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Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks

Karen E. Nelson

Note

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On June 29, 2008, a federal district judge sentenced the man who had committed the most extensive and destructive Ponzi scheme in history to 150 years in prison.[1] Bernard L. Madoff defrauded investors of up to $64.8 billion[2] in a decades-long scheme[3] in which supposed profits came not from the market, but from subsequent investors.[4] When new investors ran out, these "profits" dried up and the fraud was exposed.[5] At Madoff's final sentencing hearing, devastated investors lined up to tell their stories of savings lost and dreams destroyed.[6] For some of these investors, however, the financial ruin may be just beginning. Under federal and state fraudulent transfer law and traditional Ponzi scheme jurisprudence, the appointed trustee in a bankruptcy may "clawback" returns conveyed to

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1. *E.g.*, Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1, *available at* 2009 WLNR 12446925.

2. Martha Graybow, *Madoff Mysteries Remain as He Nears Guilty Plea*, REUTERS, Mar. 11, 2009, *available at* http://www.reuters.com/article/2009/03/11/us-madoff-idUSTRE52A5JK20090311.

3. *See* Robert Frank, *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1, *available at* 2009 WLNR 4866802 (noting that prosecutors believe Madoff's fraud began in the 1980s).

4. *See* BLACK'S LAW DICTIONARY 1278 (9th ed. 2009) (defining "Ponzi scheme").

5. *Id.*

6. *See* Henriques, *supra* note 1.

certain investors prior to the fraud's exposure.[7] Investors vulnerable to this process, often called "winners" because they received an amount larger than their principal balance from the scheme,[8] likely lost their balances left with Madoff as did "losers" who made no profit from the scheme.[9] However, trustees may also require that winners pay back any interest extracted from their accounts from up to six years prior to discovery of the fraud.[10] This power is allowed whether or not such investors still have funds to pay, and despite their lack of culpability.[11]

The magnitude of Madoff's scandal highlights the major equitable dilemmas arising from the clawback aspect of Ponzi scheme avoidance law. Fraudulent transfer laws impose strict liability on initial transferees of fraudulent transfers,[12] which has long been deemed unfair and punitive to innocent recipients of such transfers.[13] Jurisprudence specific to Ponzi schemes has exacerbated this inequity. Subjecting winning investors to clawbacks of their "fictitious profits"[14] can impose insurmountable financial burdens on innocent victims of the fraud.[15] Such a consequence encourages ethically questionable

7. *See, e.g.*, Jeff Benjamin, *Madoff Investors May Face Clawbacks*, INVESTMENT NEWS, Feb. 10, 2009, http://www.investmentnews.com/article20090210/REG/902109979.

8. *See, e.g.*, Josh Nathan-Kazis, *Should Madoff's Winners Give Back to Losers?*, JEWISH DAILY FORWARD (Oct. 16, 2009), http://www.forward.com/articles/116262/.

9. *Id.*

10. *See* Paul Hinton & Jan Larsen, *Clawbacks from Madoff Investors: Questions of Economics, Equity, and Law*, NERA ECON. CONSULTING, 1 (Apr. 28, 2009), http://www.nera.com/extImage/PUB_Madoff_Investors_Clawbacks_0409_final.pdf.

11. *See, e.g.*, Bliese v. McCarn's Allstate Fin., Inc. (*In re* McCarn's Allstate Fin., Inc.), 326 B.R. 843, 852 (Bankr. M.D. Fla. 2005).

12. 11 U.S.C. § 550(a)(1) (2006); UNIF. FRAUDULENT TRANSFER ACT § 8(b)(1), 7A U.L.A. pt. II, at 179 (2006).

13. *See, e.g.*, *In re McCarn's Allstate*, 326 B.R. at 852 (noting that "unfairness in result" is not a defense to § 550's initial transferee provisions); First Commercial Mortg. Co. v. Circuit Alliance, Inc. (*In re* Circuit Alliance, Inc.), 228 B.R. 225, 233 (Bankr. D. Minn. 1998) (arguing that prohibiting exceptions to § 550's "unqualified" language leads to "basic fairness" and equity issues); Craig H. Averch, *Protection of the "Innocent" Initial Transferee of an Avoidable Transfer: An Application of the Plain Meaning Rule Requiring Use of Judicial Discretion*, 11 BANKR. DEV. J. 595, 623 (1995).

14. *In re* Bayou Grp., LLC, 372 B.R. 661, 663 (Bankr. S.D.N.Y. 2007).

15. *See, e.g.*, Alex Berenson, *Even Winners May Lose Out with Madoff*, N.Y. TIMES, Dec. 19, 2008, at A1, *available at* 2008 WLNR 24370521.

attorney advice,[16] causes conflict among victims,[17] and strays from America's fundamental tenets of capitalism. Further, Ponzi scheme avoidance law causes economic inequities among victims despite purporting to seek equality.[18] Due to these ramifications, many analysts foresee years of protracted litigation related to clawbacks in Ponzi scheme cases.[19]

This Note argues that Ponzi scheme avoidance law must be aligned with a more equitable outcome for so-called winning investors. Part I outlines the federal and state fraudulent transfer laws relevant to Ponzi schemes, and the way courts have interpreted and applied these laws to winning Ponzi scheme investors. Part II analyzes the legal, personal, social, and economic inequities that arise from this application. Part III recommends that courts update their definition of "value" under Ponzi scheme avoidance law to allow for a more expansive and economically equitable defense for winning investors. Specifically, investors should be able to retain the time value of their initial investment and a certain degree of opportunity costs. This Note concludes that treating victimized investors more uniformly in Ponzi scheme cases will better serve the fundamental equitable purpose of fraudulent transfer law.

I. FRAUDULENT TRANSFER AND PONZI SCHEME LAW IN THE UNITED STATES

The body of law applicable to Ponzi schemes is a mixture of both state and federal statutes and court jurisprudence developed over time.[20] Understanding the current state of this law—referred to as "Ponzi scheme avoidance law" for purposes of this Note—requires an overview of the background and growth of federal and state fraudulent transfer law, as well as court-made Ponzi scheme law.

16. *See, e.g.*, H.R. REP. No. 108-40, pt. 1, at 593–97 (2003) (admonishing the "notorious 'financial planning' strategy" that utilizes Bankruptcy Code § 522's exemption rules); Asher Rubinstein, *Madoff Jailed, What's Next? Protecting Assets from Clawbacks*, RUBINSTEIN & RUBINSTEIN, LLP (Mar. 18, 2009), http://www.assetlawyer.com/wordpress/?p=149 (counseling liable clients to redirect assets into, among other things, exempt homes).

17. *See, e.g.*, Nathan-Kazis, *supra* note 8.

18. *See, e.g.*, Cunningham v. Brown, 265 U.S. 1, 13 (1924) ("[E]quity . . . is the spirit of the bankrupt law.").

19. *E.g.*, Benjamin, *supra* note 7.

20. *See, e.g.*, 11 U.S.C. §§ 546–550 (2006); N.Y. DEBT. & CRED. LAW §§ 270–281 (McKinney 2009); Bear, Stearns Sec. Corp. v. Manhattan Inv. Fund Ltd. (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 8 (S.D.N.Y. 2007).

A. FRAUDULENT TRANSFER LAW

Both state and federal fraudulent transfer laws apply in the context of a Ponzi scheme allegation. This section outlines the fundamental parts of each body of law that affect the outcome for victimized Ponzi scheme investors.

1. Federal Fraudulent Transfer Law—The Bankruptcy Code

The U.S. Constitution vests Congress with the power to establish federal bankruptcy laws,[21] and the Bankruptcy Reform Act of 1978 (the Bankruptcy Code or the Code) is the law governing bankruptcy in the United States today.[22] The current federal structure consists of a united jurisdictional arrangement of courts and judges that solely hear and determine bankruptcy-related matters.[23] Under the U.S. Trustee System, a third party is injected into bankruptcy litigation in certain circumstances[24] to oversee the "administrative and supervisory" issues in bankruptcy cases.[25] Understanding the unique bankruptcy litigation process is integral to a thorough appreciation of the issues related to fraudulent transfers that can arise in these proceedings.

One of a trustee's key duties in a bankruptcy proceeding is to recapture the value of any fraudulent or preferential transfers for the bankruptcy estate.[26] Hence, the Bankruptcy Code gives trustees "avoiding powers" to void certain transfers the bankrupt entity (the debtor) made to the transferee before the debtor went bankrupt.[27] Code § 548 details the situation under which trustees may avoid conveyances due to fraud.[28] Specifically, trustees may recapture the value of any transfer made within two years of the bankruptcy petition filing and with "actual intent to hinder, delay, or defraud any entity to which the

21. U.S. CONST. art. I, § 8, cl. 4.

22. *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 32 (1995).

23. *Id.* at 34.

24. *See* 11 U.S.C. § 1104(a) ("[T]he court shall order the appointment of a trustee (1) for cause, including fraud, dishonesty . . . [or] (2) if such appointment is in the interests of creditors . . . and other interests of the estate . . . ."); *see also* Hank Shafran, *The Appointment of a Trustee in a Chapter 11 Case*, INT'L L. OFF. (Aug. 29, 2003), http://www.internationallawoffice.com/newsletters/detail.aspx?g=7db3c6f5-de0b-43d2-b027-c8d7cfc2da15&redir=1.

25. Tabb, *supra* note 22, at 40.

26. *Id.* at 26.

27. 11 U.S.C. § 546.

28. *Id.* § 548.

debtor was or became . . .indebted."[29] Trustees commonly avoid transfers in the Ponzi scheme context using this process, which has been aptly termed a "clawback."[30]

Section 548 does contain a defense for initial transferees of fraudulent payments that took in good faith and for value.[31] Such a transferee may retain his interest "to the extent that [he] . . . gave value to the debtor" in exchange for the transfer,[32] with "value" defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor."[33] To the extent a transfer is not defensible and thus avoidable under § 548, however, § 550 subjects "initial transferees" to strict liability.[34] This means trustees have an unconditional right to reclaim property from an initial transferee, regardless of the party's good faith or consideration.[35] Thus, where a fraudulent transfer is not defensible under § 548—either not made in good faith or for value—trustees may avoid it. As a result of this defensive scheme, establishing the value exchanged in a fraudulent transaction becomes the pivotal task in determining how much money innocent Ponzi scheme investors may be able to shield against the trustees' avoidance powers.

2. State Fraudulent Transfer Laws

Separate from the federal Bankruptcy Code, laws rendering fraudulent transfers void have been part of individual American jurisdictions dating back to the English Statute of 13 Elizabeth from 1571.[36] Today, the Uniform Fraudulent Transfer Act (UFTA) is the most prevalent state statute regarding

29. *Id.* § 548(a)(1).

30. *See, e.g.*, Hinton & Larsen, *supra* note 10, at 2.

31. 11 U.S.C. § 548(c); *see also* Wilcek v. H. King & Assocs. (*In re* H. King & Assocs.), 295 B.R. 246, 286 (Bankr. N.D. Ill. 2003) (noting that § 548(c) is the only defense available for initial transferees of fraudulent transfers).

32. 11 U.S.C. § 548(c).

33. *Id.* § 548(d)(2)(A).

34. *Id.* § 550(a)(1) ("[T]he trustee may recover . . . from . . . the initial transferee of such transfer . . . ."); *see also* Hank Shafran, *Limitation of Liability of Subsequent Transferees*, INT'L L. OFF. (Dec. 10, 2004), http://www.internationallawoffice.com/newsletters/detail.aspx?g=d883ae85-4a7f-4afc-9e15-71246570d003&redir=1.

35. *See* Shafran, *supra* note 34; *see also* Atlanta Motor Speedway, Inc. v. Se. Hotel Props. Ltd. (*In re* Se. Hotel Props. Ltd.), 99 F.3d 151, 154 (4th Cir. 1996).

36. UNIF. FRAUDULENT TRANSFER ACT Prefatory Note, 7A U.L.A. pt. II, at 4 (2006); *see also* Langdon Owen, *The Basics of the Uniform Fraudulent Transfer Act*, INFORM LEGAL (June 5, 2008), http://www.informlegal.com/articles/view.php?article_id=618.

fraudulent transfers, with forty-three states and the District of Columbia having adopted some version of the Act.[37] Such predominance makes the UFTA an important component in the fraudulent transfer law relating to Ponzi schemes.

The scope of the state UFTA extends beyond the realm of bankruptcy,[38] its general purpose being to protect creditors any time their debtors—including Ponzi schemers—attempt to transfer or conceal assets that should be available to satisfy obligations.[39] The act comprises twelve sections that set forth rules establishing when a transfer has been made, when a transfer is deemed fraudulent as to both present and future creditors, and what remedies creditors have available against the debtor and its transferees.[40] The UFTA recommends that a cause of action be extinguished four years after the transfer was made, but allows a longer limitation period if the transfer was not and could not yet have been reasonably discovered.[41] It also contains defenses available for transferees who took "in good faith and for a reasonably equivalent value."[42] These transferees retain an interest in the transferred property "to the extent of the value given the debtor" for the transaction,[43] analogous to the Bankruptcy Code. Due to the UFTA's prevalence, this state law applies to investors in a Ponzi scheme proceeding in most circumstances.

Importantly, however—particularly for statutes of limitation purposes—not all states have adopted the UFTA.[44] For example, Maryland's fraudulent transfer law is still based upon the now withdrawn Uniform Fraudulent Conveyance Act

37. *Legislative Fact Sheet on the Uniform Fraudulent Transfer Act*, UNIFORM L. COMMISSIONERS, http://www.nccusl.org/LegislativeFactSheet.aspx?title=Fraudulent%20Transfer%20Act (last visited Mar. 3, 2011) (listing the states that have adopted the UFTA).

38. *See, e.g.*, Kenneth C. Kettering, *The Pennsylvania Uniform Fraudulent Transfer Act*, 65 PA. B. ASS'N Q. 67, 81 (1994).

39. *Why States Should Adopt the Uniform Fraudulent Transfer Act*, UNIFORM L. COMMISSIONERS, http://www.nccusl.org/Narrative.aspx?title=Why%20States%20Should%20Adopt%20UFTA (last visited Mar. 3, 2011).

40. UNIF. FRAUDULENT TRANSFER ACT §§ 4–7.

41. *Id.* § 9(a).

42. *Id.* § 8(a).

43. *Id.* § 8(d). Value is again defined as property or the securing or satisfying of an antecedent debt. *Id.* § 3(a).

44. *Legislative Fact Sheet on the Uniform Fraudulent Transfer Act*, *supra* note 37.

(UFCA).[45] Under the UFCA, individual state statutes of limitation apply, rather than a separate and specific extinguishment provision as under the UFTA.[46] New York also has its own state statute, the New York Debtor and Creditor Law (DCL).[47] This, too, has a separate statute of limitations, which allows avoidance of fraudulent transfers made up to six years prior to commencement of the suit or potentially earlier if the fraud was not immediately discovered.[48] A transferee's defense against avoidance is also somewhat different under the DCL, resting upon an exchange of "fair consideration without knowledge of the fraud at the time of the purchase."[49] These distinctions become important when the trustee begins combining and applying state and federal law to individual Ponzi scheme investors.

3. The Relationship Between Federal and State Bankruptcy Law

For the potentially susceptible transferee in a bankruptcy action involving fraudulent conveyances, the multitude of state and federal laws can seem overwhelming. However, lawmakers have worked hard to maintain consistency and accommodation between the laws.[50] Importantly for Ponzi scheme avoidance

45. MD. CODE ANN., COM. LAW § 15-214, (West 2010) (Historical and Statutory Notes).

46. *See, e.g.*, United States v. Bacon, 82 F.3d 822, 823 (9th Cir. 1996) (observing this difference between the UFTA and UFCA); Freitag v. McGhie, 947 P.2d 1186, 1189 (Wash. 1997). Some states have chosen not to enact this section of the UFTA (e.g., Minnesota), while other states have changed the recommended four-year period to six (e.g., Maine). UNIF. FRAUDULENT TRANSFER ACT § 9.

47. N.Y. DEBT. & CRED. LAW §§ 270–281 (McKinney 2009).

48. *See* Aaron v. Mattikow, 225 F.R.D. 407, 413 (E.D.N.Y. 2004) ("A claim pursuant to [s]ection 276 must be brought within six years of the fraud or conveyance, or within two years of discovery, whichever period is longer."); Nat'l Westminster Bank, U.S.A. v. Frank Santora Equip. Corp. (*In re* Frank Santora Equip. Corp.), 256 B.R. 354, 372 (Bankr. E.D.N.Y. 2000) ("Under the DCL, a creditor is permitted to trace a transferor's transactions back over six years.").

49. N.Y. DEBT. & CRED. LAW § 278. According to the Uniform Law Commission, the phrase "fair consideration" encompasses an element of good faith, while "reasonably equivalent value" does not. *Summary of the Uniform Fraudulent Transfer Act*, UNIFORM L. COMMISSIONERS, http://www.nccusl.org/ActSummary.aspx?title=Fraudulent%20Transfer%20Act (last visited Mar. 3, 2011).

50. *See* UNIF. FRAUDULENT TRANSFER ACT Prefatory Note; *Summary of the Uniform Fraudulent Transfer Act*, *supra* note 49 (noting that one factor in the Uniform Law Commission's decision to promulgate the 1984 UFTA was that some of the 1978 Bankruptcy Code provisions on fraudulent transfers "reduc[ed] the correspondence" between the UFCA and federal law). Many of

law, § 548 of the Bankruptcy Code and UFTA section 4 agree on the main categories of fraudulent conveyances, one of which includes transfers "made . . . with actual intent to hinder, delay, or defraud."[51] Thus, any debtor found to have made a transfer falling within this definition is similarly liable under both federal and state laws, and the transferee of that conveyance is vulnerable as well.

The Bankruptcy Code and state fraudulent transfer laws also work directly together. The link allowing for this cooperation is Code § 544(b)(1),[52] which gives trustees "an extraordinary power to step into the shoes of unsecured creditors . . . and avoid any transfer of a debtor's interest in property that is voidable under [the applicable] state law."[53] The most important benefit this power provides is a longer limitations period during which trustees may avoid transfers. For example, in New York bankruptcy proceedings, a trustee is not barred by the Code § 546's two-year statute of limitations, but rather a six-year state statute.[54] In a state that has adopted all sections of the UFTA, the period would be four years.[55] The ramification of these alternate limitations periods in a Ponzi scheme scenario should be clear: trustees will usually attempt to apply the longest period possible.[56]

Ultimately, the combination of federal and state fraudulent transfer laws makes any property a transferee received from a debtor during a certain period of time vulnerable to avoidance, or clawback, if the transfer is deemed fraudulent. Under vir-

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the UFTA's Official Comments reference corresponding Bankruptcy Code sections. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT § 5 cmt. 3; *id.* § 6 cmt. 1.

51. 11 U.S.C. § 548(a)(1)(A) (2006); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1).

52. 11 U.S.C. § 544(b)(1).

53. *In re Frank Santora*, 256 B.R. at 372. *See generally* 8A C.J.S. *Bankruptcy* § 696 (2009) ("Under certain conditions, state fraudulent-transfer law may be utilized by the trustee . . . to avoid fraudulent transfers and obligations in bankruptcy."); *id.* § 707 ("[T]he rights and powers of the trustee are measured by the applicable state or local law."). "Applicable state law" is also often called "nonbankruptcy" law. *See, e.g.*, 3A BANKRUPTCY SERVICE LAWYERS EDITION § 31:272 (2010).

54. *E.g.*, *In re Frank Santora*, 256 B.R. at 372; *see also* 3A BANKRUPTCY SERVICE LAWYERS EDITION, *supra* note 53, § 32:72.

55. UNIF. FRAUDULENT TRANSFER ACT § 9; s*ee also, e.g.*, Frost v. Contemporary Indus. Corp. (*In re* Contemporary Indus. Corp.), 296 B.R. 211, 216 (Bankr. D. Neb. 2003).

56. *See Management Alert: How Long and Strong Is Trustee Piccard's Claw?*, SEYFARTH SHAW LLP (Feb. 2009), http://www.seyfarth.com/dir_docs/news_item/4eaabe32-919f-4867-8def-df4310518c05_documentupload.pdf.

tually all fraudulent transfer laws, transfers made with "actual intent to hinder, delay, or defraud" are fraudulent.[57] And under state limitations periods, property transferred up to six years prior to the commencement of bankruptcy proceedings may be susceptible to avoidance unless the transferee can maintain an applicable defense.[58] The key defense under both federal and state law is for a transferee to assert that he acted in good faith and received some type of equivalent value for his transfer.[59] Unfortunately, Ponzi scheme avoidance jurisprudence has made it hard for investors to maintain this defense.

B. PONZI SCHEME LAW

The term "Ponzi scheme" is named after Charles Ponzi, a man convicted of multiple fraudulent schemes in Boston in the 1920s.[60] A type of pyramid plot,[61] Ponzi schemes involve apparently legitimate investment entities.[62] Rather than engaging in any underlying business or profit-producing activity for investors, the entity pays earlier investors a return using the funds of subsequent investors.[63] Since this method of paying interest often generates falsely high returns, the scheme attracts further investors,[64] and the fraud continues until new investors dry up and the scheme disintegrates.[65] The collapse of a Ponzi scheme results in a "pyramiding of the liabilities" to be dealt with in bankruptcy.[66] Later investors, as well as those who reinvested their earnings over time, often lose not only the return on investment they thought they had made, but their entire principal investments. Such investors may eventually end up in courts that have historically given Ponzi schemes specialized treatment under fraudulent transfer laws.

57. 11 U.S.C. § 548(a)(1)(A) (2006); N.Y. DEBT. & CRED. LAW § 276 (McKinney 2009); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1).

58. *E.g.*, Aaron v. Mattikow, 225 F.R.D. 407, 413 (E.D.N.Y. 2004).

59. 11 U.S.C. § 548(c); UNIF. FRAUDULENT TRANSFER ACT § 8(a).

60. BLACK'S LAW DICTIONARY, *supra* note 4.

61. *See, e.g.*, Eberhard v. Marcu, 530 F.3d 122, 132 n.7 (2d Cir. 2008) (describing a Ponzi scheme as a type of pyramid scheme).

62. *See, e.g.*, United States v. Moloney, 287 F.3d 236, 241–42 (2d Cir. 2002) (providing an example of and a definition for a Ponzi scheme).

63. *Id.*; BLACK'S LAW DICTIONARY, *supra* note 4.

64. BLACK'S LAW DICTIONARY, *supra* note 4.

65. *See, e.g.*, *Eberhard*, 530 F.3d at 132 n.7.

66. United States v. Weiner, 988 F.2d 629, 631 (6th Cir. 1993).

1. The "Ponzi Scheme Presumption"

The first principal ramification of an allegation that a debtor made transfers in the context of a Ponzi scheme is that courts apply the so-called Ponzi scheme presumption.[67] This presumption holds that, as a matter of law, any transfers made by a debtor running a Ponzi scheme were executed with "intent to hinder, delay, or defraud" under federal and state fraudulent transfer laws.[68] In other words, while the question of intent is normally a factual question for the court, courts automatically presume wrongful intent in the context of a Ponzi scheme.[69] The rationale behind this presumption is that a Ponzi scheme operator must be aware that its scheme will ultimately crumble, and therefore that the later investors will eventually lose their money.[70] As "knowledge to a substantial certainty constitutes intent in the eyes of the law,"[71] every payment out to the earlier investors had the purpose of defrauding the later ones.[72] The Ponzi scheme presumption ultimately makes it easier for bankruptcy trustees to avoid transfers made to investors by a debtor found to have been running a Ponzi scheme.[73]

2. "Fictitious Profits"

The second important ramification for Ponzi scheme investors—and the one that leads to the most extreme inequities under Ponzi scheme avoidance law—is the long-standing policy of courts to deem disbursements of "fictitious profits" to Ponzi

67. *See, e.g.*, Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 8 (Bankr. S.D.N.Y. 2007) (describing and applying the "Ponzi scheme presumption").

68. *See, e.g.*, Gredd v. Bear, Stearns Sec. Corp. (*In re* Manhattan Inv. Fund Ltd.), 310 B.R. 500, 506 (Bankr. S.D.N.Y. 2002) ("Several cases hold that transfers made by a debtor operating a Ponzi scheme are presumed to have been made with the requisite fraudulent intent required by section 548(a)(1)(A).").

69. *Id.* at 507.

70. *Id.* at 506–07 (quoting Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 860 (D. Utah 1987)).

71. *In re Manhattan Inv. Fund Ltd.*, 310 B.R at 507 (quoting *In re Indep. Clearing House Co.*, 77 B.R. at 860).

72. *See In re Manhattan Inv. Fund Ltd.*, 397 B.R. at 8.

73. *See id.* at 10, 12 (noting that "consideration of the badges of fraud is unnecessary where a debtor was engaged in a Ponzi scheme," and that "the Ponzi scheme presumption is an objective test" (quoting Sec. Investor Prot. Corp. v. Old Naples Sec., Inc. (*In re* Old Naples Sec., Inc.), 342 B.R. 310, 319 (Bankr. M.D. Fla. 2006)) (citing Shapiro v. Wilgus, 287 U.S. 348, 354 (1932))).

scheme investors *not* made for reasonably equivalent value.[74] The term "fictitious profits" refers to any interest payments transferred to investors in excess of their principal investment in the venture.[75] Since these payments are not deemed made for value, they are not defensible under the Bankruptcy Code or state fraudulent transfer law and are thus avoidable by the trustee.[76]

The rationale for this rule stems from the definition of "value" in both federal and state fraudulent transfer law as including satisfaction of an antecedent debt.[77] An investor who entrusts money to an entity that eventually becomes a debtor in bankruptcy holds a valid claim against such debtor for the return of his original investment—the investor's "principal undertaking."[78] Interest payments above this amount in the Ponzi scheme context, however, are subject to a separate analysis. As they come not from the debtor's legitimate earnings, but rather from funds that "rightfully belonged to other, defrauded undertakers,"[79] some courts have held an investor's right to payment of supposedly earned interest unenforceable as against public policy.[80] More importantly, though, most courts have held that

74. *See* Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 635–36 (Bankr. S.D.N.Y. 2007). Fictitious profits are also termed "false profits." *See, e.g.*, *In re* Carrozzella & Richardson, 286 B.R. 480, 483 n.4 (D. Conn. 2002) (declining to use the term "false profits" but indicating its common usage).

75. *See In re Bayou*, 362 B.R. at 634–36.

76. *See id.* at 636 ("[V]irtually every court to address the question has held unflinchingly 'that to the extent that investors have received payments in excess of the amounts they have invested, those payments are voidable as fraudulent transfers . . . .'" (quoting Soulé v. Alliot (*In re* Tiger Petroleum Co.), 319 B.R. 225, 239 (Bankr. N.D. Okla. 2004))); *In re Indep. Clearing House*, 77 B.R. at 869 ("[P]ayments of fictitious profits to investors in a Ponzi scheme are not made for a reasonably equivalent value and thus are avoidable as fraudulent conveyances." (citation omitted)).

77. 11 U.S.C. § 548(d)(2)(A) (2006); UNIF. FRAUDULENT TRANSFER ACT § 3(a), 7A U.L.A. pt. II, at 47 (2006).

78. *In re Indep. Clearing House*, 77 B.R. at 857. Based on contract principles, including restitution, the money owed is a legitimate debt within the definition of value under fraudulent transfer law, and investors have a right to retention of this amount as for value. Importantly, courts deem all amounts transferred to an investor less than the original investment return of principal regardless of the way in which the payments were designated by the parties. *Id.* at 857–58.

79. *Id.* at 858.

80. *Id.* These courts' rationale is that enforcement would "further the debtors' fraudulent scheme at the expense of [other investors]," and circumvent the "principle that no one should profit from a fraudulent scheme at the expense of others." *Id.* at 858, 870.

the investor's allowance of the debtor's use of his money for the period of investment was not given for equivalent "value" under fraudulent transfer law.[81] Courts have reached this conclusion because value is to be determined by an objective standard, and the only value the debtor receives through the use of investors' money is the capability to continue its fraudulent scheme.[82] The value for this purpose is objectively "negative," since it "exacerbate[s] the harm to creditors by increasing the amount of claims while diminishing the debtor's estate."[83] Thus, any interest paid in return for a debtor's use of its investor's money is not considered transferred for value, and a bankruptcy trustee may reclaim it for the bankruptcy estate.[84]

Sole contrary precedent to the fictitious-profits rule comes from a line of cases involving contractual rights to interest.[85] Two cases noted in *In re Bayou*—which investors seeking to retain interest payments from a Ponzi scheme promoted as a defense—involved transfers of contractual loan repayments[86] and commission payments[87] that were considered made for value.[88] One court has even held that interest payments to investors in a Ponzi scheme were made for value where the debtor promised a specific rate of return.[89] Unfortunately, for most Ponzi scheme investors the fictitious-profits analysis remains the fundamental rule in cases lacking a specific contract. This leaves investors in schemes such as Madoff's with no defense

81. *E.g.*, *In re* Carrozzella & Richardson, 286 B.R. 480, 488–89 (D. Conn. 2002); *In re Indep. Clearing House*, 77 B.R. at 858.

82. *E.g., In re Carrozzella*, 286 B.R. at 488.

83. *In re Indep. Clearing House*, 77 B.R. at 859.

84. *See* Hinton & Larsen, *supra* note 10, at 4 ("[R]edemptions in excess of invested principal are 'fictitious profits' and thus, as a matter of law, not redeemed for value.").

85. *See* Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 636–38 (Bankr. S.D.N.Y. 2007).

86. *Id.* at 636 (citing Sharp Int'l Corp. v. State St. Bank Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 47–48 (2d Cir. 2005)).

87. *In re Bayou*, 362 B.R. at 637 (citing Balaber-Strauss v. Sixty-Five Brokers (*In re* Churchill Mortg. Inv. Corp.), 256 B.R. 664, 679 (Bankr. S.D.N.Y. 2000)).

88. *In re Bayou*, 362 B.R. at 638.

89. *In re* Carrozzella & Richardson, 286 B.R. 480, 489 (D. Conn. 2002) ("[P]ayment of interest to innocent investors pursuant to a contractual obligation clearly constitute[s] the satisfaction of an antecedent debt and, therefore, based upon the clear language of [the Bankruptcy Code], should be considered as the receipt of value by the debtor." (citing Lustig v. Weisz & Assocs., Inc. (*In re* Unified Commercial Capital, Inc.), 260 B.R. 343, 350 (Bankr. W.D.N.Y. 2001))).

against clawbacks of interest made beyond the amount of their principal investments.

II. THE INEQUITIES OF PONZI SCHEME AVOIDANCE LAW

Investors who face clawbacks after a Ponzi scheme's exposure are among the foremost victims of the scheme.[90] While investors who lose money during the scheme are clearly victims of the debtor and the fraud, investors who become clawback targets are arguably victims of both the defrauder and the fraudulent conveyance laws that permit this remedy.[91] Fraudulent conveyance law has built-in inequities, as well as the capability to spur a multitude of additional personal and social inequities in the Ponzi scheme context. Economic imbalances compound these injustices, turning winning investors into losers in many respects.

A. LEGAL, PERSONAL, AND SOCIAL INEQUITIES OF PONZI SCHEME AVOIDANCE LAW

The legal, personal, and social inequities a clawback target faces stem from both the inherent inequity built into fraudulent transfer law as well as the law's unjust effects. Ponzi scheme avoidance law is misapplied, causes social discord, and is incompatible with America's economic ideological system.

1. The Legal Inequity of Initial Transferee Liability

First, there is a deeply ingrained equitable problem in applying § 550 of the Bankruptcy Code to any fraudulent transfer proceeding. In the fraudulent conveyance context, both courts

90. *See* Mark D. Sherrill, *Limitations of Market Participants' Protections Against Fraudulent-Conveyance Actions,* AM. BANKR. INST. J., May 2009, at 28 ("Investors are the most obvious victims of Ponzi schemes . . . whether they lose their investment or face a clawback after a successful redemption."); Randy Krebs, *Recipients of Petters Gifts Should Return Them*, ST. CLOUD TIMES (Minn.), Dec. 20, 2009, at B16 (discussing the targets of clawbacks in a Ponzi scheme and noting that "[i]t's as if the number of victims in this scam just grew again").

91. *See* David Phelps, *Returning Petters' Gifts Easier Said Than Done*, STAR TRIB. (Minneapolis, Minn.), Sept. 30, 2010, at A1, *available at* 2010 WLNR 19706524 (quoting a Ponzi scheme bankruptcy trustee discussing clawback targets as saying, "I have investors who feel they've now been victimized twice"); *A New Fear for Madoff's Victims: Clawback*, NEO-NEOCON (Feb. 26, 2009, 10:43 EST), http://neoneocon.com/2009/02/26/a-new-fear-for-madoffs-victims-clawback (opining that clawback targets "run the risk of being victimized twice").

and commentators have long recognized that inequities arise from application of the Bankruptcy Code's strict transferee liability laws.[92] Courts have criticized the "unfortunate" maxim that under the Bankruptcy Code, "neither innocence in action nor unfairness in result is a defense,"[93] and opined that the law "leaves no room to fashion a remedy that treats the initial transferee equitably,"[94] or to reach "what some may contend is a preferred result."[95] Scholars have made similar critiques, even arguing that in extreme circumstances courts circumvent the Code's clear language to avoid inequitable ramifications.[96] One scholar's solution posits that courts should be allowed to structure equitable resolutions in any case where the initial transferee no longer has possession of the transferred property, such as a transferee of a tort judgment who used the money to recuperate.[97] A balance of social and equitable doctrines—specifically the application of contract remedies like restitution defenses—should allow initial transferees to retain property in certain situations.[98] Commentators agree with courts that the overall effects of the current Bankruptcy Code's initial transferee provisions are wrongly unfair and punitive.[99]

92. 11 U.S.C. § 550(a)(1) (2006); *see* Shafran, *supra* note 34.

93. Bauman v. Bliese (*In re* McCarn's Allstate Fin., Inc.), 326 B.R. 843, 852 (Bankr. M.D. Fla. 2005) (quoting Perrino v. Salem, Inc. (*In re* Mainely Payroll, Inc.), 233 B.R. 591, 597 (Bankr. D. Me. 1999)).

94. *In re McCarn's Allstate Fin., Inc.*, 326 B.R. at 852 (quoting Bowers v. Atlanta Motor Speedway, Inc. (*In re* Se. Hotel Prop. Ltd.), 99 F.3d 151, 157 (4th Cir. 1996)); *see also* Richardson v. FDIC (*In re* M. Blackburn Mitchell Inc.), 164 B.R. 117, 123 (Bankr. N.D. Cal. 1994) (remarking that there are situations in which it would be more equitable to allow an initial transferee to keep transferred property, but that courts may not "manipulate" the Code to reach this result).

95. *In re M. Blackburn*, 164 B.R. at 123; *see also In re Se. Hotel Prop.*, 99 F.3d at 157 ("[D]ecisions as to who should bear the loss incurred by a post-petition transfer are made in the Code . . . . Whether the line which has been drawn is the best possible solution of the problem is not for the courts to say." (quoting Lake v. N.Y. Life Ins. Co., 218 F.2d 349, 399 (4th Cir. 1955))).

96. Averch, *supra* note 13, at 602 (noting that notwithstanding the language of 11 U.S.C. § 550(a)(1), some courts release an initial recipient of an avoidable payment from liability if the recipient was a "mere conduit").

97. *Id.* at 602–03 (quoting 11 U.S.C. § 550(a)(1) (arguing that 11 U.S.C. § 550 already contains an equitable option in its language "if the court so orders," and that courts should be able to rely on this language to avoid inequitable holdings)).

98. *Id.*

99. *Id.* at 618–20; *see also* David F. Kurzawa II, Note, *When Fair Consideration Is Not Fair*, 11 CORNELL J.L. & PUB. POL'Y 461, 475–76 (2002).

In the specific context of a Ponzi scheme, the law contains an additional legal inequity: a procedure that places the burden of the risk that a transfer may be avoidable on the initial transferee.[100] The rationale behind this rule has been enumerated by multiple courts holding that initial transferees are "in the best position to monitor the transaction,"[101] "to know from whom they got funds, and to guard against fraud."[102] However, it is arguable that investors in a Ponzi scheme—particularly Madoff's—would not fall into these categories. Madoff's prosecutors allege his fraud began in the 1980s,[103] meaning the scheme lasted decades. The longevity of his business would have served to assuage any suspicions an investor might have, not raise them. Further, federal agencies themselves admitted that Madoff fooled not only investors but professional securities regulators who had examined his business just one year prior to the fraud's exposure.[104] Individual investors relied on this information to make investments.[105] Thus, of all parties to be made liable under the Bankruptcy Code's burden, most individual investors in a Ponzi scheme do not fit the rationale behind the rule. This misalliance exacerbates the legal inequity of Ponzi scheme avoidance law.

2. The Personal and Social Inequity of Ponzi Scheme Investor Liability

The justice of requiring so-called winners to pay losers in the aftermath of a Ponzi scheme is at the heart of the personal and social debate surrounding clawbacks of fictitious profits.[106]

100. *See, e.g.*, Schafer v. Las Vegas Hilton Corp. (*In re* Video Depot, Ltd.), 127 F.3d 1195, 1198 (9th Cir. 1997).

101. *Id.*

102. Bailey v. Hazen (*In re* Ogdon), 243 B.R. 104, 116 (B.A.P. 10th Cir. 2000).

103. Frank, *supra* note 3, at A1.

104. *See* Helen Kearney, *Report: FINRA Missed Multiple Warning Signs in Madoff/Stanford Schemes*, FIN. PLAN., Oct. 2, 2009, http://www.financial-planning.com/news/finra-mised-multiple-warnings-madoff-stanford-2664116-1.html; *Were the Regulators and the Regulated Too Close?*, ECON. TIMES (India), Dec. 17, 2008, http://economictimes.indiatimes.com/news/international-business/madoff-scandal-were-the-regulators-and-the-regulated-too-close/articleshow/3850103.cms.

105. *See* Thomas Zambito, *Bernie Investors Burned for 13 Years,* N.Y. DAILY NEWS, Feb. 21, 2009, at 6, *available at* 2009 WLNR 3423167.

106. *See, e.g.*, Nathan-Kazis, *supra* note 8; Patrick M. O'Keefe et al., *Ponzi Schemes in Bankruptcy*, AM. BANKR. INST., 1–2 (July 2007), http://www.abiworld.org/committees/newsletters/CFTF/vol4num4/5.pdf.

"Winners" are defined as investors who made money during their time in the fraudulent fund, meaning they ultimately withdrew more money in profits than they had initially invested.[107] Since these investors are considered to have "come out ahead" in the context of the scheme, they may thus be burdened with returning to the bankruptcy estate the difference between their initial investment and the money they ultimately withdrew from the fund.[108] Apart from the law's rationale that such fictitious profits were not received for value,[109] the equitable argument on the side of the law is that all investors should share equally in the harm from the fraud.[110] In other words, investors who fortuitously escaped the worst of the fraud, and are thus presumed to have retained excess funds, should sacrifice for the benefit of the rest.

While societal notions of fairness and kindness may seem to support such an argument, there are many key arguments that refute such a mode of thought. First, and most important, the designation of liable investors as "winners" can be severely inappropriate.[111] Ponzi scheme avoidance law places victims deemed, or at-risk of being deemed, winners in a "precarious Catch 22."[112] Not only do they have a lesser chance of retrieving any funds left in their account through filing a claim with the Securities Investor Protection Corporation (SIPC),[113] they could actually make themselves worse off by alerting the trustee to their status as a winner and increasing the chances of a clawback claim.[114] Despite this risk, many winning investors may

107. *See* Berenson, *supra* note 15, at A1.

108. *Id.*

109. *See* O'Keefe et al., *supra* note 106, at 2.

110. *See, e.g.*, *Poll*: *Should Madoff Winners Have to Share with Madoff Losers?*, CRAIN'S N.Y. BUS. (May 13, 2009), http://mycrains.crainsnewyork.com/polls/2009/05/should-madoff-winners-have-to.php.

111. *See* Berenson, *supra* note 15, at A1.

112. *See* Rubinstein, *supra* note 16.

113. The SIPC, a securities industry fund whose purpose is to insure investors, has already denied insurance to many winning investors—over 2500 people thus far. Brian Ross & Megan Chuchmach, *Madoff 'Losers' Get Only $534 Million; 'Winners' Get Zero*, ABC NEWS, Oct. 28, 2009, http://abcnews.go.com/Blotter/Madoff/madoff-victims-denied-claims-sipc/story?id=8936796; *see also* Lawrence R. Velvel, *Re: Of Markopolos and Madoff, New Times and Conventional Wisdom, SIPC and Clawbacks, Equitable Estoppel and Declaratory Judgments*, VELVEL ON NAT'L AFFAIRS (Feb. 23, 2009, 11:22 AM) http://velvelonnationalaffairs.blogspot.com/2009_02_01_archive.html (explaining why no SIPC recovery is likely).

114. *See Madoff 'Victims' Do Math, Realize They Profited*, BISMARK TRIB., Jan. 9, 2009, at A8, *available at* 2009 WLNR 476045; Henry Blodget, *Madoff*

truly need and deserve SIPC protection. As one commentator has noted, Madoff investors considered winners could include elderly people who depended on interest payments for their livelihood and now "don't know where their next dollar will come from or how they will buy food."[115] One Madoff victim stated that most of the investors he knew who consistently took out interest were retirees living off of the returns from their principal investment.[116] This group of victims also includes those who may have spent withdrawn funds to buy a home, pay for college for their grandchildren, or pay the taxes on what eventually proved to be "phantom income."[117] To protect themselves, these investors must spend even more money to engage the judicial process and represent themselves in court.[118] Lastly, winners even include charities to which the debtor gave voluntary donations.[119] Many investors—even the losers—find it morally reprehensible to take back funds given to charity regardless of whether or not the charities ultimately profited.[120] This is especially true in the context of Madoff's scheme, since a majority of his charitable beneficiaries were Jewish focused, aiding the community of which so many Madoff investors are a part.[121] Analyzing these so-called winners more closely reveals

Winners Wonder Whether to Complain or Shut Up, BUS. INSIDER (Jan. 8, 2009), http://www.businessinsider.com/2009/1/madoff-winners-have-tough-decisions-to-make.

115. Velvel, *supra* note 113; *see also Madoff Investors Continue to Seek Protection*, REUTERS, May 27, 2009, *available at* http://www.reuters.com/article/pressRelease/idUS121354+27-May-2009+PRN20090527 ("Today, many calls are from elderly people who have lost all or most of their money and are afraid that the trustee will take their home . . . .").

116. Berenson, *supra* note 15, at A1.

117. Velvel, *supra* note 113.

118. *See* Kurzawa, *supra* note 99, at 476 ("[G]ood faith investors must either engage in costly litigation or pay the trustee the interest paid to them."); *see also* Zambito, *supra* note 105, at 6 (interviewing an investor appearing in court on behalf of her eighty-seven-year-old mother-in-law).

119. *See, e.g.*, Josh Nathan-Kazis, *Charities Hurt by Madoff May Have to Return Funds*, JEWISH DAILY FORWARD (Aug. 19, 2009), http://www.forward.com/articles/112466/; Phelps, *supra* note 91, at A1 (quoting a Ponzi scheme bankruptcy trustee as saying, "[i]t hasn't been a lot of fun . . . . I've had to sue charities").

120. *See* Nathan-Kazis, *supra* note 8 (quoting one Madoff victim who felt charities should be able to keep the funds they received from the scheme because the money was used for "good works").

121. Jocelyn Noveck, *Madoff Scheme Hits Jewish Charities Hard*, PITTSBURGH POST-GAZETTE, Dec. 17, 2008, at A9, *available at* 2008 WLNR 24134165.

the error in such a classification and the problems such investors still face once the fraud is revealed.

Further, despite the argument that Ponzi scheme avoidance law is the communally fair solution, this law actually causes numerous undesirable societal consequences. The first of these consequences is questionable attorney advice. Ponzi scheme avoidance law places lawyers in a difficult position when counseling net winners,[122] since lawyers know that the law ultimately requires those investors to return their fictitious profits. Such lawyers may end up advising investors to "[k]eep quiet and hope nobody notices,"[123] or to convert vulnerable funds into exempt assets.[124] This is exactly what bankruptcy law should and does desire to avoid,[125] and even attorneys who would counsel their clients to pursue such tactics recognize that the law disapproves.[126] Ponzi scheme avoidance law also pits victims of the fraud against one another. As losers become aware that the law authorizes clawbacks from winners for redistribution, it is only "a matter of time before investors wiped out in the scandal turn on those who unknowingly enjoyed the fruits of the fraud."[127] To at least one investor, the fact that this scenario occurs is devastating, and evades the real issue of securing punishment for the truly guilty parties.[128] Unfortunately, the law ultimately forces innocent victims to "claw at each other, whether they want to or not."[129] Such negative social side effects have real harmful impacts on all victims.

Finally, the overall theory that winners must share with losers seems to contradict fundamental tenets of America's val-

122. *See Madoff 'Victims' Do Math, Realize They Profited*, *supra* note 114, at A8.

123. *Id.*

124. *See Madoff Investors Continue to Seek Protection*, *supra* note 115; Rubinstein, *supra* note 16 (counseling liable clients to redirect assets into everything from foreign annuities and life insurance policies via offshore wire transfers to a new home in Florida). Exempt assets can include retirement funds, certain types of insurance, and different levels of equity in a home. *Id.*

125. *See* H.R. REP. No. 108-40(I), at 595 (2003) (singling out as "notorious" the "'financial planning' strategy by which debtors purchase expensive homes" in order to qualify for exemptions under § 522 of the Bankruptcy Code).

126. *See* Rubinstein, *supra* note 16 (explaining that clients may need to prove that their new investments in exempt assets were "legitimate financial or estate planning," otherwise they could be subject to clawbacks as made with "intent to hinder the trustee from reaching those assets").

127. *Madoff 'Victims' Do Math, Realize They Profited*, *supra* note 114, at A8 (quoting one attorney as saying, "[t]he sharks are all circling").

128. Nathan-Kazis, *supra* note 8.

129. *A New Fear for Madoff's Victims: Clawback*, *supra* note 91.

ued system of capitalism—a system that enabled Madoff investors to accumulate wealth in the first place.[130] Much of the country reacted in uproar to a comment made by President Obama during his run for the White House in which he insinuated America would be better off if wealth were "redistributed."[131] The process of collection and redistribution in a Ponzi scheme bankruptcy sounds strikingly similar. While it is clear Madoff investors did not necessarily work hard for the profits they earned, the capitalist mentality serves to protect not only those who deserve their income, but also those lucky enough to accede to wealth without individual effort.[132] As one commentator on clawbacks recognized, "We live in a world full of randomness and risks that we can never fully anticipate or control."[133] A capitalist system embraces this risk for better or for worse, and the law should not serve to punish those who, due purely to fortuity, sold "at the right time" in the context of a Ponzi scheme of which they were unaware.[134]

B. ECONOMIC INEQUITIES OF PONZI SCHEME AVOIDANCE LAW

The specific economic inequities winners experience are just as harmful as the legal, individual, and social inequities stemming from Ponzi scheme avoidance law. The court's reasoning in *In re Independent Clearing House Co.* is representative of the faulty economic rationale behind the current law's allowance of clawbacks.[135] Permitting the trustee to avoid payments of all fictitious profits in a Ponzi scheme, the *Clearing*

130. Kal Gullapalli, *What Do Mortgages, Madoff, and Quiznos Have in Common?*, BUS. INSIDER (Jan. 10, 2010, 4:40 PM), http://www.businessinsider.com/what-do-mortgages-madoff-and-quiznos-have-in-common-2011-1.

131. *McCain, Palin Hint That Obama's Policies Are "Socialist,"* CNN.COM (Oct. 18, 2008, 5:48 PM), http://www.cnn.com/2008/POLITICS/10/18/campaign.wrap/index.html. Comparing this theory to socialism, many Americans made clear that they associate socialist ideology with legitimate wealth being taken away from some and given to others whom a third party—the government—deems in need of it. *See, e.g.*, Editorial, *What 'Socialism' Means to the Masses*, N.Y. TIMES: ROOM FOR DEBATE (Sept. 18, 2009, 8:41 PM), http://roomfordebate.blogs.nytimes.com/2009/09/18/what-socialism-means-to-the-masses/?scp=2&sq=redistribute%20the%20wealth%20obama%20socialist&st=cse.

132. *The Danger of Madoff Style "Clawbacks,"* JOHN STANDERFER (Apr. 27, 2009), http://www.johnstanderfer.com/?p=45.

133. *Id.*

134. *Id.*; *see also Should Madoff Winners Have to Share with Madoff Losers?*, *supra* note 110 ("Playing the market is like going to the races. You win some, you lose some.").

135. Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 870 (D. Utah 1987).

House court noted that "defendants are not hurt [by losing their fictitious profits] but will be in roughly the same position they were in before they entrusted their money to the debtors. They will still have all the funds that they invested . . . ."[136] This viewpoint ignores fundamental economic principles by failing to recognize reliance interests, opportunity costs, and the time value of a winner's initial investment.

1. Real Losses: Reliance Damages

As the court in *In re Bayou Group, LLC* noted, § 548 of the Bankruptcy Code is an equitable provision.[137] Its purpose is to put winners in the same position as losers who did not receive payments of fictitious profits.[138] Since equity is at the core of bankruptcy laws, equitable concepts such as the contractual doctrines of equitable estoppel and reliance damages[139] should support and coincide with the outcome in Ponzi scheme avoidance. Instead, however, such doctrines serve to illustrate the economic inequity of fraudulent transfer laws.

The defense of equitable estoppel stems from principles of fraud, giving recourse to those who rely on and are injured due to fraudulent representations.[140] A plaintiff who prevails with this defense may be awarded reliance damages.[141] The theory behind reliance damages is that injured parties should be placed in the same economic positions they held before the fraudulent transaction.[142] Courts thus award compensation for losses incurred in reliance on the fraudulent representations.[143] Reliance damages are recognized as "real" economic losses, as

136. *Id.*

137. *In re* Bayou Grp., LLC, 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*, 439 B.R. 284, 303, 338–39 (S.D.N.Y. 2010).

138. *Id.*

139. *See, e.g.*, Transcon. Realty Investors, Inc. v. John T. Lupton Trust, 286 S.W.3d 635, 648 (Tex. App. 2009) (noting that reliance damages are available under valid promissory or equitable estoppel claims).

140. BLACK'S LAW DICTIONARY, *supra* note 4, at 630 (defining "estoppel").

141. *Transcon. Realty*, 286 S.W.3d at 648; *see also* CHARLES L. KNAPP ET AL., PROBLEMS IN CONTRACT LAW: CASES AND MATERIALS 968 (6th ed. 2007) (using *Wartzman v. Hightower Products., Ltd.*, 456 A.2d 82 (Md. Ct. Spec. App. 1983), to explain "the injured party has a right to damages based upon his reliance interest").

142. BLACK'S LAW DICTIONARY, *supra* note 4, at 448 (defining "reliance damages").

143. *See Transcon. Realty*, 286 S.W.3d at 648.

opposed to expectation damages.[144] However, there are multiple ways in which Ponzi scheme avoidance law fails to recognize these real economic losses sustained by so-called winners.

The first relates to the most common type of reliance damages: out-of-pocket expenditures.[145] Ponzi scheme avoidance law fails to recognize the additional out-of-pocket expenditures winners will likely have to make due to their reliance on the fraud. As a result of their status, winners are likely clawback targets, making them legally liable for money they may no longer have.[146] In such a situation, winners must expend additional resources to either sell assets to recover the money they owe, or litigate the issue against the trustee.[147] If an investor's spent funds are irretrievable, he has no choice but to expend resources on legal representation. Thus, even if winners and losers eventually end up with the "same" amount—their principal balance—winners' economic positions may be worse due to additional out-of-pocket expenditures they were forced to make because of their reliance on fraudulent representations. These costs are legitimate reliance damages that Ponzi scheme avoidance law does not recognize.

Further, courts have held that reliance damages can also include foregone opportunities, or the "opportunity cost" of a transaction.[148] One of the most obvious ways current laws take such costs into account is through awards of prejudgment in-

144. BLACK'S LAW DICTIONARY, *supra* note 4, at 448 (defining "reliance damages"). In the context of a Ponzi scheme, expectancy damages would give investors everything they would have received had the "contract" been upheld as portrayed. *See id.* at 446 (defining "expectation damages"). Thus, if this measure of damages were used, investors would receive the entire amount shown on any Madoff investor's false statement, including fictitious profits.

145. *See, e.g.*, Kreitzer v. Xethanol Corp., No. 08-14 (DSD/JJK), 2009 WL 113373, at *4 (D. Minn. Jan. 16, 2009).

146. *See* Berenson, *supra* note 15, at A1.

147. For example, if a winner had bought a house with fictitious profits, he would have to incur additional costs to market and sell his dwelling in order to recoup the funds he owes. He may also lose money if the house declined in value from the time he purchased it.

148. *See, e.g.*, Cole Energy Dev. Co. v. Ingersoll-Rand Co., 913 F.2d 1194, 1202–03 (7th Cir. 1990); KNAPP ET AL., *supra* note 141, at 974; 1 ROGER J. MAGNUSON, SHAREHOLDER LITIGATION § 2:32 (2010). Economists have also recognized this aspect of legal damages. *See* Kenneth L. Hubbell, *Compensation for Pecuniary Losses in Breach of Contract Cases*, 1 J. FORENSIC ECON. 27, 32, 36 (1987) (finding that contract law damages are "consistent with economic theory" and "reflect[] the economic cost of the breach [of contract]" by taking into account opportunity costs).

terest.[149] As noted in *Amara v. CIGNA Corp.*, one of the main purposes of prejudgment interest is to reimburse victims for true damages experienced.[150] Although the specific rate may be determined in different ways,[151] prejudgment interests' underlying rationale is to compensate a plaintiff for being deprived of the use of the usurped funds.[152] Thus, such an award is in essence an opportunity-cost reliance damage award, and economists have specifically cited it as a legal argument that Ponzi scheme winners should use in attempting to protect some of their fictitious profits.[153] Courts also award opportunity-cost reliance damages apart from prejudgment interest. In *Medical Associates of Hamburg, P.C. v. Advest, Inc.*, for example, the court noted that in allowing recovery of actual damages, the applicable securities law meant to compensate plaintiffs for the "economic loss" resulting from the law's violation.[154] Consequently, the plaintiff's damages were to be "market adjusted" to reflect that a properly managed investment would have kept up with the overall market.[155] The court in *Cole Energy Development Co. v. Ingersoll-Rand Co.* similarly allowed foregone opportunity damages in a breach of contract and fraud case, holding that the "economic concept of opportunity cost" is a method of adjusting value to reflect the fact that "for every use of one's resources there is an alternative use, with its own return, foregone."[156] Courts clearly recognize that the opportunity

149. *See, e.g.*, Amara v. CIGNA Corp., 559 F. Supp. 2d 192, 220 (D. Conn. 2008).

150. *Id.*

151. *See, e.g.*, Saavedra v. Korean Air Lines Co., 93 F.3d 547, 555 (9th Cir. 1996) (recommending the use of a "fluctuating rate"); Gamma-10 Plastics, Inc. v. Am. President Lines, Ltd., 839 F. Supp. 1359, 1362 (D. Minn. 1993) (promoting the use of the rate "prevailing during the relevant period"), *aff'd in part, rev'd in part*, 32 F.3d 1244, 1257 (8th Cir. 1994). Rates may also be set by state or federal statute. *See* Hinton & Larsen, *supra* note 10, at 5.

152. Midwest Petroleum Co. v. Am. Petrofina Mktg., Inc., 644 F. Supp. 1067, 1070 (E.D. Mo. 1986).

153. *See* Hinton & Larsen, *supra* note 10, at 5–6.

154. Medical Assocs. of Hamburg, P.C. v. Advest, Inc., No. CIV-85-837E, 1989 WL 75142, at *1 (W.D.N.Y. July 5, 1989) (citing Osofsky v. Zipf, 645 F.2d 107, 111 (2d Cir. 1981)).

155. *Id.*; *see also* MAGNUSON, *supra* note 148, § 2:32 n.51 (noting that "market adjustment" measures "loss of investment opportunity caused by the failure of the account to earn a rate of return based on suitable alternative investments during the same period of time").

156. Cole Energy Dev. Co. v. Ingersoll-Rand Co., 913 F.2d 1194, 1202–03 (7th Cir. 1990) (citing Fishman v. Estate of Wirtz, 807 F.2d 520, 556 (7th Cir. 1986)).

costs of a fraudulent transaction are real reliance damages, and thus real economic losses.

Ponzi scheme avoidance law, however, fails to account for the difference in foregone opportunity winners suffer as compared to losers. Due to the nature of a Ponzi scheme, winners are often those who invested earlier in the fraud.[157] This means they spent more time than many losers investing money in a venture that was relaying fictitious profits they later may have to repay. Since this is time during which those funds could have been invested in a legitimate security, such time represents an opportunity cost.[158] In the hypothetical scenario of two investors—one who invested a principal amount six years ago and routinely extracted interest payments, and another who invested the same principal amount six months before the fraud was exposed—it is clear that the earlier investor suffers greater reliance damages in the form of foregone opportunities if forced to repay his interest due to a Ponzi scheme.[159] And if the later investor is ultimately able to recoup the amount of his initial investment through SIPC protection and/or trustee distributions, fraudulent transfer law will have put the winning investor in a worse economic situation than the losing investor by ignoring the reality of opportunity costs—a valid component of reliance damages.

2. The Time Value of Money

In a similar vein, though perhaps even more extreme in its economic deviance, Ponzi scheme avoidance law completely ignores the reality of money's baseline "time value."[160] While to some extent an opportunity cost, the concept of the time value

157. *See* Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 870 (D. Utah 1987) ("The fortuity that these defendants got into the scheme early enough to make a profit should not entitle them to a reward at the expense of equally innocent undertakers who entered the scheme later."); BLACK'S LAW DICTIONARY, *supra* note 4 (stating in the definition of "Ponzi scheme" that "money contributed by later investors generates artificially high . . . returns for the original investors").

158. *Cole Energy Dev. Co.*, 913 F.2d at 1202–03.

159. If such an investor is deemed a "winner" and required to pay back fictitious profits, he loses up to six years of the rate of interest he could have legally been earning on his principal balance, while the later investor loses only six months.

160. For a clear definition and explanation of the concept of money's "time value," see EUGENE F. BRIGHAM & PHILLIP R. DAVES, INTERMEDIATE FINANCIAL MANAGEMENT 28-1 to -10 (8th ed. 2007), *available at* http://www.swlearning.com/finance/brigham/ifm8e/ifm8e.html.

of money also includes recognition of the impact of inflation on the value of money and the availability of risk-free interest.[161]

Time value's inflationary element differs from the opportunity cost of lost investment interest, since an interest calculation could include the foregone opportunity of investing in a higher return venture.[162] Accounting for inflation instead recognizes the common financial understanding that if one's money is not keeping up with inflation, one is essentially losing money.[163] The value of money is considered "preserved" by the fact that banks generally offer savings account interest rates that equal the inflation rate.[164] The inflationary aspect of the time value of money impacts funds sitting in a savings account to the same extent as funds being invested in the marketplace, illustrating the concept that the purpose of inflation-related interest is to maintain the value of one's money—not to increase it. Even the Bankruptcy Code itself recognizes inflation and its impact on the "real value" of amounts it uses in parts of the Code.[165] This recognition makes Ponzi scheme avoidance laws' ignorance of inflation even more anomalous.

The rate of interest given on a "risk-free" investment also reflects the baseline time value of money. Instead of using statutory judgment or opportunity cost interest rates, for example, a smaller time value rate could be computed by using the "risk-free rate."[166] This rate reflects interest on an investment that is essentially risk free—for example, government-issued treasury securities whose default risk is negligible.[167] Treasury Inflation Protected Securities get their "principal value" adjusted consis-

161. *Id.* at 28-15 & n.13 (describing U.S. Treasury bonds, which are risk-less investments that provide a real rate of return plus expected inflation).

162. *See, e.g.*, *Cole Energy Dev. Co.*, 913 F.2d at 1202–03 (equating "opportunity cost" with one's "alternative use . . . foregone").

163. *See, e.g.*, Becky Barrow, *Eight in 10 Savings Accounts Lose Cash: Inflation Goes Up—But Banks Still Pay Interest Rates Just Above Zero*, MAILONLINE (Nov. 18, 2009), http://www.dailymail.co.uk/news/article1228676/Nine-10-savings-accounts-pay-paltry-customers-losing-money.html; Sol Nasisi, *Impact of Inflation on Savings Account Rates and Returns,* BESTCASHCOW (Feb. 20, 2009), http://www.bestcashcow.com/savings_-_checking_-_cds/article/sol_nasisi/impact-of-inflation-on-savings-account-rates-and-returns.

164. *Inflation and Interest Rate*, ECONOMY WATCH, http://www.economywatch.com/inflation/economy/interest-rates.html (last visited Mar. 3, 2011).

165. 11 U.S.C. § 104 (2006) (Historical and Statutory Notes) (requiring adjustment of dollar amounts in the Bankruptcy Code every three years for the "housekeeping function of maintaining the dollar amounts in the code at *fairly constant real* dollar levels" (emphasis added)).

166. *See* Hinton & Larsen, *supra* note 10, at 6.

167. *Id.*

tently based on the Consumer Price Index,[168] reflecting the notion that the actual initial value of an investment—not interest earned—changes due to inflation. Allowing winning investors to keep the risk-free rate of return on their investments would be a way of recognizing the value of "the duration of their investments, [] while depleting the potential pool of clawback funds to a lesser extent."[169] Whichever methods courts choose, however, it is clearly economically inequitable for winning investors to receive no acknowledgment of the time value of their money or the opportunity costs of their investment.

III. CORRECTING THE VALUATION OF "VALUE"

The current state of Ponzi scheme avoidance law—specifically, its allowance of clawbacks—results in an extensive array of legal, individual, social, and economic inequities. To avoid injustice, Ponzi scheme avoidance law must take into account the time value and opportunity costs associated with winning investors' expenditures, and allow such investors to retain a portion of these costs. Such an approach will cause less imbalance and friction among victimized investors, encourage proper legal advice, and comport more thoroughly with the United States' capitalist system. It is also economically sound. Importantly, this solution does not require an overhaul of state or federal fraudulent transfer laws. Rather, courts can achieve a more expansive defense against clawbacks for winning investors by updating the way they define and determine value under fraudulent transfer law.

A. DEFINING VALUE

Current jurisprudence holds that only an investor's exact principal balance has been given for value under fraudulent transfer law.[170] Courts must shift this definition to account for flexible interpretive rules and new legal distinctions. Doing so will allow courts to recognize winners' opportunity costs and their money's time value, and thus achieve a more equitable outcome under Ponzi scheme avoidance law.

168. *Protecting Your Money with Inflation Adjusted Bonds*, BIONOMIC FUEL, http://www.bionomicfuel.com/protecting-your-money-with-inflation-adjusted-bonds (last visited Mar. 3, 2011).

169. Hinton & Larsen, *supra* note 10, at 6.

170. Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 857 (D. Utah 1987); Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 636 (Bankr. S.D.N.Y. 2007).

1. Integral Interpretive Rules

Courts have specifically been given deference to determine the "scope and meaning" of value on a case-by-case basis.[171] Under Ponzi scheme avoidance law, however, courts use a strict interpretation that provides only a dollar-for-dollar defense for investors.[172] Such an interpretation is far too narrow, and, under already established jurisprudence, should be much more flexible. Courts have held that the standard to determine "for value" under Code § 548(c) is the same as the standard to determine "reasonably equivalent value" as used elsewhere in § 548 and in the UFTA.[173] The principles for determining equivalent value in most contexts are much more expansive than current Ponzi scheme courts recognize. Most other courts assess the "totality of the circumstances,"[174] and make determinations of value on an individualized basis.[175] Specifically, dollar-for-dollar equivalency is not required.[176] Rather, courts consider three elements: the fair market value of the property the debtor received in exchange for the transfer, whether or not the transfer was an arm's-length transaction, and whether the transferee acted in good faith.[177] Courts compare the "value of

171. *E.g.*, Hirsch v. Steinberg (*In re* Colonial Realty Co.), 226 B.R. 513, 523 (Bankr. D. Conn. 1998) (quoting Cooper v. Ashley Commc'n, Inc. (*In re* Morris Commc'n NC, Inc.), 914 F.2d 458, 466 (4th Cir. 1990)).

172. Investors are protected up to the precise amount of their initial principal investments, but no more. *In re Indep. Clearing House*, 77 B.R. at 869–70.

173. *See* Dobin v. Hill (*In re* Hill), 342 B.R. 183, 203 (Bankr. D.N.J. 2006) (holding that the standard for defining value under § 548(c) should be reasonably equivalent value); Satriale v. Key Bank USA (*In re* Burry), 309 B.R. 130, 136 (Bankr. E.D. Pa. 2004); 3B BANKRUPTCY SERVICE LAWYERS EDITION, *supra* note 53, § 34:470 ("Term 'value,' as used in the section of the Bankruptcy Code setting forth the good faith defense to transfer avoidance . . . means reasonably equivalent value. 11 U.S.C.A. § 548(c).").

174. *E.g.*, Official Comm. of Unsecured Creditors of Fedders N. Am. Inc. *ex. rel.* Debtors' Estates v. Goldman Sachs Credit Partners (*In re* Fedders N. Am., Inc.), 405 B.R. 527, 547 (Bankr. D. Del. 2009).

175. *E.g.*, Shafran, *supra* note 34.

176. *See* Greenspan v. Orrick, Herrington & Sutcliffe LLP (*In re* Brobeck, Phleger & Harrison LLP), 408 B.R. 318, 341 (Bankr. N.D. Cal. 2009) ("Reasonable equivalence does not require exact equality in value . . . ."); ASARCO, LLC v. Ams. Mining Corp., 404 B.R. 150, 172 (S.D. Tex. 2009) ("[C]ourts look to see if what debtor received was 'in the range of a reasonable measure of the value of what the debtor transferred.'" (quoting Viscount Air Servs., Inc. v. Cole (*In re* Viscount Air Servs., Inc.), 232 B.R. 416, 434 (Bankr. D. Ariz. 1998))).

177. *In re Fedders N. Am. Inc.*, 405 B.R. at 547; Cardiello v. Casale (*In re* Phillips Grp., Inc.), 382 B.R. 876, 887 (Bankr. W.D. Pa. 2008). Many courts hold that fair market value is the most important element. *See* Brandt v. nVidia Corp. (*In re* 3dfx Interactive, Inc.), 389 B.R. 842, 863–64 (Bankr. N.D. Cal.

what went out with the value of what was received,"[178] but remain flexible in deciding the factual issue of whether or not a transfer was for reasonably equivalent value.[179] Thus, to better position themselves to allow equitable remedies for winning investors, Ponzi scheme courts must update the way they define value to include these reasonable and more flexible rules.

2. New Legal Distinctions

Courts reviewing Ponzi scheme cases also continue to use outmoded legal determinations related to fraudulent transfer law. While these courts have historically deemed fictitious profit transfers not "for value" because of their negative implications in furthering a fraudulent scheme, recent decisions have begun to shift from this viewpoint and to construe value more favorably to winning investors. Ponzi scheme courts must officially recognize these current trends in avoidance jurisprudence, which will allow them to fashion more equitable remedies for winning investors.

The first trend stems from *In re Carrozzella & Richardson* and a line of cases discussed therein.[180] In *Carrozzella,* the court determined that contractual interest payments from a Ponzi scheme debtor to investors could be considered for value, and thus immune to avoidance.[181] While contractual interest is not necessarily at issue in a situation such as Madoff's scheme, *Carrozzella*'s analysis included the broader issue of whether payments of fictitious profits should always be deemed as received for "negative value"—the traditional Ponzi scheme avoidance law determination.[182] The court held that such a traditional view was erroneous in many respects, most importantly in its interpretation of the statutory language itself. Pointing to the avoidance language of the UFTA that directs courts to examine what is received "in exchange for the transfer,"[183] *Car-*

2008); Heritage Bank Tinley Park v. Steinberg (*In re* Grabill Corp.), 121 B.R. 983, 994 (Bankr. N.D. Ill. 1990).

178. *In re Grabill*, 121 B.R. at 994.

179. *See* Shafran, *supra* note 34.

180. Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 487–88 (D. Conn. 2002).

181. *Id.* at 492.

182. *See In re Carrozzella*, 286 B.R. at 488; Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 635 (Bankr. S.D.N.Y. 2007).

183. UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2), 7A U.L.A. pt. II, at 58 (2006). This language is almost identical to the language of 11 U.S.C.

rozzella held that looking at the negative value in payments assisting the debtor's Ponzi scheme would incorrectly focus on the "supposed significance or consequence of the . . . transaction in the context of the Debtor's whole Ponzi scheme."[184] The purpose of fraudulent transfer law is to "right the wrong of a single transaction,"[185] rather than to achieve "distributional equality."[186] Therefore, courts should focus only on one specific transaction in determining whether equivalent value was exchanged, not on an overarching scheme.[187] Furthermore, *Carrozzella*'s holding is consistent with the fraudulent transfer rule that courts should examine what is exchanged at "the time of the transfer" to determine equivalent value.[188] Ponzi scheme courts thus should no longer consider a transfer's subsequent impact on the debtor's total business, but instead use this alternate statutory interpretation in analyzing whether a winning investor gave value in return for his or her "interest" payments.

The second trend in the legal construction of value that should be followed to benefit winning investors relates to a difference in the way the term is used in the statutes—that is, whether it is part of a cause of action or a defense. Sections 548(a)(1)(B) of the Bankruptcy Code and 4(a)(2) of the UFTA authorize trustees to avoid any transfers in which the debtor obtained less than reasonably equivalent value.[189] As the language implies, and as courts have universally recognized, the value in this case is measured from the perspective of the debtor,[190] not the perspective of the transferee.[191] However, Bank-

§ 548(d)2)(A) (2006). *In re Carrozzella*, 286 B.R. at 489.

184. *In re Carrozzella,* 286 B.R. at 488 (quoting *In re* Churchill Mortg. Inv. Corp., 256 B.R. 664, 680 (Bankr. S.D.N.Y. 2000)).

185. *Id.* at 489 n.19 (citing *In re* Unified Commercial Capital, Inc., 260 B.R. 343, 352 n.10 (Bankr. W.D.N.Y. 2001)).

186. *Id.*

187. *Id.* The court also noted that any analysis beyond a specific transaction would be going beyond the "plain language" of the statutes, and "usurp[ing] the function of the legislature." *Id*. at 491.

188. *See, e.g.*, Greenspan v. Orrick, Herrington & Sutcliffe LLP (*In re* Brobeck, Phleger & Harrison LLP), 408 B.R. 318, 341 (Bankr. N.D. Cal. 2009); Slone v. Lassiter (*In re* Grove-Merritt), 406 B.R. 778, 805 (Bankr. S.D. Ohio 2009).

189. 11 U.S.C. § 548(a)(1)(B)(i) (2006); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2), 7A U.L.A. pt. II, at 58 (2006).

190. *See, e.g.*, *In re* Hannover Corp., 310 F.3d 796, 802 (5th Cir. 2002) ("[T]he recognized test is whether the investment conferred an economic benefit on the debtor." (quoting *In re* Fairchild Aircraft Corp., 6 F.3d 1119 (5th Cir. 1993))); *In re Grove-Merritt*, 406 B.R. at 805.

ruptcy Code § 548(c) is worded differently than § 548(a)(1)(B), and is analogous to the transferee defense under UFTA section 8(d).[192] The court in *In re Hannover Corp.* explained that as a defensive provision § 548(c) is meant to protect transferees from an "unfortunate selection of business partners."[193] Consequently, analysis of equivalent value in this defense must be made from the standpoint of the *transferee*, not the transferor.[194] Ponzi scheme courts must heed this key distinction when determining whether an investor's fictitious profits were transferred for value.

At least one court has already combined both trends to hold against trustee avoidance powers in a Ponzi scheme case. *In re Financial Federated Title & Trust, Inc.* reiterated that courts cannot look at a transaction's impact on the debtor's business to determine value, since "by definition, a Ponzi scheme is driven further into insolvency with each transaction."[195] Noting that only erroneous reasoning could result in every transaction with the debtor being avoided, the court held that the determination of value under § 548 must focus on the value of what is provided to the debtor, rather than value from the debtor's standpoint.[196] While more recent cases seem to have ignored these trends,[197] the Madoff calamity has illustrated the depth of the inequities caused by outdated interpretations of Ponzi scheme avoidance law. Courts must update their determination of value under fraudulent transfer law to allow retention for winners of some fictitious profits equal to the time value of their money and their opportunity costs.

191. *See, e.g.*, *In re Brobeck*, 408 B.R. at 341 (citing Brandt v. nVidia Corp. (*In re* 3dfx Interactive, Inc.), 389 B.R. 842, 863 (Bankr. N.D. Cal. 2008)).

192. 11 U.S.C. § 548(c); UNIF. FRAUDULENT TRANSFER ACT § 8(d) (allowing a good-faith transferee to retain interest in a transferred asset "to the extent of the value given the debtor for the transfer").

193. *In re Hannover Corp.*, 310 F.3d at 802 ("[T]he provision at § 548(c) . . . provides a means by which the unwitting trading partner can protect himself.").

194. *Id.* ("The concern here, quite properly, is for the transferee's side of the exchange, not the transferor's gain."); *see also* Dobin v. Hill (*In re* Hill), 342 B.R. 183, 203 (Bankr. D.N.J. 2006) ("[T]he relevant inquiry is the value given by the transferee, rather than the value received by the debtor as would be examined under § 548(a)(1)(B)(I)."); Shafran, *supra* note 34.

195. Orlick v. Kozyak (*In re* Fin. Federated Title & Trust, Inc.), 309 F.3d 1325, 1332 (11th Cir. 2002) (quoting Merrill v. Allen (*In re* Universal Clearing House Co.), 60 B.R. 985, 999 (Bankr. D. Utah 1986)).

196. *Id.*

197. *E.g.*, Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (*In re* Bayou Grp., LLC), 362 B.R. 624, 636 (Bankr. S.D.N.Y. 2007).

B. APPLYING VALUE

Courts that update their definition of value using more appropriate interpretive rules and new legal distinctions will be positioned to allow more equitable solutions in Ponzi scheme cases. These equitable solutions can and should take into account the time value and opportunity costs associated with winning investors' investments.

1. Time Value

The time value of money is an economic reality courts must no longer ignore in determining whether a transfer was for value. It is consistently taken into account in determining the true value of one's money at banks, in courts, and in the Bankruptcy Code itself. It reflects the fundamental maxim that a dollar today is worth more than a dollar tomorrow,[198] and thus that a debt owed today should be higher if not paid until tomorrow. Under a more flexible and case-by-case interpretation of equivalent value, courts must consider the fact that dollar-for-dollar value is not required, but fair market value is key. Since fair market value often includes future value based upon time value,[199] courts should easily be able to rationalize accounting for time value in considering Ponzi scheme winners' interest payments.

Specifically, time value should be acknowledged in considering the rule that a Ponzi scheme debtor's repayment of an investor's principal balance is deemed for value as satisfaction of an antecedent debt. Current Ponzi scheme avoidance law would hold that a payment of $100 in ten years would satisfy fully a $100 debt today. Using time value principles, however, courts should recognize that if adjusted for inflation, the debt owed to the investor would have risen by a small percentage each year. Thus, where the debtor paid ten percent interest annually and inflation was two percent, the debtor must still pay another twelve percent after $100 in payments for the investor to break even. By taking into account the time value of the investor's principal balance, courts will reach the correct amount the debtor must pay to truly satisfy its antecedent debt to the investor

198. *See, e.g.*, The Investor, *Time Value of Money: Why Locking Money Away Earns a Better Return*, MONEVATOR (Jan. 29, 2009), http://monevator.com/2009/01/29/time-value-of-money.

199. *See* Eugenie Bertus & Mark Bertus, *Determining the Value of Human Factors in Web Design*, *in* HANDBOOK OF HUMAN FACTORS IN WEB DESIGN 685 (Robert W. Proctor & Kim-Phuong L. Vu eds., 2005).

under fraudulent transfer law. This amount should rightfully be considered for value, and thus retainable for winning investors.

2. Opportunity Costs

In analyzing payments the debtor made to an investor above an investor's time-value-adjusted principal balance, a somewhat less mathematical approach must be taken. Rather than transferring satisfaction of an antecedent debt as above, the transferee in the situation of fictitious profits is necessarily transferring a different type of consideration. Correctly valuing the consideration to determine whether equivalent value was exchanged requires courts to recognize the two modern trends in Ponzi scheme law.

First, courts must only examine the consideration given in the specific transaction. In the case of a payment of fictitious profits, the value of the consideration given to the investor is clear: payment of money. The consideration given in return for these payments is the investor's continued allowance of the debtor's use of her funds. That leaving one's funds in a certain investment equates to valuable consideration is made clear by understanding that the fair market value of an asset is the "present value of its expected future payoffs," which the "opportunity cost of capital" helps determine.[200] It is likely that had the debtor not relayed money to the investor, she would have taken her money out of the fund and placed it in a different investment that would have compensated her for the choice to invest with that fund instead. Thus, the value of money made available for investment has a true fair market value, determinable by assessing an investor's alternative investment options.[201] This comports with the second trend in construction, which is that in determining the extent to which a transferee exchanged equivalent value under the Bankruptcy Code and the UFTA, value from the investor's perspective should be used. Therefore, from the standpoint of the transferee investor, the measure of the value of her consideration must be her opportunity cost—the worth of the next-best alternative investment she forewent by leaving her money in the debtor's hands.

200. *Id.* (noting that a key element in determining market value is an asset's rate of return, also called its opportunity cost).

201. *Id.* (stating that investment opportunity costs in business are calculated by appraising alternative investments comparable in level of risk and possible return).

As discussed above, courts and scholars consider foregone opportunity to be an actual loss suffered. Ultimately then, retaining the value of one's opportunity cost from a transaction should not be seen as a windfall to the transferee who received fictitious profits, but rather as a real part of the extent of value given in the specific transaction. In other words, for each payment of fictitious profits made to the transferee, the extent of the value given in return—and thus retainable under defenses in both Code § 548 and the UFTA—should be equal to the fair market value of the investor's next-best alternative investment at the time of the transfer.

C. DETERMINING VALUE

The most challenging element of this solution is the actual valuation of opportunity costs and the time value of money. However, such an evaluation is not as complex as it may appear. In measuring the baseline time value of money adjusted solely for inflation, the Bankruptcy Code already provides a workable and approved solution: the Consumer Price Index (CPI).[202] The CPI is a recognized method of determining inflation,[203] which the Bureau of Labor Statistics updates on a monthly basis.[204] This measure could easily be applied to the amount of an investor's principal balance over the time span during which she invested to determine the value of the payments for which the investor returned the consideration of satisfaction of antecedent debt to the debtor under the Bankruptcy Code and the UFTA.

Evaluating an investor's opportunity cost is somewhat more difficult, but not impossible. The largest hurdle would seem to be the factual issue of proving, after the fact, which alternative investment an investor would have made. Courts have consistently applied a more standardized approach to account for opportunity costs, however. Issuing prejudgment interest awards to plaintiffs reflects compensation for the opportunity costs of the loss of use of their money, and is often a

202. *See* 11 U.S.C. § 104 (2006).

203. *See generally* WALTER LANE & MARY LYNN SCHMIDT, COMPARING U.S. AND EUROPEAN INFLATION: THE CPI AND THE HICP 20 (2006), *available at* http://www.bls.gov/opub/mlr/2006/05/art3full.pdf; U.S. Dept. of Labor, *Consumer Price Index: Frequently Asked Questions*, BUREAU LAB. STAT., http://www.bls.gov/cpi/cpifaq.htm (last visited Mar. 3, 2011).

204. U.S. Dept. of Labor, *Consumer Price Index:, Frequently Asked Questions*, *supra* note 203.

fixed rate set by state or federal statute.[205] Other courts have recommended using a "fluctuating rate,"[206] or the rate "prevailing during the relevant period."[207] In determining an equitable rate, courts may take into account the condition of the money market and the rate banks charge for the use of money.[208] Most relevant to the situation of Ponzi scheme interest are the factors the court in *Amara* deemed to be overarching in determining a compensable rate: "(i) the need to fully compensate the wronged party for actual damages suffered, (ii) considerations of fairness and the relative equities of the award, (iii) the remedial purpose of the statute involved, and/or (iv) such other general principles as [the court deems] relevant."[209]

Amara's four factors can be directly applied to determine the fair rate of interest a Ponzi scheme investor should get to keep to reflect the extent of the value of her consideration in a fictitious-profits payment transaction. Under the first factor, courts must consider an investor's reliance damages, including opportunity costs and the next-best alternative to the sham investment. Under the second factor, however, courts can also consider the relative equities of both winning and losing investors, and take into account the bankruptcy estate's benefit to losers in determining how much winning investors get to keep. As outlined above, fraudulent transfer laws have the goal of equity at their core, but not necessarily the goal of distributional equity among creditors.[210] Courts should take this into account under the third factor. Finally, the fourth factor may include consideration of the specific circumstances of the investor, the scheme, or other equitable legal principles.

It is important to note that equities may not result in investors getting to keep all of their fictitious profits. For example, although the Madoff scheme's payout was on the low end of the interest rates typically offered to investors in Ponzi

205. *See, e.g.*, Hinton & Larsen, *supra* note 10, at 5.

206. Saavedra v. Korean Air Lines Co., 93 F.3d 547, 555 (9th Cir. 1996).

207. Gamma-10 Plastics, Inc. v. Am. President Lines, Ltd., 839 F. Supp. 1359, 1362 (D. Minn. 1993) (also noting that determining this market rate is a "factual inquiry").

208. *E.g.*, Emp'r-Teamsters Joint Council No. 84 v. Weatherall Concrete, Inc., 468 F. Supp. 1167, 1171 (S.D.W.Va. 1979).

209. Amara v. CIGNA Corp., 559 F. Supp. 2d 192, 220 (D. Conn. 2008) (quoting Jones v. UNUM Life Ins. Co. of Am., 223 F.3d 130, 139 (2d Cir. 2000)).

210. *See* Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 489 n.19 (D. Conn. 2002).

schemes,[211] a court may consider the fact that most Ponzi schemes pay higher returns than those that could have been achieved in a legitimate market venture.[212] Obviously, only legal returns should be the benchmark by which courts compensate investors in an opportunity-cost situation. Ultimately, however, courts must use their flexibility and fact-finding capabilities to reach the fairest solution based on all of the facts and circumstances. This is what both the law and society require of them.[213]

CONCLUSION

Fraudulent transfer law has equity as its underlying goal. Particularly in bankruptcy, it attempts to achieve a balance between innocent creditors and third-party transferees. In the case of a Ponzi scheme—a scheme in which almost all investors are defrauded in some way or another—equity is even more vital. Ponzi scheme avoidance law, however, as both federal and state statutes and courts interpreting these statutes have created, has landed stiffly on the side of "losing" investors to the detriment of "winning" investors. While doing so in the name of equity, its consequence has been to create even more victims in the fallout of a Ponzi scheme by subjecting winners to clawbacks under both state and federal law. Finding true equity in the aftermath of a Ponzi scheme requires courts to recognize the personal and economic losses winners suffer as well as losers. By redefining the value required for a transferee's good faith defense to include consideration of the fundamental legal and economic concepts of time value and opportunity-cost reliance damages, courts can reach a more just solution for so-called winners in the wake of a Ponzi scheme.

211. Berenson, *supra* note 15, at A1.

212. *Id.*; *see also* BLACK'S LAW DICTIONARY, *supra* note 4 (defining "Ponzi scheme"); Phelps, *supra* note 91, at A1 (quoting a Ponzi scheme trustee as arguing that the Ponzi schemer "promised, and produced, returns that were too good to be true, reflecting a pattern of abnormally consistent and significant profitability that was not credible").

213. *See, e.g.*, Hinton & Larsen, *supra* note 10, at 7 ("[W]hether [statutes preclude] the application of interest adjustments to principal for the purpose of computing covered investor losses has no bearing on whether time value of money adjustments should be made to invested principal in the context of a 'good faith' defense. The legal basis for making these adjustments is different in each case and there is no requirement for symmetric treatment.").