds needed are now $172,800), and so on. The *initial* reward for running a Ponzi scheme is huge. In the example above, the Ponzi perpetrator pockets the initial $100,000.
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> Ponzi schemes are doomed because their funding requirements increase geometrically over time (as the above example illustrates) . . . . [T]he scheme relies on an infinite supply of capital. However, this is obviously not possible, and that is one reason Ponzi schemes eventually fail.[20]

IV. WHAT MOTIVATES REASONABLY INTELLIGENT PEOPLE TO INVEST IN PONZI SCHEMES?

A man is incapable of comprehending any argument that interferes with his revenue. – Renee Descartes

Ponzi victims run the gamut, from ordinary citizens to sophisticated, intelligent financial professionals. One criticism they commonly face is that they "should have known better."[21] The returns were so high, and they came so fast, that the victims should have

[20] *Id.*

[21] Saul Levmore, *Rethinking Ponzi-Scheme Remedies In And Out of Bankruptcy*, 92 B.U. L. REV. 969, 982 (2012).

known the scheme was "too good to be true."[22] The Fourth Circuit was quite blunt in one case, referring to a certain group of Ponzi victims "as stupid victims of a transparent fraud."[23]

However, human beings are complex creatures, so there are complex motivations for what people do. Accordingly, we think it appropriate briefly to survey some of the most common reasons why people choose to invest in Ponzi schemes.

Since before the time of Charles Ponzi, the primary inducement for people to invest in Ponzi schemes has surely been that the "operator promises high financial returns . . . that are not available through traditional investments."[24] The operator typically represents that such returns are possible "because of [his] unique skills and investment strategy."[25] For instance, Bernard Madoff attributed his consistently high "profits" to his proprietary "split strike conversion" trading strategy.[26] The strategy seems to have been a smokescreen, designed to hide what was little more than the crafty shifting of funds from one investor to another.[27]

Nevertheless, the question remains: Why do people believe the operator's lies?

First, many people believe the operator, because he initially delivers on his promises by using later contributions to pay very large returns to the initial investors.[28] Others perceive this, and therefore find it plausible that the Ponzi operator can (and will) produce similar results for them.[29] This, in turn, seduces them to invest.[30]

In this regard, perhaps it is helpful to note the observations of one who actually invested in a series of Ponzi schemes executed in

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22 *Id.* at 979.

23 In re Young v. Eby, 294 F. 1, 4 (4th Cir. 1923).

24 Jory & Perry, *supra* note 16 (quoting FBI, *Common Fraud Schemes*, http://www.fbi.gov/majcases/fraud/fraudschemes.htm (last visited May 2, 2014)).

25 *Id.*

26 Denis Colins, *Case Study: Bernie Madoff's Ponzi Scheme: Reliable Returns from a Trustworthy Financial Adviser*, *in Business Ethics: How to Design and Manage Ethical Organizations*, 435, 438 (John Wiley & Sons, 2006), *available at* http://dcollins.faculty.edgewood.edu/pdfdocuments/Madoff%20Case.pdf.

27 *Id*. at 439.

28 *Id*.

29 *Id*. at 440.

30 *See* R. Alexander Pilmer & Mark T. Cramer, *Swindler's List*, 32-JUN L.A. Law. 22, 23 (June 2009) ("The initial investors usually receive the promised returns, which attracts additional investors"); *see also* Jory & Perry, *supra* note 16 (noting the success often experienced by initial investors).

the country of Jamaica. He writes, "[t]he fact that people I knew were investing in the [Ponzi] schemes and were, to my certain knowledge, making good money from them, carried a lot of weight with me."[31]

Furthermore, this investor claims to have been promised returns of around 10% per *month*—a ludicrously high rate. Realizing that some would argue he "should have known better," he responds as follows:

> *How the heck should I know 10% a month is unreasonable?* I'm not a banker . . . [a]nd I'm not Warren Buffett either. I have a vague notion that my savings account pays a yearly interest rate somewhere in the single digits. If you offer me 10% *a month* I'm gonna take it, and I would've taken 25% a month too. I only took what the regular financial institutions offered because I figured I couldn't do any better.[32]

Second, once people see their peers "making good money" from the schemes, an irrational optimism about the scheme often sets in. This phenomenon causes otherwise rational people to disregard even sensible and persuasive arguments against the scheme. Professor Richard Taffler addresses this conflict—between irrational optimism about the scheme on the one hand, and rational evaluation of it on the other—as follows:

> [The emerging field of] [e]motional finance teaches that we often deal with this conflict by avoiding what we don't want to know – we repress these feelings – they become unconscious . . . . There's a conflict between the outcomes and returns we wish for and cold, hard, reality . . . .[33]

Furthermore, as Anne Kates Smith notes,

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[31] Skulduggery, *Investing in Ponzi Schemes (or "Why Investing in a Ponzi Scheme Made Perfect Sense at the Time")*, THINGS JAMAICANS LOVE (Feb. 16, 2010, 5:45 PM), http://www.thingsjamaicanslove.com/the_full_list/investing_in_ponzi_schemes_or_why_investing_in_a_ponzi_scheme_made_perfect_sense_at_the_time.html.

[32] *Id.*

[33] Penelope Jenkins, *Why Investors Fall for Ponzi Schemes*, U. WARWICK (Feb. 17, 2014), http://www2.warwick.ac.uk/knowledge/business/ponzischemes/ (internal quotation marks omitted) (summarizing and quoting the inaugural lecture of Professor Richard Taffler, professor of business and finance at the University of Warwick. A recording of the lecture is available on the website at the foregoing URL).

> [m]ost of us have a general bias toward optimism. "Nobody thinks anything bad is going to happen. Otherwise, you'd never leave home in a world full of crime, germs and teenage drivers," says [Pat] Huddleston [SEC trial counsel and fraud expert]. A *congruence bias* prevents us from seeking evidence that conflicts with our [favorable] impressions [of the Ponzi scheme], and leads us to discount such evidence if it's presented. So even if you set out to investigate an investment proposition, your unconscious goal may be to prove it legitimate.[34]

Let us again draw insight from our Jamaican Ponzi investor, who experienced this baffling mentality:

> The warnings were getting louder. The regulators were naming names and placing full-page ads about the schemes in the newspapers. . . . Traditional financial institutions were screaming bloody murder. I, on the other hand, chalked it all up to [among other things] a "conspiracy to hold down poor people." I was baffled by all the negativity and pessimism directed at the schemes. . . . Some people were seeing clouds gathering on the horizon and were getting nervous. Not me. No sir, I was giving it another six months. I figured that in six months I would have earned enough to pay off my credit card bills and buy that Honda. . . . As it turns out, I overestimated the longevity of the scheme by about . . . six months.[35]

Here, we see the profound truth of the Descartes quote above: Having seen others making "good money" from Ponzi schemes, people become "incapable of comprehending any argument that interferes with" their optimism about the schemes' positive impact on their "revenue."[36]

Third, Ponzi investors are often beguiled by the personality and reputation of the con man. Once people believe in the con man

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[34] Anne Kates Smith, *The Lure of Ponzi Schemes*, KIPLINGER'S PERS. FIN. (Mar. 2013), *available at* http://www.kiplinger.com/article/investing/T031-C023-S002-lure-of-ponzi-schemes.html.

[35] *See* Skulduggery, *supra* note 31.

[36] Colins, *supra* note 26, at 435.

personally, they tend, in turn, to believe in his scheme.[37] Bernard Madoff is a prime example.

> [P]eople were drawn in by [his] personality. He was quiet yet charismatic and did not boast about his financial success. [Madoff] exhibited a strong sense of family, loyalty, and honesty, and did not drink alcohol. Elderly clients treated [Madoff] as a son, peers treated him like a brother, and younger clients treated him like a friendly uncle.[38]

Mr. Madoff's reputation made it all the easier for his investors to believe in him. Indeed,

> [i]nvestors are drawn to successful fund managers trusted by others. [Madoff] had a long track record of successful investing, and was at the forefront of the computerization of stock trading. He served on SEC advisory committees, held a four-year elected term on the NASD Adviser Council, and was elected as non-executive chairman of NASDAQ.[39]

Additionally, many "Ponzi [operators] are known to be generous donors and regularly contribute to charities, educational institutions, and political campaigns."[40] This fosters a "good guy" image, which in turn leads people to trust the operator.[41] Relatedly,

> [m]any Ponzi operators target specific religious or ethnic groups. . . . They exploit the built-in trust of these . . . affinity groups to establish their credibility, to identify potential investors, and to promote their schemes. . . . Ponzi himself targeted his fellow Italian immigrants. More recently, Madoff preyed on members of the Jewish community, including numerous

[37] *Cf.* Jory & Perry, *supra* note 16 ("To be able to sell a false idea of consistently high returns, it is likely that Ponzi perpetrators are charismatic salespeople, persuasive and good at successfully closing a sales pitch," and that "they exploit the trust between them and the people they know.").

[38] Colins, *supra* note 26, at 440.

[39] *Id.* (enhancing Mr. Madoff's credibility was the fact that he "owned a successful and legitimate brokerage firm" apart from the Ponzi scheme, which he used to "shield his fraudulent activities.").

[40] Jory & Perry, *supra* note 16.

[41] *Id.*

Jewish charities.[42]

Fourth, one of the hallmarks of a typical Ponzi scheme is that investors are lured in by the promise of returns that are higher and/or more consistent than what the market can typically offer. However, the truly elite Ponzi schemers of today are much more subtle than was Mr. Ponzi, who promised an over-the-moon 50% return within ninety days of any investment. The slickest of the modern Ponzi schemers tend to offer returns that, while certainly better than what investors could expect elsewhere, are still low enough to maintain a whiff of plausibility, and thus deter suspicion.

As Anne Kates Smith observes, in the modern era of Ponzi schemes,

> [K]nowing better isn't easy. Ponzi operations are typically light-years more sophisticated than the Nigerian money-transfer scams caught by your e-mail spam filter. As fraud expert and SEC trial counsel Pat Huddleston is fond of saying, "If it sounds too good to be true, you're dealing with an amateur." Madoff and his ilk don't promise the moon; the returns they offer, albeit fictitious, are plausible.[43]

High (but still plausible) returns, consistently delivered over a period of time, are generally much more consistent with the expectations of investors and are therefore much less likely to raise red flags, as compared to the otherworldly returns that Mr. Ponzi offered.[44] Accordingly, the smartest of the modern Ponzi operators have made their schemes more difficult to weed out.

Fifth, modern Ponzi operators have become adept at lending their operations the appearance of professional legitimacy, which in turn makes the schemes harder to spot. Again, we glean insight from our Jamaican Ponzi investor:

> *[t]he schemes looked legit:* Some schemes sent monthly statements. Others allowed investors to check their statements on-line. One or two of them even had . . . nicely appointed offices with attractive staff members falling over themselves to do your bid-

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[42] Pilmer & Cramer, *supra* note 30, at 24.
[43] Smith, *supra* note 34.
[44] *Id.*

> ding. In other words, the schemes ran what seemed like legitimate, professional operations.[45]

Mr. Madoff, for instance, rented extravagant offices in one of the more expensive buildings in New York City, replete with teams of busy underlings.[46] Additionally, a sophisticated computer program enabled him to create very professional-looking account statements—but the statements were phony.[47] They purported to account for investor dividends by documenting potentially hundreds of securities transactions, most of which never took place.[48] Through these and other tactics, Mr. Madoff was able to make his enterprise seem like a real top-flight business, rather than the fraud that it was.

Sixth, the best Ponzi schemers are generally able to exploit their victims' natural yearning for social status. Counterintuitive though it may seem, oftentimes a Ponzi schemer may deliberately play "hard to get," and he may even turn some potential investors away.[49] This creates the impression that those afforded the "privilege" of investing with the schemes are members of an "exclusive club."[50] We all want to be members of exclusive clubs. Indeed,"our craving for social status explains why, when Ponzi perpetrators try to turn would-be investors away, [the investors] fight all the harder to get in on the 'exclusive' opportunity. Sophistication is no defense: Educated investors are often too confident in their own capacity to evaluate a deal."[51]

Mr. Madoff exploited this phenomenon masterfully. As Professor Colins observes,

> [Madoff] played hard to get. When approached by potential investors, [Madoff] typically told them his investment fund was closed, having reached its peak capacity. Then he'd re-contact them and offer a huge favor by reopening the fund just for them. [Accordingly], having [Madoff] manage their money became a

45 Skulduggery, *supra* note 31.
46 *See* Colins, *supra* note 26, at 441-42.
47 *Id.* at 442.
48 *Id.* at 440.
49 *Id.*
50 *See, e.g.*, Smith, *supra* note 34.
51 *Id.*

status symbol.[52]

Consequently, the Ponzi operator who can impart an air of exclusivity to his scheme can lure many status-hungry investors who may otherwise (wisely) refrain from contributing.

V. WHAT HAPPENS AFTER THE DOWNFALL OF A PONZI SCHEME, WITHOUT A SYSTEM OF ORDERLY LIQUIDATION, SUCH AS BANKRUPTCY?

Three great problems typically accompany the downfall of any Ponzi scheme. The first (and worst) is the fact that many Ponzi victims can never be made truly whole, no matter what remedies the law provides. Due to the inherent insolvency of the scheme, the value of the assets available for distribution can never equal the victims' legitimate claims.[53] The other two problems manifest most acutely without a system of orderly liquidation such as bankruptcy. They are: (1) the race to the bank; and (2) the race to the courthouse.

The race to the bank is a phenomenon typically seen near the end of a Ponzi scheme when the fraud begins to come to light. Here (as happened in Charles Ponzi's case), investors rush to the bank (or wherever they get their payouts from the scheme) in order to withdraw their investments before the entire operation falls apart.[54] The investors who arrive first stand to receive substantial payments, while those who arrive later often wind up with nothing.[55]

Disappointed at the "bank," this latter group may "race to the courthouse" to file lawsuits against the Ponzi scheme, its operators, and even one another, all in an effort to recoup whatever they can out of whatever is left after the race to the bank.[56] Again, here some investors may enjoy meaningful recovery, while some will be left with nothing. [57]

Much inequity results from the races to the bank and courthouse. The Ponzi victims trying to exercise their own, independent remedies are all situated in the same equitable position vis-à-vis the

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52 *See* Colins, *supra* note 26, at 440.

53 Lustig v. Weisz & Assoc., Inc. (In re Unified Commercial Capital, Inc.), 260 B.R. 343, 349 (Bankr. W.D.N.Y. 2001) (citation omitted).

54 *Cunningham*, 265 U.S. at 10-11.

55 *Id.* at 11.

56 Andrew Kull, *Common-Law Restitution and the Madoff Liquidation*, 92 B.U. L. REV. 939, 960 (2012).

57 *Cunningham*, 265 U.S. at 11.

scheme, its assets, and each other.[58] Accordingly, and for reasons explored in more detail, it is an affront to equity for one Ponzi victim to recover a higher percentage of her investment than any other investor.[59] Relatedly, the fact that the Ponzi victims who participate in the race to the courthouse are asserting the same rights to the same limited pool of assets threatens to breed duplicative and wasteful litigation; this may consume large sums that could otherwise be distributed to the victims.[60]

Accordingly, without some means to halt the races to the bank and courthouse, and without some system of orderly liquidation and distribution to claimants, Ponzi victims are essentially left to a feeding frenzy, which stands to generate much inequity and disappointment, while doing little that will actually make the victims of the scheme whole. A chapter 7 liquidation under the U.S. Bankruptcy Code offers an effective means to address these problems.

VI. CHAPTER 7 OF THE U.S. BANKRUPTCY CODE

At the commencement of a bankruptcy case, an "estate" is created, which is generally comprised of "all legal [and] equitable interests of the debtor in property as of the commencement of the case . . . wherever located and by whomever held."[61] In a chapter 7 liquidation, the fiduciary in charge of the estate is not the debtor or its principals, but rather an independent "trustee in bankruptcy," usually appointed by the Office of the United States Trustee.[62] The goal of the chapter 7 trustee is not to save the debtor's business (if any), but rather to marshal the assets of the estate and liquidate them expeditiously for the benefit of creditors (including Ponzi victims).[63] An immediate advantage here is that those who ran the scheme pre-bankruptcy are divested of control. This offers comfort to Ponzi victims that the "foxes" who looted the "henhouse" have been displaced

[58] *See* Kull, *supra* note 56, at 953.

[59] *Id.* at 954.

[60] *Id.* at 960. This brings to mind Charles Dickens' classic novel, *Bleak House,* wherein an entire testamentary estate was consumed by the cost of litigating over it in the English Courts of Chancery, leaving nothing for the rightful beneficiaries. CHARLES DICKENS, BLEAK HOUSE (Norman Page ed., Penguin Books 1971) (1853), *available at* http://www.worldwideschool.org/library/books/lit/charlesdickens/BleakHouse/chap1.html.

[61] 11 U.S.C. § 541(a) (2010). There are exceptions to this, set forth largely in 11 U.S.C. §§ 522, 541(b) (2010).

[62] 11 U.S.C. §§ 701, 702, 703, 704 (2010).

[63] 11 U.S.C. § 704.

by a disinterested fiduciary acting under the supervision of the Bankruptcy Court.

Otherwise, perhaps the most effective solution that the Bankruptcy Code offers to the problems posed by the races to the bank and the courthouse is the "automatic stay" of 11 U.S.C. § 362(a), as supplemented by the equitable powers of the Bankruptcy Court under 11 U.S.C. § 105(a).[64] The automatic stay generally bars any act against the debtor to collect upon any claim that came into being prior to the filing of the bankruptcy petition.[65] Obviously, for a Ponzi investor to withdraw his or her pre-bankruptcy investment in the debtor is an "act to collect" upon a pre-bankruptcy claim, since the investor is attempting to satisfy a pre-bankruptcy right to payment.[66] Therefore, such actions come within the scope of the automatic stay. Accordingly, once the bankruptcy commences, Ponzi victims are forbidden by law from attempting to withdraw their investments in the debtor. This stops the "race to the bank" dead in its tracks.

The automatic stay also stops the "race to the courthouse." First, 11 U.S.C. § 362(a)(1) prohibits the "continuation or commencement" of most kinds of lawsuits that were or could have been commenced against the debtor pre-petition.[67] Accordingly, Ponzi investors who come up short after the "race to the bank" are forbidden by law from suing the debtor directly.

However, the automatic stay would not seem to prohibit defrauded investors from suing one another, as well as any affiliates or insiders of the debtor (such as the principals of an artificial entity used to run a Ponzi scheme), as by its terms it only applies to actions and proceedings against the debtor.[68] This is important, because outside of bankruptcy, Ponzi victims would in many cases possess equitable rights of action against *each other*, in restitution and unjust enrichment, as well as claims against the insiders and affiliates of the debtor.[69]

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[64] 11 U.S.C. § 362(a) (2010); *see also* 11 U.S.C. §105(a) (2010).

[65] 11 U.S.C. § 362(a)(1-8). There are limitations on the scope of the automatic stay, set forth in other subsections of 11 U.S.C. § 362, most notably subsections (b) and (d). *Id.*

[66] *Compare* 11 U.S.C. § 362(a)(6) (providing an "act to collect" operates as a stay), *with* 11 U.S.C. § 101(5) (2010) (defining "claim" as, among other things, "any right to payment").

[67] 11 U.S.C. §362(a)(1).

[68] 3 COLLIER ON BANKRUPTCY ¶ 362.03 (Alan N. Resnick & Henry J. Somme eds., 16th ed. 2013) [hereinafter COLLIER].

[69] For an excellent discussion of this topic, see Kull, *supra* note 56.

The reason Ponzi victims may have claims against one another is that, under basic principles of restitution, where the cash contributions of defrauded Ponzi investors have been un-traceably commingled into one fund (as is the usual case), no one investor has any entitlement to any specific portion of the fund. Rather, "[t]he recovery belongs to the victims jointly, in proportion to their losses."[70] Accordingly, given the inevitably limited assets available for distribution to Ponzi victims, each victim who recovers more than his/her *pro rata* share from the Ponzi fund is unjustly enriched at the expense of others who got less.[71] This, in turn, gives rise to an equitable claim in restitution in favor of all victims who got less than their *pro rata* share of the available assets, and against each similarly-situated victim who received more.

Relatedly, it goes without saying that, very often, Ponzi investors have rights of action in law and equity against the affiliates, officers, directors, and management of entities that were used to perpetuate Ponzi schemes.[72]

If the Bankruptcy Court were not empowered to stop Ponzi victims from suing one another, as well as insiders and affiliates of the debtor, then many Ponzi bankruptcies would be impossible to administer. These ancillary lawsuits would necessarily impede the trustee as she seeks to marshal estate property for distribution, since the trustee and the victims would be competing for the same limited pool of assets—while compounding everyone's misery and loss through duplicative, wasteful litigation. The resulting confusion would render the trustee unable to act effectively for the benefit of victims and creditors at large.[73]

Fortunately, 11 U.S.C. § 105(a) permits the Bankruptcy Court to enjoin these ancillary lawsuits if they bear a close enough nexus with the bankruptcy case.[74] Once this is done, the trustee is empow-

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[70] *Id.* at 953 (citing RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 59(4) (2011)).

[71] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 59(4) (2011); *see also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 cmt. f (2011) (explaining that, under the law of restitution, Ponzi investors may generally keep dividends that represent a return of principal, but no profits).

[72] COLLIER, *supra* note 68, ¶ 362.03.

[73] *See* Kull, *supra* note 56, at 960 ("[I]t is essential that the victims' restitution claims be aggregated and prosecuted together.").

[74] 11 U.S.C. §105(a); *see also* Secs. Investor Protection Corp. v. Bernard L. Madoff Inv. Secs. (In re Madoff), 443 B.R. 295, 315 (Bankr. S.D.N.Y. 2011).

ered, on behalf of the general body of claimants, to assert claims against both the former operators of the scheme and the Ponzi investors who got more than their *pro rata* share.[75] Proceeds of these lawsuits are then absorbed into the estate for ratable distribution.[76]

In light of all this, we see how that the automatic stay, supplemented by the powers of the Bankruptcy Court under 11 U.S.C. § 105(a), may serve to halt the races to the bank and the courthouse, and thereby preserve the assets of the estate for the benefit of Ponzi victims.

VII. THE ADVERSARIAL PROCESS: TRUSTEE V. DEFRAUDED INVESTOR

However, the automatic stay and the Bankruptcy Court's injunctive powers are largely proactive solutions that can only go so far; although highly effective in terms of stopping any ongoing damage resulting from the races to the bank and the courthouse, they often cannot reach back in time and undo whatever damage had already been done. This is where the Trustee comes in. The trustee's job is to recapture excess returns paid out to some Ponzi investors, for ratable distribution to all, so long as those funds would have been estate property if not paid out.[77] As most Ponzi investors are reluctant to disgorge any part of their returns, litigation ensues, pitting the trustee against many of the people for whose benefit s/he is charged to act.

This adversarial process is rife with pitfalls, both for the trustee on the one side, and the investors on the other. The Bankruptcy Code gives the trustee an arsenal of avoidance actions that s/he can use to force Ponzi investors to disgorge excess returns. This article discusses two: preference actions under 11 U.S.C. § 547[78] and fraudulent transfer actions under 11 U.S.C. § 548.[79] Nevertheless, the Bankruptcy Code also gives investors many defenses, which may enable them to keep some portion of their returns from the Ponzi

[75] Kull, *supra* note 56, at 958.

[76] Fisher v. Apostolou, 155 F.3d 876, 880, 883 (7th Cir.1998); *see also In re Madoff*, 443 B.R. at 311; Kull, *supra* note 56, at 967 n.46; *see also Fisher*, 155 F.3d at 879 (providing that the Trustee is not empowered to assert claims arising out of particularized injuries suffered by individual claimants, or claims belonging to a specific creditor and not to the body of defrauded victims as a whole).

[77] *See* Kull, *supra* note 56, at 958.

[78] 11 U.S.C. § 547 (2010).

[79] 11 U.S.C. § 548 (2005).

scheme.

(1). *Preference Actions*

11 U.S.C. § 547(b) sets forth the basic elements of the trustee's *prima facie* case for avoidance of a "preference." It provides as follows:

> [With certain exceptions], the trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[80]

It is worth nothing that the preference statute is basically indifferent to whether payments to the Ponzi investor represent a return of principal or a net gain, and to factors like "good faith" or "reasonably equivalent value." Accordingly, barring some defenses, the trustee can usually recover every penny an investor received from the scheme during the preference period.[81]

The first requirement of a preferential transfer is that the

[80] 11 U.S.C. § 547(b).

[81] *See* McDermott, *supra* note 18, at 181 ("The potential advantage of a preference action is that it allows the trustee to recover the return of an investor's principal, even though the investor made the investment in both subjective and objective good faith (and thus would have a defense to any fraudulent conveyance action).").

transfer be "of an interest of the debtor in property."[82] Some have argued that the funds that a Ponzi debtor raised by defrauding investors were never the debtor's property in the first place.[83] They contend that, because the debtor obtained the funds by fraud, the debtor is unjustly enriched at the expense of the victims.[84] Therefore, the debtor held the funds in trust for the benefit of the victims.[85] A similar argument is that the Ponzi debtor obtained the funds by "theft," and therefore had no real "title" to the funds.[86] Accordingly, any payments from a Ponzi debtor to its investors cannot constitute a transfer of an interest of the debtor in property because the debtor never had any legal interest in the funds.[87]

Courts consistently reject such arguments. First, a constructive trust is a remedy without effect until a court decrees it, so it conveys no equitable ownership in anything until then.[88] Second, it is true that one who obtains property through outright *larceny* has no title.[89] However, one who convinces someone to turn property over to him *voluntarily*, albeit through fraud, has an "interest" in that property, if only a "possessory interest," or "voidable title."[90] Hence, a transfer of funds from the Ponzi debtor to its investors is one of "an interest of the debtor in property."[91]

The next requirement is that the transfer must have been "to or for the benefit of a creditor."[92] Each defrauded Ponzi investor who *loses* money is a "creditor" for purposes of the preference statute.[93] Under principles of restitution, the Ponzi investor acquires an inchoate claim for unjust enrichment against the Ponzi debtor to the extent of her "net loss"—that is, to the extent her aggregate investment exceeds her ultimate recovery.[94] This is because the debtor is unjustly

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[82] 11 U.S.C. § 547(b).

[83] *See* McDermott, *supra* note 18, at 161.

[84] *Id.* at 161-62.

[85] *Id.* at 162.

[86] *Id.* at 161.

[87] *See, e.g.*, Jobin v. Lalan (In re M&L Bus. Mach. Co., Inc.), 160 B.R. 851, 857 (Bankr. D. Colo. 1993); *see also* Kull, *supra* note 56; McDermott, *supra* note 18, at 161.

[88] *See* McDermott, *supra* note 18, at 161-62.

[89] *See* Irving Trust Co. v. Leff, 171 N.E. 569, 571 (N.Y. 1930).

[90] Phelps v. McQuade, 115 N.E. 441, 441-42 (N.Y. 1917).

[91] *See* Jobin, 160 B.R. at 857; *accord* McDermott, *supra* note 18, at 162-63.

[92] 11 U.S.C. § 547(b)(1).

[93] *See* McDermott, *supra* note 18, at 182.

[94] *See, e.g.*, RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67(1)(c) cmt. f (2011); McDermott, *supra* note 18, at 168.

enriched to the extent it obtains funds through fraud.[95] (Of course, a transfer of funds from the scheme to the investor is obviously "to" the investor, or for his/her "benefit.") However, for reasons we will discuss more fully *infra*, a Ponzi investor's legitimate claim against the Ponzi debtor in restitution lies only to the extent of her "net loss." Accordingly, some courts have held that the trustee may only use the preference statute to recapture returns of principal, and may not use it to recapture "net profits" that investors obtain from the scheme.[96]

Next, the transfer must have been "for or on account of an antecedent debt."[97] A debt is "antecedent" to the transfer when it arises prior to the transfer.[98] A Ponzi investor's inchoate claim for restitution against the Ponzi debtor arises at the moment the investor contributes.[99] Accordingly, any subsequent payments to the investor are made on account of antecedent debt.[100]

Next, the debtor must have been "insolvent" at the time of the transfer.[101] The preference statute itself rebuttably presumes that the debtor was insolvent within ninety days before the filing of the bankruptcy petition.[102] Moreover, for purposes of the preference statute, "insolvency" is generally measured by the extent to which the debtor's liabilities exceed a fair valuation of its assets (except for, *inter*

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[95] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 (with comments) (2011); *see also* McDermott, *supra* note 18, at 182-83; 11 U.S.C. §§ 101(5), 101(10) (defining "claim" and "creditor"). Depending on the nature of the arrangement between the investor and the Ponzi debtor, this general proposition might not hold true in every case. *See* McDermott, *supra* note 18, at 182 n.108.

[96] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 (with comments) (2011); *see also* McDermott, *supra* note 18, at 182, 183 (citing Wootton v. Barge (In re Ronald Cohen), 875 F.2d 508, 510 (5th Cir. 1989)). Thus, for example, suppose Investor contributes $100,000 to Ponzi. Before Ponzi's bankruptcy, Investor withdraws his $100,000 of principal, plus an additional $10,000 of fictitious profits, all within the preference period. Under the reasoning of *Wootton*, only $100,000 principal could be recaptured by the trustee under the preference statute, since Investor's inchoate claim in restitution against Ponzi only extends to his $100,000 principal investment. The trustee would have to resort to another provision of the Bankruptcy Code—such as the fraudulent transfer provisions of 11 U.S.C. §§ 544 and 548—in order to recapture the remaining $10,000.

[97] 11 U.S.C. § 547(b)(2).

[98] *Id.*; Southmark Corp. v. Schulte, Roth, & Zabel (In re Southmark Corp.), 88 F.3d 311, 316 (5th Cir. 1996).

[99] *See* McDermott, *supra* note 18, at 182.

[100] *See* Danning v. Bozek (In re Bullion Reserve of N. Am.), 836 F.2d 1214, 1219 (9th Cir. 1988).

[101] 11 U.S.C. § 547(b)(3).

[102] 11 U.S.C. § 547(f); Official Comm. of Unsecured Creditors of R.M.L., Inc. v. Sabrina (In re R.M.L., Inc.), 195 B.R. 602, 611 (Bankr. M.D. Pa. 1996).

alia, "property transferred, concealed, or removed with intent to hinder, delay, or defraud . . . creditors," which is also presumed in Ponzi cases).[103] Recall that, the more money a Ponzi scheme raises from defrauded investors, the more its liabilities exceed the value of its assets. Accordingly, most courts presume that a Ponzi scheme is insolvent from its very inception, leaving the preference defendant to prove otherwise.[104]

The next element of a preference action is that the preferential transfer must have taken place within a very specific period of time.[105] Generally, that period is ninety days before the filing of the bankruptcy petition.[106] However, where the transfer was to an "insider" of the debtor, the reach-back period extends to one year pre-petition.[107] This temporal limitation often dramatically reduces the effectiveness of the preference statute as a means for the trustee to recover payments made to Ponzi investors because many Ponzi schemes have existed for years by the time they get to Bankruptcy Court and most investors with such schemes are not insiders.[108]

Lastly, the trustee must establish that the Ponzi "investor received more than he would have received as an unsecured creditor in a [chapter 7] liquidation of the debtor's estate."[109] Because the assets available for distribution in the typical Ponzi case virtually never equal the claims of defrauded investors, this element is usually fairly easy to meet.[110]

Though 11 U.S.C. § 547 outlines several preference-specific defenses available, Ponzi investors typically assert three: (1) the "subsequent new value" defense; (2) the "contemporaneous exchange for new value" defense; and, (3) the "ordinary course of business" defense.[111]

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[103] 11 U.S.C. § 101(32)(A)(i). Various state fraudulent transfer laws contain similar definitions of insolvency. *See* McDermott, *supra* note 18, at 171.

[104] *See* McDermott, *supra* note 18, at 171.

[105] 11 U.S.C. § 547(b).

[106] 11 U.S.C. § 547(b)(4)(A).

[107] 11 U.S.C. § 547(b)(4)(B).

[108] Kenneth E. Aaron, *The Bankruptcy Code and Ponzi Schemes: Good Luck, You'll Need It!*, 31 BANKR. CT. DEC. NEWS 1 (Feb. 3, 1998).

[109] McDermott, *supra* note 18, at 183-184; 11 U.S.C. § 547(b)(5).

[110] McDermott, *supra* note 18, at 184 (cautioning, however, that "if the investor received less than his principal investments, then his percentage return must be compared to the estimated percentage return to all creditors in a liquidation.").

[111] 11 U.S.C. § 547(b)(5)(c); *see* McDermott, *supra* note 18, at 184 (explaining that "Ponzi investors usually assert either new value defenses the ordinary course of defense, or

A. The "Subsequent New Value" Defense

The "subsequent new value" defense is found in 11 U.S.C. § 547(c)(4).[112] This defense is basically meant to permit a creditor to retain otherwise avoidable preferential payments to the extent that: (1) *subsequent to* receiving the preference, the creditor gave the debtor "new value"[113] as defined in 11 U.S.C. § 547(a)(2); and (2) the debtor made no unavoidable transfer to the creditor on account of such "new value." The "new value" defense thus permits a creditor to offset subsequent transfers of "new value" to the debtor against prior preferential payments.[114]

Now to illustrate the basic concept with an example that is (admittedly) a great deal simpler than what is likely to be encountered in actual practice:

> **Example:** Investor contributes $100,000 to Ponzi on January 1, 2014. On January 31, 2014, Ponzi returns $50,000 to Investor (a preferential transfer). On February 8, 2014, Investor contributes an additional $30,000 to Ponzi, which meets the definition of "new value" under 11 U.S.C. § 547(a)(2). After Ponzi files for bankruptcy, Trustee sues Investor to recover the $50,000 payment of January 31 as a preference under 11 U.S.C. § 547(b). Here, Trustee's recovery will be limited to $20,000, since the "subsequent new value" defense permits Investor to essentially offset the subsequent $30,000 contribution of "new value" against the prior $50,000 preferential payment, leaving only $20,000 for Trustee to recapture as a preference.[115]

both").

[112] 11 U.S.C. § 547(c)(4) (providing that the trustee may not avoid a preferential transfer: "[T]o or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor").

[113] *See* 11 U.S.C. § 547(a)(2) (stating that, for preference purposes:" '[N]ew value' means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation").

[114] *See* McDermott, *supra* note 18, at 184.

[115] Robert H. Bowmar, *The New Value Exception to the Trustee's Preference Avoidance Power: Getting the Computations Straight*, 69 AM. BANKR. L.J. 65, 70 (1995); *see also* Ger-

> The $100,000 initial investment cannot be used to offset any part of the $50,000 preferential payment, since § 547(c)(4) is clear that only new value provided *subsequent to* a preferential payment may be used to offset the preferential payment.

Many complexities attend the application of the "subsequent new value" defense; one is worth mentioning here. "New value" for purposes of Section 547 only consists of "money or money's worth in goods, services," and other things.[116] Often, rather than making fresh cash contributions to Ponzi schemes, investors will simply "roll over" their fictitious profits into new "investments" in the scheme. Because the "profits" generated by a Ponzi scheme have no real economic substance, some courts refuse to treat the rollover of fictitious profits as the provision of "new value" for purposes of the "subsequent new value" defense.[117] Additionally, 11 U.S.C. § 547(a)(2) expressly provides that "new value . . . does not include an obligation substituted for an existing obligation."[118] One commentator has argued that "new value" credit should not be given for rollovers here because a rollover merely constitutes the substitution of one obligation for another.[119]

B. The "Contemporaneous Exchange for New Value" Defense

The "contemporaneous exchange for new value" defense is provided for in 11 U.S.C. § 547(c)(1), under which the trustee may not avoid an otherwise preferential transfer "to the extent that such transfer was—(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange."[120] The purpose of this defense is to preserve transactions that do not have the net effect of diminishing

ald B. Kirksey, *A Simplified Approach to Preference Calculations—Section 547(c)(4) of the Bankruptcy Reform Act of 1978 and the "At Risk" Rule*, 61 AM. BANKR. L.J. 255, 257-58 (1987) (providing a detailed example).

[116] 11 U.S.C. § 547(a)(2).

[117] *See, e.g.*, Floyd v. Dunson (In re Ramirez Rodriguez), 209 B.R. 424, 432 (Bankr. S.D. Tex. 1997).

[118] 11 U.S.C. § 547(a)(2).

[119] McDermott, *supra* note 18, at 184.

[120] 11 U.S.C. § 547(c)(1).

the estate that will ultimately be available for the benefit of creditors, in that the creditor gave the debtor "new value" in exchange for the otherwise preferential payment.[121]

The first element of the "contemporaneous exchange" defense is subjective—that is, "[t]here must be some manifest desire by the parties that the exchange contemporaneously grant money or money's worth in new credit, goods, services, or property to the debtor."[122] This element has teeth; even if the exchange winds up being substantially contemporaneous through fortuitous happenstance, the defense will not apply unless the parties actually, subjectively *intended* it to be contemporaneous *at the time* of the preferential transfer.[123]

The second element is objective—that is, the exchange must, in fact, have been "substantially contemporaneous," apart from what the parties intended.[124] This determination "requires a case-by-case inquiry into all relevant circumstances (*e.g.*, length of delay, reason for delay, nature of the transaction, intentions of the parties, possible risk of fraud) surrounding an allegedly preferential transfer."[125] The modifier "substantially" makes it clear that the exchange does not need to be *exactly simultaneous*, so there is some room for a slight time interval between the preferential payment and the provision of new value to which it relates.[126]

Lastly, the "contemporaneous exchange" defense only operates to the extent of new value given.[127] A simple example of the operation of this defense follows:

> **Example:** Investor contributes $100,000 to Ponzi on January 1, 2014. On February 2, 2014, Ponzi pays Investor $50,000 in exchange for Investor's late-model luxury SUV. Investor delivers the SUV on February 6. After Ponzi files for bankruptcy, Trustee seeks to

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[121] *See* Anderson-Smith & Assocs., Inc., v. Xyplex, Inc. (In re Anderson-Smith & Assocs., Inc.), 188 B.R. 679, 688 (Bankr. N.D. Ala. 1995).

[122] *See id.* (internal citation and quotation marks omitted).

[123] *See* COLLIER, *supra* note 68, ¶ 547.04.

[124] *See Danning*, 836 F.2d at 1219.

[125] Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 969 F.2d 321, 328 (7th Cir. 1992).

[126] *See id.* (finding that courts have tended to use, as a guideline, the grace period for perfection of security interests found in 11 U.S.C. § 547(e)(2)). That period has varied over time, but is currently 30 days. The Ninth Circuit once held that a delay of 75 days was too long. *See Danning*, 836 F.2d at 1219.

[127] COLLIER, *supra* note 68, ¶ 547.04.

> avoid the $50,000 payment of February 2 as a preference. The evidence at trial shows that the SUV was worth only $35,000 at the time Ponzi purchased it. Investor was aware of this, but he assumed Ponzi would treat the $15,000 surplus as a partial return of Investor's prior $100,000 contribution of January 1. Ponzi did, in fact, so treat the surplus. Under these facts, Trustee may avoid only $15,000 of the $50,000 payment of February 2. The rest corresponds to the value of the SUV given in exchange. The fact that the SUV was delivered within four days of payment suggests that the exchange was intended to be contemporaneous, and was substantially contemporaneous.

C. The "Ordinary Course of Business" Defense

Another defense that Ponzi investors commonly invoke is the "ordinary course of business" defense, set forth in 11 U.S.C. § 547(c)(2), which provides that the trustee may not avoid an otherwise preferential transfer:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> > (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
> >
> > (B) made according to ordinary business terms.[128]

Thorough treatment of § 547(c)(2) is well beyond the scope of this article. It will suffice for us to note that many courts have held flatly that a defrauded Ponzi investor simply cannot (as a matter of law) use this defense to shield Ponzi returns from a trustee's preference powers.[129] The reasoning is that such payments are made in furtherance of a Ponzi scheme, which generally has no *legitimate* busi-

[128] 11 U.S.C. § 547(c)(2).

[129] *See* Sender v. Heggland Family Trust (In re Hedged-Invs. Assocs., Inc.), 48 F.3d 470, 475 (10th Cir. 1995) (listing several cases determining that this defense "does not apply in the context of a Ponzi scheme").

ness in the "ordinary course" of which the debt could have been incurred, or the payments made.[130] Some also reason that no "ordinary business" ever pays out fictitious profits, as a Ponzi scheme does, so payments by a Ponzi scheme to its investors cannot be "made according to ordinary business terms."[131]

VIII. FRAUDULENT TRANSFER CLAIMS UNDER 11 U.S.C. § 548

11 U.S.C. § 548(a)(1) contains the heart of the trustee's bankruptcy-specific fraudulent-transfer avoidance powers.

(1) *Transfers Made with Actual Fraudulent Intent*

Under 11 U.S.C. § 548(a)(1)(A), if the Ponzi debtor transferred any property to a Ponzi investor within two years pre-bankruptcy, and if it did so with "actual intent to hinder, delay, or defraud any present or future creditor," then the transfer is avoidable whether it represents a return of principal or "fictitious profits," subject to any applicable defenses.[132] Moreover, the state of mind of the investor receiving the payment is irrelevant.[133] All that matters is whether the *debtor* (or its agents) possessed the requisite fraudulent intent at the time of the transfer.[134]

The trustee's burden of proving fraudulent intent, in the context of a Ponzi debtor, is eased by the so-called "Ponzi scheme presumption." As *Collier on Bankruptcy* notes,

> most courts hold that "[p]roof of a Ponzi scheme is sufficient to establish the Ponzi operator's actual intent to hinder, delay or defraud creditors for purposes of actually fraudulent transfers under Bankruptcy Code § 548(a)(1)." Some courts go further and under some cir-

[130] *See* McDermott, *supra* note 18, at 186. Some courts have applied this blanket prohibition not only to defrauded investors seeking to shield their returns from the scheme, but also to *non-investor* creditors, like trade vendors and utility providers. Other courts apply it only to defrauded investors seeking to shield returns. *See id.*

[131] *See, e.g.*, *Sender*, 48 F.3d at 476 (internal citation and quotation marks omitted).

[132] *See* COLLIER, *supra* note 68, ¶ 548.04[1] (internal citation and quotation marks omitted). We discussed the issues of whether the transfer was one of "an interest in property of the debtor" earlier, in connection with preference actions.

[133] COLLIER, *supra* note 68, ¶ 548.04[2].

[134] *Id.*

cumstances make the presumption irrebutable [sic].[135]

Many courts require that the payment be made " 'in furtherance' of the Ponzi scheme" in order for the presumption to apply.[136] Virtually every payment from a Ponzi scheme to its investors, relating to their investment, will have been made "in furtherance of" the scheme. Remember that, if the Ponzi debtor did not pay handsome returns to early investors, then it could hardly attract the *new* investors it needs to keep the scam afloat. Accordingly, any such payment is made "in furtherance of" the scheme. [137]

(2). *Constructively Fraudulent Transfers*.

11 U.S.C. § 548(a)(1)(B) permits the trustee to avoid the transfer of any interest of the debtor in property to the extent that (1) the debtor did not receive "reasonably equivalent value in exchange," and (2) at least one of four additional factors is present.[138] Of these four, the most important factor, for our purposes, is that the debtor was insolvent at the time of the transfer.[139] Transfers under § 548(a)(1)(B) are typically referred to as "constructively fraudulent transfers."[140]

For purposes of § 548, " 'value' means property, or satisfaction . . . of a present or antecedent debt of the debtor."[141] Accordingly, the trustee may not avoid a transfer, as constructively fraudulent, to the extent that the debtor received satisfaction of a present or antecedent debt in exchange. This rule raises some interesting issues in Ponzi cases.

Recall that every defrauded investor in a Ponzi scheme has a claim in restitution against the scheme to the extent of his or her "net loss" (aggregate investment minus aggregate returns). Each dollar that the Ponzi investor gets *from* the scheme correspondingly satisfies one dollar of that claim, (and, hence, gives "reasonably equivalent value" to the debtor), at least up to the point where the investor

[135] *Id.* ¶ 548.04[3][b] (internal citations omitted).

[136] *Manhattan*, 379 B.R. at 13.

[137] Cuthill v. Greenmark, LLC (In re World Vision Entm't, Inc.), 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002).

[138] 11 U.S.C. § 548 (a)(1)(B)(i-ii).

[139] *Id*.

[140] COLLIER, *supra* note 68, ¶ 548.05.

[141] 11 U.S.C. § 548(d)(2)(A).

breaks even. Conversely, payments representing a net positive return to the investor do not represent "reasonably equivalent value" since they exceed what is necessary to satisfy the restitution claim. [142]

The refusal of many courts to consider even one penny of recovery, past the break-even point, to represent "reasonably equivalent value" to the debtor is a source of some controversy. After all, the plain language of most agreements between Ponzi debtors and their investors call for the investors to receive net positive returns. Should not payment of the contractual "profits" under an agreement constitute satisfaction of a debt and, hence, represent "reasonably equivalent value"? Most courts say no. They reason that any agreement in furtherance of a Ponzi scam is illegal and unenforceable as against public policy.[143] An unenforceable agreement cannot give rise to *any* lawful debt, satisfaction of which could give the debtor "reasonably equivalent value."[144] Notwithstanding, the investor acquires an *equitable* claim for unjust enrichment, but *only* to the extent of her "net loss."[145] The "net loss" limitation is imposed, because, as we have discussed, any "net winners" are unjustly enriched at the expense of the "net losers" to the extent their returns exceed their investments.[146] Accordingly, only to the extent of an investor's "net loss" will the courts recognize a valid debt, satisfaction of which is "reasonably equivalent value."[147]

In the more sophisticated Ponzi schemes, an investor's "net loss" might be obscured in a maze of separate transactions and accounting gimmicks. Even so, the true measure of "net loss" is nothing more or less than the difference between (1) the number of dollars that the investor put into the scheme and (2) the number of dollars

[142] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67; *see also* McDermott, *supra* note 18, at 164-67 (explaining that some courts require a finding of objective "good faith" on the part of the investor before they will recognize payments to her, from the Ponzi debtor, as providing "reasonably equivalent value" to the debtor). This, however, seems to make the "reasonably equivalent value" analysis unnecessarily redundant of the affirmative "good faith defense" of 11 U.S.C. § 548(c), which we will discuss. *See infra*, p.528-30.

[143] *See, e.g.*, *Floyd*, 209 B.R. at 434 (internal citation omitted).

[144] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67 cmt. i.

[145] *See* McDermott, *supra* note 18, at 169.

[146] *Id.*

[147] *See* McDermott, *supra* note 18, at 169 (discussing various cases); *accord* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 67; *but see* Daly v. Deptula (In re Carozzella & Richardson), 286 B.R. 480 (D. Conn. 2002); *see also* Kull, *supra* note 56, at 2 (opining that the Restatement (Third) of Restitution and Unjust Enrichment would allow for interest in these circumstances).

she received from it, regardless of how the parties characterize the payments.[148] To illustrate:

> **Example**: On January 1, 2014, Investor paid Ponzi $20,000, pursuant to a "short form investment agreement." On January 15, January 31, February 5, and March 1, 2014, Investor and Ponzi executed similar agreements, with Investor contributing $20,000 each time, for an aggregate contribution of $100,000.
>
> Each "short form investment agreement" called for Investor to receive 20% interest every month on his outstanding principal, payable on the last day of each month. Accordingly, on January 31, Ponzi paid investor $12,000 as "interest." On February 28, Ponzi paid Investor $16,000 as "interest." On March 31, Ponzi paid Investor $20,000 as "interest." On April 30, Ponzi paid Investor $20,000 as "interest." On May 1, Investor withdrew $40,000 of "principal" from his "investment account" with Ponzi. After this, Ponzi made no further payments to Investor. Total payments from Ponzi to Investor equal $108,000.
>
> Sometime later, Ponzi filed for bankruptcy. Trustee indicated that she will attempt to avoid all $108,000 of the payments from Ponzi to Investor as constructively fraudulent transfers under § 548(a)(1)(B). Assuming that all the other elements are met, Trustee will be successful insofar as she seeks to avoid the $8,000 that Investor received in excess of what he contributed, but she will not be able to avoid the remaining $100,000. This is because Investor had an inchoate claim in restitution against Ponzi to the extent of his $100,000 investment. Accordingly, the first $100,000 of payments from Ponzi to Investor represented a dollar-for-dollar reduction of that claim, and hence gave "reasonably equivalent value" to

[148] *See* McDermott, *supra* note 18, at 169 ("This may be the only workable rule in the typical Ponzi-scheme case, where documentation of transfers is less than complete, payments are sporadic and not always in accordance with the documentation of the investment, and neither the investor nor the debtor can recall precisely what the parties intended.").

> Ponzi for purposes of § 548(a)(1)(B). However, Investor had no valid claim in excess of his $100,000 investment, because each "short form agreement" was illegal and unenforceable at law, and because Investor would be unjustly enriched insofar as he were permitted to profit from the Ponzi scheme while other, similarly-situated investors suffered loss. Accordingly, Ponzi did not receive reasonably equivalent value for the remaining $8,000 of payments to Investor.

As for the "insolvency" requirement, here the trustee is aided by the same "insolvency" presumption that applies in connection with preference actions.[149] Therefore, if the trustee can establish that the investor received more than his or her principal investment within the reach-back period, then practically speaking that is all the Ttrustee will need to prove in most cases in order to avoid the excess payments under § 548(a)(1)(B).[150]

(3). *The "Good Faith" Defense of 11 U.S.C. § 548(c)*

11 U.S.C. § 548(c) provides as follows:

> Except to the extent that a transfer . . . voidable under this section is voidable under section 544, 545, or 547 . . . a transferee . . . that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer . . . .[151]

Accordingly, even a Ponzi investor who received an actual fraudulent transfer can retain it to the extent that she (1) gave "value" in exchange for the transfer, and (2) accepted the transfer in "good faith."[152] The "value" component of § 548(c) is identical to the "reasonably equivalent value" prong under § 548(a)(1)(B) (although here it is the investor, and not the trustee, who bears the burden of proof).[153] Thus, if a Ponzi investor can prove that she took actual fraudulent transfers from the debtor in "good faith," many courts hold that she

[149] Scholes v. Lehmann, 56 F.3d 750, 762 (7th Cir. 1995).
[150] *See* McDermott, *supra* note 18, at 173.
[151] 11 U.S.C. § 548(c).
[152] *Id.*
[153] COLLIER, *supra* note 66, at §§ 548.03, 548.09[2].

may keep them insofar as they do not represent a net "profit" from the scheme.[154]

"Good faith" is not defined in the Bankruptcy Code. It is hardly addressed in the legislative history.[155] Even so, most modern courts have developed a general framework for analyzing the issue. It seems obvious that an investor who is subjectively aware of the fraudulent nature of the Ponzi scheme or knowingly promotes it cannot participate in "good faith."[156] Otherwise, the majority of courts and commentators agree that the standard for measuring "good faith" is objective, hinging on the reasonableness of the investor's conduct in participating in the scheme and accepting the payments.[157] The general inquiry has two basic steps: First, courts ask whether the transferee knew, or should have known, of circumstances that would place a reasonable, similarly-situated investor on notice that the debtor was either (A) running a Ponzi scheme and hence acting with actual fraudulent intent in making the payment, or (B) insolvent.[158] If so, the second step of the inquiry asks whether the transferee conducted a "diligent investigation" into the circumstances giving rise to the notice, which may include an analysis of whether an investigation would have allayed a reasonable investor's suspicions, or would have revealed the debtor's fraud or insolvency.[159] If a diligent investiga-

[154] *Id.* at § 548.04[3][c]. However, some courts hold that the "good faith" defense is never (or virtually never) available to participants in a Ponzi scheme, either because a reasonable, similarly-situated investor would never have participated, or perhaps for fear of validating an illegal contract. *Id.*

[155] *Id.* at § 548.09[2][b]

[156] *See* Merrill v. Abbott (In re Indep. Clearing House Co.), 77 B.R. 843, 861-62 (D. Utah 1987).

[157] *See* COLLIER, *supra* note 66, at §548.09[2][b];. *see also, e.g.*, Jobin v. McKay (In re M & L Buc. Mach. Co.), 84 F.3d 1330, 1338 (10th Cir. 1996); *but see, e.g.*, Meoli v. Huntington Nat'l Bank (In re Teleservs. Grp., Inc.), 444 B.R. 767, 773 (Bankr. W.D. Mich. 2011) (following a minority of cases adopting a "subjective" approach to "good faith," based upon "traditional notions of honesty and integrity").

[158] *See* Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC), 439 B.R. 284, 315(S.D.N.Y. 2010). This court notes that there was some confusion over whether the transferee must have had reason to know that the debtor made the specific payment with fraudulent intent, or whether the debtor's operations generally were fraudulent. *Id.* As we have discussed, all payments from a Ponzi scheme to its investors, relating to their investment, are virtually certain to have been made with fraudulent intent, because those payments are necessary in order to perpetuate the fraud. Accordingly, objective reason to suspect the mere existence of a Ponzi scheme is likely reason enough to suspect that any specific payment to an investor in the scheme was made with fraudulent intent.

[159] *Id.* at 316.

tion would have revealed the fraud/insolvency, and if the transferee did not conduct one, then good faith will likely be found lacking.[160]

In this fact-intensive analysis, courts usually consider: the sophistication, intelligence, and other characteristics of the particular investor; the persuasiveness of the con-man running the Ponzi scheme, including the believability of his story; the extent to which the dividends paid out to prior investors could reasonably allay suspicions about the scheme; whether the promised returns were so high as not to be reasonably believable; and similar factors.[161]

IX. GENERAL DEFENSES TO AVOIDANCE ACTIONS

(1). *Limitations periods*

The Ponzi trustee seeking to recapture investors' returns must work quickly, because the Bankruptcy Code imposes stringent deadlines by which the trustee must sue to (A) avoid a transfer, and (B) recover a transfer that has already been avoided. 11 U.S.C. § 546(a) provides that certain avoidance actions (including preference and fraudulent-transfer actions):

> may not be commenced after the earlier of—
> (1) the later of—
> (A) 2 years after the entry of the order for relief; or
> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
> (2) the time the case is closed or dismissed.[162]

Though the remedies of *avoidance* and *recovery* of transfers are often thought of as one remedy, they are quite distinct. Accordingly, better practice, where possible, seems to be to file consolidated actions in which the trustee simultaneously seeks both avoidance *and* recovery. Failure to do so might result in the anomaly of a trustee be-

[160] *See* COLLIER, *supra* note 66, at § 548.09[2][b]; *see also Christian Bros.*, 439 B.R. 284 at 316; *Jobin*, 84 F.3d at 1336, 1338.

[161] *See* McDermott, *supra* note 18, at 178-80 (surveying various cases).

[162] 11 U.S.C. § 546(a).

ing unable to recover a transfer that s/he has successfully avoided.[163]

(2). *The "Good Faith" Defense of "Subsequent Transferees*

The Bankruptcy Code empowers the trustee to seek recovery (for the benefit of the estate) of an avoided transfer from either (1) the "initial" transferee of the debtor (that is, the entity which took directly from the debtor), or (2) any "mediate or immediate" transferee of the initial transferee.[164] The trustee is only entitled to one satisfaction.[165]

An important question to answer at the outset here is that of just who constitutes a "transferee" for purposes of § 550. Most courts require that, in order for the recipient of an avoided transfer to qualify as a "transferee," that entity must have sufficient "dominion" or "control" over the property transferred, so that:

> they exercise legal control over the assets received, such that they have the right to use the assets for their own purposes, and not if they merely served as a conduit for assets that were under the actual control of the debtor-transferor or the real initial transferee.[166]

Accordingly, a financial institution through which a Ponzi debtor transfers funds to an investor is not likely a "transferee" for purposes of § 550, since it is a "mere conduit."[167]

> **Example**: Debtor has a deposit account with Bank. Debtor effectuates an avoidable transfer to Transferee 1, in the amount of $50,000, by writing a check drawn against Debtor's account at Bank. Transferee 1 transfers the cash to Transferee 2, who gives some of it to Transferee 3, who gives some to Transferee 4. Bar-

[163] *See* 5-550 COLLIER, *supra* note 66, ¶ 550.07.

[164] 11 U.S.C. § 550(a)(1)-(2).

[165] *See* 11 U.S.C. § 550(d). The requirement that the recovery be "for the benefit of the estate" is itself a meaningful limitation on the trustee's recovery powers. One implication is that the trustee may not recover a transfer when the result would not produce a benefit for the body of general, unsecured creditors, such as most cases where the proceeds would clearly wind up going to the debtor (unless, perhaps, the recovery consists of exempt property for the benefit of an individual debtor). *See* 5-550 COLLIER, *supra* note 66, ¶ 550.02.

[166] *See, e.g.*, Andreini & Co. v. Pony Express Delivery Servs., 440 F.3d 1296, 1300-01 (11th Cir. 2006).

[167] *See* 5-550 COLLIER, *supra* note 66, ¶ 550.02.

> ring a defense, Trustee may seek recovery from Transferees 1-4 under § 550(a), since they all had control over the money. Since Trustee is only entitled to one satisfaction, her aggregate recovery from all defendants will be limited to $50,000 (with interest, etc). Trustee may not recover from Bank, as Bank is a "mere conduit."

Furthermore, the Bankruptcy Code offers special protection to "immediate or mediate" transferees of an "initial" transferee of the debtor. Specifically, 11 U.S.C. § 550(b) offers the immediate transferee of the initial transferee of the debtor a defense to the extent that such a transferee takes (1) "for value" (including satisfaction of a present or antecedent debt); (2) in "good faith" and (3) without knowledge that the transfer was avoidable.[168] Later transferees have the same defense, but they only need to prove "good faith," provided that a transferee before them (other than the initial transferee) has proven good faith, value, and lack of knowledge.[169] This defense is *not* available to the *initial* transferee of the debtor.[170]

> **Example**: In our prior example, Transferee 1 is the "initial transferee" of Debtor, since he took directly from Debtor (discounting Bank, which is a "mere conduit" and therefore not a "transferee"). Since § 550(b) by its terms does not apply to the initial transferee of the debtor, Transferee 1 cannot make use of it. Transferee 2 is the "immediate transferee" of the initial transferee, since he took directly from Transferee 1. Accordingly, § 550(b) applies both to Transferee 2 and to all of his immediate or mediate transferees—that is, Transferees 3 and 4. The precise elements that each transferee must prove in order to use § 550(b) will depend in part on where they are in the "chain" of transfers.
>
> - In order for Transferee 2 to prove the defense, he must prove value, good faith, and lack of knowledge. *If* he does, then Transferees 3 and 4 need only prove good

168 11 U.S.C. § 550(b).
169 *Id.*
170 *Id.*; *accord* 5-550 COLLIER, *supra* note 66, ¶ 550.03.

faith.

- If Transferee 2 does not prove all three elements, then Transferee 3 must prove all three in order to use the defense.
- If either Transferee 2 or 3 proves value, good faith, and lack of knowledge, then Transferee 4 need only prove good faith—but if not, then he must prove value, good faith, and lack of knowledge.

Some courts interpret the "value" requirement of § 550(b) similarly to the requirement of "reasonably equivalent value" under § 548(a)(2)(B), while others use the "fair market value" standard found elsewhere in the Code. However, other courts (as well as *Collier's*) prefer to define "value" under § 550(b) to mean value sufficient to support a simple contract.[171] Further, in Ponzi cases, the modern trend seems to be to interpret the "good faith" requirement of § 550(b) similarly to the "good faith" standard of § 548(c).[172]

As for the requirement that the transfer be taken without knowledge of its avoidability, *Collier's* offers the following insight:

> Neither the [Bankruptcy] Code nor the legislative history interprets this standard. The language . . . was included as surplusage to illustrate a transferee that could not be in good faith. The Commission intended the standard to mean "if the transferee knew facts that would lead a reasonable person to believe that the property [transferred] was recoverable."[173]

However, the Eighth Circuit has remarked that:

> [i]f a transferee possesses knowledge of facts that suggest a transfer may be fraudulent, and further inquiry by the transferee would reveal facts sufficient to alert him that the property is recoverable, he cannot

[171] See discussion in 5-550 COLLIER, *supra* note 66, ¶ 550.03. This standard would be similar to the standard for "value" that applies in the "bona fide purchaser for value" analysis at state law. *See id.*

[172] *Id.*

[173] *Id.* (citing *In re Sherman, infra,* and noting also that not all courts treat the language as surplusage, but rather strive to impart independent meaning to it, raising the possibility that one might take in objective good faith, but still be subjectively aware that the transfer is avoidable).

> sit on his heels, thereby preventing a finding that he has knowledge. In such a situation, the transferee is held to have knowledge of the [a]voidability of the transfer.[174]

(3). *The Safe Harbor for Certain Payments Made in Connection with Securities Contracts under 11 U.S.C. § 546(e)*

11 U.S.C. § 546 contains a panoply of general defenses against avoidance actions; it would be well beyond the scope of this article to treat them all thoroughly. One in particular, however, has stirred up much controversy: The safe harbor for certain payments made in connection with "securities contracts" under 11 U.S.C. § 546(e).[175] Section 546(e) is one of the more formidable sections of the Bankruptcy Code. We can give it only surface treatment here. The text of the statute reads as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[176]

A "margin payment" is unhelpfully defined as:

> payment or deposit of cash, a security, or other

[174] Brown v. Third Nat'l Bank (In re Sherman), 67 F.3d 1348, 1357 (8th Cir. 1995).
[175] 11 U.S.C. § 546(e).
[176] *Id.*

> property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency . . . .[177]

Similarly, a "settlement payment" is unhelpfully defined as

> a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.[178]

The definition of "settlement payments" is "somewhat circular."[179] However, the courts have defined "settlement payment" as a transfer of consideration, which completes a transaction in "securities."[180] This definition is "extremely broad."[181] This is so, in part, because the definition of "securities" in § 546(e) is much broader than what one may initially conceptualize when one thinks about "securities transactions." Indeed, even a promissory note comes within the definition of "security" for purposes of § 546(e).[182] Thus, even from this cursory examination of § 546(e), it becomes fairly clear that the language of the statute, taken to its outermost bounds, might seriously impede the trustee's avoidance powers in Ponzi bankruptcies.

Now, it is true that *actual* fraudulent transfers under § 548(a)(1)(A) are exempted from the protection of § 546(e). However, we must also remember that the reach-back period for actual fraudulent transfers under § 548(a)(1)(A) is only two years prepetition. This makes § 548(a)(1)(A) of little use in the case of a Ponzi scheme like Mr. Madoff's, which spanned the better part of a lifetime. Worse for the trustee, § 546(e) *still* reaches fraudulent transfer actions brought under state law pursuant to § 544, which may have much longer reach-back periods.

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[177] 11 U.S.C. §§ 101(38), 741(5).

[178] 11 U.S.C. § 741(8).

[179] QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545, 549 (6th Cir. 2009).

[180] Enron Creditors Recovery Corp. v. ALFA, 651 F.3d 329, 336-37 (2d Cir. 2011); Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 849-50 (10th Cir. 1990); In re Hamilton Taft & Co., 114 F.3d 991, 993 (9th Cir. 1997).

[181] *QSI Holdings*, 571 F.3d at 545, 549.

[182] 11 U.S.C. § 101(49)(A)(i).

These concerns have made the precise reach of § 546(e) the subject of much controversy in recent years.[183] One controversial issue, which we will explore for illustrative purposes, is whether a "settlement payment" must be a public securities transaction involving a "clearing house," or whether it may be a private transaction directly between private persons.[184]

The courts holding that a "settlement payment" must involve publicly-traded securities read the legislative history to indicate that Congress' main purpose in enacting § 546(e) was to protect, from avoidance, settled transactions in the public securities markets, in the event of "a major bankruptcy affecting those industries."[185] Public securities transactions involve certain national "clearing houses," which not only serve as conduits, but also take title to the securities and independently guarantee the obligations of the buyers and sellers.[186] If a bankruptcy trustee could avoid such transactions, this could subject these clearing houses to vast liability and seriously undermine investor confidence in the stability of settled securities transactions. These courts feel that private securities transactions simply do not implicate these concerns, and therefore should not come under the protection of § 546(e).[187]

However, the courts espousing the opposite view also have strong arguments. It seems that the trend among the Circuit Courts of Appeal is to hold that "settlement payments" do include private securities transactions.[188] Nothing in the relevant statutory text or legislative history indicates that Congress intended to exclude private securities transactions from the definition of "settlement payment." Granted, protection of the "clearing houses" was one important reason for enacting § 546(e), but some would argue that this was merely

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[183] *See, e.g.*, SIPC v. Bernard L. Madoff Invest. Secs., LLC (In re Madoff Secs.), 476 B.R. 715 (S.D.N.Y. 2012).

[184] *Compare QSI Holdings*, 571 F.3d at 549-550 (stating that "settlement payment" can involve a private securities transaction), *with* Official Comm. of Unsecured Creditors v. Lattman (In re Norstan Apparel Shops, Inc.), 367 B.R. 68, 76 (Bankr. E.D.N.Y. 2007) ("settlement payment" must involve a public securities transaction).

[185] *QSI Holdings*, 571 F.3d at 549-50.

[186] *Enron*, 651 F.3d at 344 (Koeltl, J., dissenting).

[187] *Id.* at 343-45; *QSI Holdings*, 571 F.3d at 549-50; Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 985-86; *Norstan Apparel Shops*, 367 B.R. at 76.

[188] *See, e.g.*, *Enron*, 651 F.3d at 338 ("settlement payments" need not pass through hands of intermediaries who take title); *QSI Holdings*, 571 F.3d at 550 (holding that "settlement payments" can involve transactions in privately-held securities); In re Plassein Int'l Corp., 590 F.3d 252, at 258-59 (3rd Cir. 2009); *Frost*, 564 F.3d at 985-86.

a means to the greater end of promoting investor confidence in the stability of securities transactions generally.[189] Indeed, *prima facie* there is arguably no reason to suppose that uprooting settled private securities transactions undermines investor confidence any less than uprooting settled public ones. Bankruptcy-induced volatility in either context could destroy investor confidence.[190]

There are, of course, other controversial issues surrounding § 546(e), thorough treatment of which could produce an article unto itself. We hope that this brief discussion serves to illustrate the importance of this provision.

X. Conclusion

Although any court may be sympathetic to the many hard-working people who emptied their savings, and sometimes even took out mortgages, to invest in Ponzi schemes, hoping to see their investment grow to enable them to have a more comfortable life, the law does not either condone their actions or grant them immunity from the trustee's right, and even duty, to claw back what they received from such enterprises.

In spite of the fact that Ponzi schemes are more well-known and exposed for what they are, it is unlikely that they will not reappear in the future in some newly-invented form. Given the nature of man, history will repeat itself! The Ponzi scheme of the future will be reinvented and remarketed to the unwitting public. Please be forewarned.

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[189] *Frost*, 564 F.3d at 985-86; *see also* In re Bernard L. Madoff Inv. Secs., LLC, 458 B.R. 87, 117 (Bankr. S.D.N.Y. 2011).

[190] *QSI Holdings*, 571 F.3d at 550.