

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

“Shell Games” Ponzi Scheme Cases: The Liability of Investors,  
Sales Agents, Professionals and Others

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## **I. Introduction**

More and more investors, sales people and other entities are finding themselves targets of a trustee's avoiding power rights in bankruptcy cases involving Ponzi schemes. Trustees in bankruptcy cases seek to recover funds paid by the Ponzi debtor to investors as a return of principal or payment of fictitious profits or to sales people as commissions. These materials outline issues arising in connection with fraudulent transfer claims brought by trustees against investors and sales people and the defenses which can be asserted to those claims.

## **II. Ponzi Scheme Defined**

A "Ponzi scheme" is defined as:

[A] fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any 'profits' of the underlying business venture. The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment. *See, Cunningham v. Brown*, 265 U.S. 1, 7-8 44 S.Ct. 424, 425, 68 L. Ed. 873 (1924); *Hayes v. Palm Seedlings Partners (In re Agricultural Research and Technology Group, Inc.)*, 916 F.2d 528, 536 (9th Cir. 1990).

*Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n.1 (9th Cir. 1991).

## **III. Fraudulent Transfer Claims**

The primary method to recover transfers to investors and commissions paid to sales people is a fraudulent transfer claim, based either on actual fraudulent intent or a constructive

fraud as set forth in 11 U.S.C. § 548(a) or applicable state fraudulent transfer law.<sup>1</sup>

Under these statutes, there are two theories under which a trustee or receiver may seek to recover transfers made by the Ponzi debtor -- actual fraudulent intent or constructive fraud. Under actual fraudulent intent, it is alleged that the Ponzi scheme operator made transfers to the transferee with “actual intent to hinder, delay or defraud” the creditors of the debtor. Under constructive fraud, it is alleged that the transfer is made without receiving “a reasonably equivalent value in exchange for the transfer” at a time when the debtor was insolvent or about to become insolvent.

#### **IV. Actual Fraud Claims**

##### **A. Actual Fraudulent Intent**

Section 548(a)(1)(A) authorizes a trustee to avoid a transfer of the debtor’s property made with the “actual intent to hinder, delay or defraud” any current or future creditor made during the two-year period preceding the bankruptcy.<sup>2</sup> Under this theory, the entire amount of any transfer (both repayments of principal and interest) may be avoided, and the transferee’s lack of knowledge of the Ponzi scheme is irrelevant to a finding of actual fraudulent intent. *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006).

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

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

### **1. Proof of Fraudulent Intent Inferred from Operation of Ponzi Scheme**

In the case of an established Ponzi scheme, actual intent to defraud may be inferred simply from the operation of a Ponzi scheme itself, rather than proof of fraud through circumstantial evidence. *See, e.g., Agric. Research*, 916 F.2d at 534.

### **2. Circumstantial Evidence of Fraudulent Intent**

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

### **3. Use of Criminal Plea or Conviction**

A last possible mechanism by which a trustee could establish fraudulent intent is by relying on an admission of the debtor, usually in a criminal plea agreement, or if the debtor is found criminally liable for fraud. *See, e.g., Santa Barbara Capital Management v. Neilson (In re Slatkin)*, 525 F.3d 805, 814 (9th Cir. 2008).

#### **B. Entirety of Transfer Avoided**

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

The transferee's lack of knowledge of the Ponzi scheme is irrelevant to a finding of actual fraudulent intent. *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006).

## **V. Constructive Fraud Claims**

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

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

On a constructive fraud basis, the first element that must be established is that the transfer was made for less than reasonably equivalent value<sup>3</sup> during the applicable time period pre-petition.

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

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

There is a sharp split of authority over the issue of whether the payment to an investor of "interest" or "profits" on its investment was made in exchange for reasonably equivalent value. Many courts follow *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 871 (D. Utah 1987) and its progeny, which conclude that no reasonably equivalent value is provided in

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

exchange for the payment of profits and, therefore, the transfer of profits is recoverable as a public policy matter, so as not to permit earlier investors to profit at the expense of later investors who received substantially less on their investments. *See Indep. Clearing House*, 77 B.R. at 858. On the other hand, some courts have placed their focus not on public policy or an analysis of equity, but rather on the contractual relationship between the investor and the debtor. *See Lustig v. Weisz & Assoc., Inc. (In re Unified Commercial Capital, Inc.)*, 260 B.R. 343 (Bankr. W.D.N.Y. 2001), *aff'd*, 2002 WL 32500567 (W.D.N.Y. 2002); *Balaber-Strauss v. Lawrence*, 264 B.R. 303, 308 (S.D.N.Y. 2001), *aff'g*, *Balaber-Strauss v. Sixty-five Brokers (In re Churchill Mortgage Inv. Corp.)*, 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000) (court must evaluate the consideration exchanged by the debtor and transferee in the specific transaction which the trustee seeks to avoid, not the transaction's impact on the debtor's overall business).

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

### **(a) Restitution Claim Theory**

With respect to amounts transferred to investors that constitute a return of their principal, and therefore release of their corresponding claim for the return of that principal, courts have found that reasonably equivalent value is exchanged by the investor where the investor is deemed to have acquired a restitution claim at the time of the investment, which claim is arguably exchanged when the investor received a transfer of funds. *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700 (9th Cir. 2008). This reasoning does not apply where investors received more from the debtor than the amounts of their respective total investments and it is limited to the amount of principal transferred, not profits. *Indep. Clearing House Co.*, 77 B.R. at 857.

### **(b) Limits on Restitution Claim Theory**

However, courts have limited the use of the restitution claim theory to situations where the investor acted in good faith regarding the investments made in the Ponzi scheme. *See, e.g., United Energy Corp.*, 933 F.2d at 596 n. 7 (“In recognizing these claims for rescission and restitution, we assume that the investors had no knowledge of the fraud the debtors were perpetrating.”). An investor’s good faith in this context is measured by a subjective standard so that a court can determine what the investor actually knew. *Jobin v. McKay (In re M&L Bus. Mach. Co.)*, 84 F.3d 1330, 1340-41 (10th Cir. 1996).

### **3. Accounting Allocating Transfers to Principal or Profits**

A question may arise as to whether the transfers paid to the investor should be applied first to the principal investment, or whether the payments should be applied first to the profits that the investor was promised. In calculating whether an investor is liable to return funds in connection with a fraudulent transfer claim, courts in Ponzi scheme cases have applied a netting rule by looking at the transfers in the aggregate to determine whether an investor is a net-winner (i.e., received profits in addition to the return of all principal invested) or a net-loser (i.e., only received a portion of the principal invested). It is, therefore, not necessary in a Ponzi scheme case to analyze each payment, transfer by transfer, to characterize the payments as either principal or profit. *See, Donell*, 533 F.3d at 771. *But see, Scholes v. Ames*, 850 F. Supp. 707, 713-15 (N.D. Ill. 1994), *aff’d, Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995) (investor was a net loser, yet still subject to liability on the facts of that case where setoff was not permitted against portion of investment that came from a separate investor).

### **4. Value in Exchange for Commissions Paid to Brokers**

A particular category of transfers subject to avoidance claims in Ponzi scheme cases are

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

Other courts have looked more narrowly at the relationship between the debtor and the broker and measure “what was given and received” by the debtor and the broker, looking at the market commission rates versus what was paid and acknowledging that “[m]oney is valuable even when used for illegal purposes.” *Solow v. Reinhardt (In re First Commercial Mgmt. Group, Inc.)*, 279 B.R. 230, 238 (Bankr. N.D. Ill. 2002); *In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664 (Bankr. S.D.N.Y. 2000); see also, *Orlick v. Kozyak (In re Fin. Federated Title & Trust Inc.)*, 309 F.3d 1325, 1332 (11th Cir. 2002) (“[A] determination of whether value was given under Section 548 should focus on the value of the goods and services provided rather than on the impact that the goods and services had on the bankrupt enterprise.”).

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

Once the element of reasonably equivalent value has been established, then the trustee must establish one of the three elements under section 548(a)(1)(B) regarding insufficient value being received by the debtor: (1) the debtor was either insolvent on the date the transfer was made, or became insolvent as a result of the transfer; (2) the transfer left the debtor with



unreasonably small capital to continue its business or transaction; or (3) the debtor intended or believed that it would incur debts beyond its ability to pay as such debts matured.

Insolvency of the debtor is established when the debtor is operating a Ponzi scheme. *Cuthill v. Kime (In re Evergreen Sec., Ltd.)*, 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003); *Ramirez Rodriguez*, 209 B.R. at 432. Some courts have found that a presumption of insolvency may apply from inception of the Ponzi scheme. *See, e.g., Independent Clearing House*, 77 B.R. at 871. However, where there is some ambiguity as to when the Ponzi scheme began or whether there was an ongoing legitimate business operation, the presumption may not be applied. *See McKay*, 155 B.R. at 535 n. 7.

Regarding unreasonably small capital, the court in *In re Taubman*, 160 B.R. 964, 986 (Bankr. S.D. Ohio 1993), held that “in the circumstances of this bankruptcy case, that insolvency constitutes unreasonably small capital per se.” But see, *Emerson v. Maples (In re Mark Benskin & Co., Inc.)*, 161 B.R. 644, 650 (Bankr. W.D. Tenn. 1993) (the presumption did apply and stated that “the fact that the debtor operated primarily if not exclusively on fraudulently obtained funds establishes that the debtor had little if any legitimate operating capital. It would seem axiomatic that the debtor was operating its business with unreasonably small capital.”).

Regarding the debtor’s intent to incur debts beyond its ability to repay, the *Taubman* court refused to apply a presumption and made inquiry into the debtor’s subjective intent. *Taubman*, 160 B.R. at 987.

## **VI. Defenses To Ponzi Fraudulent Transfer Claims**

The defenses of a target defendant from whom a trustee is seeking to recover monies paid may depend on whether such target defendant was the initial transferee or a subsequent

transferee. Section 548(c) carves out an exception for the initial recipient of the alleged fraudulent transfer to the claim to avoid fraudulent transfers where the transferee takes for value and in good faith. Additional defenses may be available to a subsequent transferee pursuant to section 550(b) that are not otherwise available to an initial transferee.

## **A. The Initial Transferee**

### **1. The Good Faith Defense**

The transferee bears the burden of showing that it is entitled to protection under section 548(c). *Agric. Research*, 916 F.2d at 536. The good faith defense must be established by an objective standard, not merely subjective proof that the investors did not have knowledge of the fraud. *See Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund, Ltd.)*, 359 B.R. 510, 517-18 (Bankr. S.D.N.Y. 2007), *rev'd in part*, 397 B.R. 1 (S.D.N.Y. 2007); *McKay*, 84 F.3d at 1338; *Agric. Research*, 916 F.2d at 535.

The focus of the courts' inquiry centers around the state of mind of the transferee -- whether the transferee has knowledge of the debtor's insolvency or fraudulent activity; whether that knowledge is actual or constructive, and whether the transferee should have been placed on inquiry notice. Factors considered in Ponzi scheme cases are described generally as follows:

- a. Promise of high or exorbitant returns puts investor on inquiry notice.
- b. Investor's education, experience and level of business knowledge can preclude a finding of good faith.
- c. Suspicious circumstances place reasonable person on inquiry notice, and if a diligent inquiry would have uncovered the fraud, then a finding of good faith will be unlikely.
- d. If insufficient due diligence was done by the investor, then good faith may not be found.

e. The investor's actual knowledge is a factor. If the investor had actual knowledge of the fraudulent scheme, a finding of good faith will be precluded.

f. The transaction must have been an arms-length transaction in order for the good faith exception to apply.

## **2. The Value Defense**

Even if the transferee can establish good faith under section 548(c), it must also establish that it gave value to meet the criteria under section 548(c). Courts have taken essentially two differing views in evaluating whether value was given: (1) value must be assessed "on a case-by-case basis, looking at surrounding circumstances and by focusing on the precise transfer in question." *Fin. Federated*, 309 F.3d at 1332 ("focus on the value of the goods and services provided rather than on the impact the goods and services had on the bankrupt enterprise"); or (2) value should be evaluated by consideration of whether the reasonably equivalent value confers an economic benefit upon the debtor. *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981) ("the debtor's net worth has been preserved" and the interests of creditors have not been harmed by the transfer).

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

Another possible defense of an initial transferee is to assert that it is not a transferee in the first instance as contemplated by section 550(a). Courts have widely accepted the "dominion and control" test set forth in *Bonded Financial Service, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988), to evaluate whether the defendant is the initial transferee. The test has been extended to the "mere conduit" test, finding that a party is not an initial transferee if was a "mere conduit" of the funds. *See Christy v. Alexander & Alexander of New York (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52 (2d Cir.

1997). In essence, a party who acts as a conduit and simply facilitates the transfer of funds from the debtor to a third party is not deemed an initial transferee. See *Poonja v. Charles Schwab & Co., Inc. (In re Dominion Corp.)*, 199 B.R. 410, 413 (B.A.P. 9th Cir. 1996); *Morris v. Sampson Travel Agency, Inc. (In re U.S. Interactive, Inc.)*, 321 B.R. 388, 395-96 (Bankr. D. Del. 2005).

## **B. A Subsequent Transferee**

Section 550(b)(1) provides additional defenses for a mediate or immediate transferee (a subsequent transferee) that would not be available to an initial transferee. A subsequent transferee will be protected from avoidance of the transfer to it under section 550(b)(1) if the subsequent transferee: (1) takes for value; (2) in good faith; and (3) without knowledge of the voidability of the transfers.

### **1. Good Faith vs. Knowledge**

The good faith standard is measured using an objective standard, i.e., a transferee acts in good faith if it had no facts before it that would cause a reasonable person to investigate whether the transfer would be avoidable. *Enron Corp. v. Avenue Special Situations Fund II, L.P. (In re Enron Corp.)*, 333 B.R. 205 (Bankr. S.D. N.Y. 2005).

Courts have noted the distinction between “good faith” and “without knowledge,” finding that “[k]nowledge” is a stronger term than “notice” and that, “[a] transferee that lacks the information necessary to support an inference of knowledge need not start investigating on his own.” *Bonded*, 838 F.2d 890, 898 (failure to make inquiry did not permit court to attribute to transferee knowledge of voidability of transaction).

### **2. Value from a Subsequent Transferee**

The “value” required to be paid by the subsequent transferee to be eligible for the defense under section 550(b) is merely consideration sufficient to support a simple contract; there is no

requirement that the value given by the transferee be a reasonable or fair equivalent. Additionally, there is no requirement that the initial transferee must have given value to the debtor before a subsequent transferee is protected. *See, Bonded* 838 F.2d at 896-97 (noting the difference in “value” in section 550(b) and “value to the debtor” in section 548(c)). This exception, therefore, applies regardless of whether the initial transferee gave any value to the debtor.

## **VII. CONCLUSION**

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

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

The fraudulent transfer laws as applied in Ponzi scheme cases have largely viewed the transactions from the investors’ perspective, analyzing what they knew or should have known,

with an eye toward striving to accomplish equity and ratable distribution among earlier and later investors in a Ponzi scheme. There are, however, a growing number of courts taking a narrower approach, choosing to look at the transfer transaction in isolation to evaluate the merits of the fraudulent transfer claim, rather than viewing the impact of the transaction on the entire case. A plaintiff's success in pursuing fraudulent transfer claims may, therefore, depend on the precedential authority in the jurisdiction or the views of the judge presiding over their case, as the struggle between the public policy equitable viewpoint and the transactional viewpoint can significantly change the outcome of the case.