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James Butler Cash Jr.
University of Kentucky

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NOTES

When Is an Equity Participant Actually a Creditor? The Effects of *In re AFI Holding* on Ponzi Scheme Victims and the Good Faith Defense

James Butler Cash Jr.[1]

INTRODUCTION

THE recent discovery and subsequent fallout from the fraud perpetrated by Bernard L. Madoff has returned Ponzi schemes to the forefront of the investment community. The size of the deception is monumental by any standard. Officials at the Securities and Exchange Commission (SEC) described a level of deception that was "stunning" and "of epic proportions."[2] According to Madoff's own estimations, before the SEC filed its complaint in the Southern District of New York, his investment advisory business had been "a giant Ponzi scheme," the firm had been insolvent for years, and the losses "from this fraud were at least $50 billion."[3] As the tally of victims in this fraud has climbed,[4] attorneys for the aggrieved investors and news agencies alike have scrambled to find new wrinkles in Ponzi scheme jurisprudence.[5]

Investor-victims of Ponzi schemes typically find their options for recourse severely limited or altogether nonexistent.[6] A victim's prospect of collecting all or any of his or her investment is fraught with obstacles, the

1 James Butler Cash Jr. is a Juris Doctor candidate at the University of Kentucky College of Law. He would like to thank Professor Christopher W. Frost for the invaluable help he provided on this Note. He would also like to thank his mother and father for their love and support.

2 Press Release, SEC, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), http://www.sec.gov/news/press/2008/2008-293.htm.

3 *Id.*

4 *Madoff's Victim List*, WALL ST. J., Mar. 6, 2009, http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html.

5 *See generally* Jane J. Kim et al., *Investors May Have to Surrender Gains*, WALL ST. J., Dec. 15, 2008, at A16; Carrie Coolidge, *Lessons for Madoff Investors from the Bayou Fund Ponzi Scheme*, FORBES, Dec. 12, 2008, http://www.forbes.com/ (search "Lessons for Madoff Investors"; then follow "Lessons for Madoff Investors From the Bayou Fund Ponzi Scheme" hyperlink).

6 *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998).

largest of which is the shortfall of money as compared to the claims of the defrauded investors.[7]

In most Ponzi scheme cases, the disparity between the actual funds after the collapse and the claims of the defrauded investors eventually drive the scam into bankruptcy protection.[8] This disparity often leads to a shocking revelation for investors of the Ponzi scheme who were fortunate enough to withdraw their money before the collapse: bankruptcy courts can, at a minimum, require the return of any profits they received from the investment.[9] A bankruptcy court can also recover payments representing the investor's initial investment.[10] The result is that investors who withdrew money from a Ponzi scheme years before its collapse are surprised by a bankruptcy trustee knocking on their doors years later,[11] regardless of whether the withdrawn money has been spent.[12] The power of courts and bankruptcy trustees to repossess funds from investors years removed from their investment in a Ponzi scheme derives from the fraudulent transfer statutes in the Bankruptcy Code.[13] Subjecting present and past investors of Ponzi schemes to such an unforgiving remedy may seem grounded in the maxim "misery loves company"; however, fraudulent transfer law purports to promote an "equality of distribution" policy, seeking to treat investors who were financially hurt by fraud the same as those who escaped the Ponzi scheme in time.[14]

Lucky investors who pulled their money from the fraudulent scheme before its disintegration are provided a statutory defense against bankruptcy trustees seeking to repossess their investment: the good faith defense.[15] This affirmative defense can be asserted against a bankruptcy

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7 *Id.* at 158–59.

8 *See* Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 701 (9th Cir. 2008); Johnson v. Neilson (*In re* Slatkin), 525 F.3d 805, 809–810 (9th Cir. 2008); Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 823–824 (Bankr. S.D.N.Y. 2008).

9 McDermott, *supra* note 6, at 187.

10 *Id.*

11 *See* Kim et al., *supra* note 5 (where investor who withdrew his funds from Bayou Group two years before the collapse was required to pay back his profits); Mark Gimein, *Madoff Madness: Even Investors Who Think They're Safe Are Wrong*, THE BIG MONEY, Dec. 16, 2008, http://www.thebigmoney.com/articles/news/2008/12/16/madoff–madness.

12 Scholes v. Lehmann, 56 F.3d 750, 761 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995).

13 11 U.S.C. § 548 (2006).

14 *See* Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008); Dan Schechter, *Innocent Investor in Ponzi Scheme May Assert Good–Faith Defense to Fraudulent Transfer Claim Because Surrender of Restitution Claim in Exchange for Full Payment Constitutes "Reasonably Equivalent Value,"* COM. FIN. NEWSL., Apr. 21, 2008, at 33.

15 *See* 11 U.S.C. § 548(c) (2006); McDermott, *supra* note 6, at 175–81.

trustee attempting to avoid transfers from a debtor–Ponzi scheme to its earlier investors.[16] In sum, the defense allows investors who received distributions from the Ponzi scheme without knowledge of the fraud to keep an amount equal to their principal investment. For those who redeemed their investment knowing of or suspecting the fraud, the good faith defense is foreclosed and the investors must return the entire sum received from the scheme, regardless of whether the payouts from the fund constituted profits or a return of principal.[17] Besides ignorance of the fraud during the distribution, investors must also establish that they took distributions from the Ponzi scheme for value.[18] This requirement means that the Ponzi scheme must have received some valuable consideration when it transferred funds to an investor.

Ponzi schemes created and operated in the form of partnerships provide an interesting dilemma for courts when analyzing the good faith defense. The Bankruptcy Code includes limited partnership interests in its definition of "equity securities."[19] Under past case law, a distribution to an investor in exchange for equity securities did not provide the debtor–Ponzi scheme with "value."[20] In light of these past decisions, an investor who exchanged a partnership interest in a Ponzi scheme to redeem his principal investment would fail to satisfy the second prong of the good faith defense: "giving for value."[21] Bankruptcy scholar Professor Dan Schechter explains why limited partners and other equity participants fail to meet the second prong of the good faith defense as follows:

> [A] willing equity participant (such as a partnership investor) does not have a "claim." A "claim" is a "right to payment" under [the applicable statute]. An equity participant does not have a "right" to payment. An investor has a "hope" of payment.[22]

16 *See* McDermott, *supra* note 6, at 175–81; Hayes v. Palm Seedlings Partners–A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 535–36 (9th Cir. 1990); *In re Bayou Group, LLC*, 396 B.R. at 843–45.

17 *See* McDermott, *supra* note 6, at 175–81; *Hayes*, 916 F.2d at 535–36; *In re Bayou Group, LLC*, 396 B.R. at 843–45.

18 11 U.S.C. § 548(c).

19 11 U.S.C. § 101(16)(B) (2006).

20 *See Hayes*, 916 F.2d at 540; McConnell v. Estate of Butler, 402 F.2d 362, 366 (9th Cir. 1968) (citing Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935)) (finding that reasonably equivalent value was not established when a corporation repurchased its own stock, an equity claim); Le Café Creme, Ltd. v. Le Roux (*In re* Le Café Creme, Ltd.), 244 B.R. 221, 239–41 (Bankr. S.D.N.Y. 2000) (finding that debtor did not receive adequate consideration upon the repurchase of its stock, an equity claim).

21 11 U.S.C. § 548(c).

22 Schechter, *supra* note 14 (citation omitted).

The Ninth Circuit, however, does not agree with Professor Schechter. In a recent decision, the court in *In re AFI Holding, Inc.* (hereinafter "*AFI Holding*"), determined that the investor-partners, upon purchase of the fraudulent partnership interests, had in fact exchanged those interests "for a proportionately reduced restitution claim."[23] With such a pronouncement, transfers of principal investments to investor-partners in exchange for equity interests in the partnerships were deemed to be of sufficient value to satisfy § 548(c) and, therefore, unassailable by a bankruptcy trustee of the defunct partnership-Ponzi scheme.[24]

AFI Holding marks a break from past precedent. The Ninth Circuit decided that the equity interest the Ponzi scheme obtained from investor-partners constituted value, so as to offset the restitution claims of investor-partners resulting from the fraud inherent in the Ponzi scheme. Restitution can best be termed a debt owed from one party to another, and forgiveness of debt can act as sufficient consideration for § 548(c).[25] The problem, however, is that "[a]n outstanding equity interest is not a 'debt.'"[26] Thus, exchanging an equity interest for a reduced claim of restitution should *never* provide the value required under § 548(c). Nevertheless, the Ninth Circuit held to the contrary in *AFI Holding.*

Professor Schechter warns that this "decision will make it much more difficult for bankruptcy trustees to recover distributions made to the 'early investors' in Ponzi schemes, thus prejudicing the rights of the later 'investors.'"[27] While case law exists buoying the court's decision in *AFI Holding*,[28] interpreting a partnership interest as a creditor interest seems to turn on its head the purpose of 11 U.S.C. § 548, the equitable distribution of funds to defrauded creditors.

The result in *AFI Holding* poses a perplexing question: Is this decision an anomaly applicable only when Ponzi schemes intersect with partnerships? Or are the interests of creditors in danger from this new debt-redeeming equity interest? Although the answer may be strictly limited to fraudulent partnerships, the Ninth Circuit appears to have extended the rights of a creditor to an equity participant in a partnership as a matter of fairness to defrauded investors. Proponents of *AFI Holding* might view the issue

23 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 702 (9th Cir. 2008).

24 *See id.* at 708. The court and both sides in the case agreed that the partnerships had received the transfers in good faith, thereby satisfying the second requirement of the good faith defense. *Id.*

25 5 COLLIER ON BANKRUPTCY ¶ 548.05[1][b] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2009).

26 Schechter, *supra* note 14.

27 *Id.*

28 *See* Sender v. Hannahs (*In re* Hedged Invs. Assocs., Inc.), 176 B.R. 214 (D. Colo. 1994) (finding that limited partnership interests are entitled to the good faith defense under § 548(c)); Sender v. Simon, 174 B.R. 601, 603 (D. Colo. 1994).

not as creditors' rights versus equity participants' rights, but instead as whether a release of a legal claim against the Ponzi scheme can constitute sufficient value to satisfy the good faith defense.[29] Others could defend the decision on the basis that defrauded investors are due an equitable remedy in a Ponzi scheme's extreme circumstances. Yet both rationales ignore the broader implications of this decision: if the claims of a limited partner can be converted into creditor claims, could other types of equity interests also be converted? This possible implication is a legitimate concern of Professor Schechter and other bankruptcy legal scholars.

Victims of Ponzi schemes need to be protected and afforded sufficient remedies under the law, yet the current fraudulent transfer statutes do not provide proper remedies for victims asserting the good faith defense where investors possess equity securities. Investors in *AFI Holding* and similar circumstances should be afforded all statutory defenses; however, that right cannot come at the expense of ignoring the explicit statutory definition of "equity security" in the Bankruptcy Code. Disregarding a definition this clear is not the practice of any court.

This Note first examines the intricacies of Ponzi schemes and the applicable fraudulent transfer law that governs the actions of a bankruptcy trustee's pursuit of investor funds. It then discusses *AFI Holding* in greater detail and, finally, examines the rationale, implications, and problems the decision poses for the bankruptcy process and fraudulent transfer law.

I. Ponzi Schemes

Charles Ponzi has the dubious honor of having his name attached to the fraudulent investment scheme he is credited with inventing.[30] A Ponzi scheme is

> an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The

29 *See* 11 U.S.C. § 548(c) (2006) (describing the good faith defense).

30 James Walsh, You Can't Cheat an Honest Man 1 (1998). An Italian immigrant living in Boston, Ponzi touted an investment scheme that exchanged foreign postage coupons for American stamps. This exchange would supposedly yield several cents per transaction; however, Ponzi promised his investors returns of 100% or more. Within ten months, the scheme had collapsed with $10 million lost from close to 20,000 investors. *Id.* at 1–5.

> person who runs this scheme typically uses some of the money invested for personal use. Usually, this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments.[31]

Upon the collapse of an unsuccessful scheme and the filing of a petition, the bankruptcy process commences and the stewardship of a bankruptcy trustee begins.[32] A bankruptcy trustee is charged with collecting the remaining assets of the Ponzi scheme to pay the claims arrayed against it.[33] Generally, though, the trustee finds himself dealing with "very few physical or liquid assets."[34]

Trustees are frequently left with little else than claims against investors who withdrew their money from the scheme before its collapse.[35] At times, bankruptcy trustees have been able to bring actions against the spouses or families of the individuals instigating the fraud.[36] Nevertheless, the most important assets for the trustee "are the claims that the [bankrupt] estate has against those investors who received 'returns' on their investments."[37] These claims are pursued by the bankruptcy trustee through the fraudulent transfer laws in the Bankruptcy Code.[38]

II. FRAUDULENT TRANSFER LAWS

Fraudulent transfer laws have their origin in the Statute of 13 Elizabeth I (1570).[39] Today "[t]here are three main sources of fraudulent transfer law: (1) § 548 of the Bankruptcy Code, (2) the Uniform Fraudulent Conveyance Act (UFCA), and (3) the Uniform Fraudulent Transfer Act (UFTA)."[40] Although actions under fraudulent transfer statutes may incite feelings to the contrary, it is assumed that the fraudulent transfer provision of the Bankruptcy Code "is not a punitive provision designed to punish the transferee, but is instead an equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive

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31 McDermott, *supra* note 6, at 158.

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

36 *See* Scholes v. Lehmann, 56 F.3d 750, 758 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995).

37 McDermott, *supra* note 6, at 158.

38 *Id.*

39 Hayes v. Palm Seedlings Partners-A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 534 (9th Cir. 1990).

40 McDermott, *supra* note 6, at 159 (citations omitted).

fraudulent [transfers]."[41]

Under the Bankruptcy Code, bankruptcy trustees utilize two specific statutes to recover the transfers after the collapse of a Ponzi scheme: § 547 and § 548.[42] Section 547, however, is not considered under the umbrella of the fraudulent transfer statutes. While related in function to other fraudulent transfer provisions, § 547 is referred to as the "Preferential Transfer Law."[43] As § 547 preference actions are not subject to the good faith defense in § 548(c), their effect and scope are not relevant to this Note.[44]

State fraudulent transfer statutes parallel § 548 of the Bankruptcy Code.[45] State statutes are frequently used by federal courts in fraudulent transfer cases, as § 544(b) and § 550 allow a trustee to adjudicate and collect claims in federal court under the appropriate state fraudulent transfer provisions.[46] While there are numerous reasons to use state statutes over federal statutes, a significant reason is the different statutes of limitations: the federal fraudulent transfer statute limits a trustee's recapture to transfers made within the past two years,[47] while some states allow a trustee to reach back further in time.[48]

41 Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008).

42 *See* 11 U.S.C. § 547 (2006); 11 U.S.C. § 548 (2006). The statutes use the word "avoid" in the sense that a trustee attempts to "avoid" transfers to investors and recoup the amount of the transfers.

43 11 U.S.C. § 547; McDermott, *supra* note 6, at 181–82.

44 11 U.S.C. § 547. No mention of the defense is found in 11 U.S.C. § 547. *Id.* An advantage to using § 547 over § 548 is that "it allows the trustee to recover the return of an investor's principal, even though the investor made the investment in both subjective and objective good faith." McDermott, *supra* note 6, at 181. However, because § 547 is limited to only ninety days before the debtor seeks bankruptcy protection, it is seldom applicable in bankruptcy cases involving Ponzi schemes. *See* 11 U.S.C. § 547. This is because investors who have been wiped out by the Ponzi scheme must attack the transfers to investors who withdrew their principal and profits years before the collapse of the scheme. *See* Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 703 (9th Cir. 2008) ("Our concern here is not the law of preferences under 11 U.S.C. § 547, because we are years removed from that section's ninety-day reach back period."); Kim et al., *supra* note 5.

45 *See* ARIZ. REV. STAT. ANN. § 44-1004 (2003); CAL. CIV. CODE § 3439.05 (West 1997); CAL. CIV. CODE § 3439.04 (West 1997 & Supp. 2009); COLO. REV. STAT. § 38-8-105 (2008); HAW. REV. STAT. § 651C-4 (1993).

46 11 U.S.C. § 544(b) (2006); 11 U.S.C. § 550 (2006); *see also* Hayes v. Palm Seedlings Partners-A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 534 (9th Cir. 1990); Wyle v. Rider (*In re* United Energy Corp.), 944 F.2d 589, 593 (9th Cir. 1991); McDermott, *supra* note 6, at 159–60 ("Almost all states have enacted either the [Uniform Fraudulent Conveyance Act] or the [Uniform Fraudulent Transfer Act], and there are few substantive distinctions between the two uniform statutes, or between the two statutes and § 548 of the Bankruptcy Code.").

47 11 U.S.C. § 548(a)(1) (2006).

48 *See* CAL. CIV. CODE § 3439.04. California fraudulent conveyance law does not have a

A. *Recovery under 11 U.S.C. § 548: Fraudulent Transfers and Obligations*

Pursuant to § 548, a bankruptcy trustee may recapture transfers under "two distinct theories of recovery . . . in a case against a Ponzi-scheme investor: constructive fraud and actual fraud."[49] The two theories differ in elements and requirements of proof; however, the most important distinction between the two is their treatment of the bankruptcy trustee's recovery of fictitious profits versus the recovery of an investor's investment principal. The difference between the "profits" investors receive from the Ponzi scheme and the return of their principal investment is an important distinction in understanding § 548. Investors are never able to keep the profits distributed by the Ponzi scheme.[50] The general rationale for this rule is that a Ponzi scheme, being fraudulent in nature, never actually turns a profit that can be distributed to investors. Therefore, when an investor withdraws his investment from a Ponzi scheme before its collapse, the "profits" that are credited to the investor are nonexistent, as they arise not from an underlying business venture but instead from outright theft. To use a common maxim, if a Ponzi scheme robs Peter to pay Paul, Paul is not entitled to his misbegotten profits.

This rule for fictitious profits does not apply to the return of an investor's principal investment. Whether an investor is entitled to his initial investment withdrawn before the collapse of a Ponzi scheme is an often-litigated matter over which trustees and investor-defendants frequently battle.[51] Thus, while an investor is never entitled to the fictitious profits he withdraws from a Ponzi scheme, he may be able to keep his initial investment, depending on the circumstances.

1. *Constructive Fraud and Fraudulent Transfer Law.*— The constructive and actual fraud theories under § 548 share one common element: the Ponzi-scheme operator must maintain an interest in the investors' funds.[52] Constructive fraud requires the bankruptcy trustee to show two additional elements to collect a transfer from an investor: 1) that the debtor (the defunct Ponzi scheme) "received less than a reasonably equivalent value in exchange for such transfer or obligation"[53] and 2) that the debtor

> I) was insolvent on the date that such transfer was made

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temporal limitation. *Id.*; *see also In re AFI Holding, Inc.*, 525 F.3d at 703.

49 McDermott, *supra* note 6, at 160.

50 *See* Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995); Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 857 (D. Utah 1987).

51 *See Scholes*, 56 F.3d at 757; *Merrill*, 77 B.R. at 857.

52 11 U.S.C. § 548(a)(1) (2006); *see* McDermott, *supra* note 6, at 160.

53 11 U.S.C. § 548(a)(1)(B)(i) (2006).

> or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
> III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
> IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[54]

The first element, the requirement that the Ponzi-scheme operator maintain an interest in investor funds, is rarely litigated. In some cases, investor-defendants "have asserted that the property they received from the debtor did not actually constitute property in which the debtor had an interest."[55] The argument stems from the notion that the perpetrator of a Ponzi scheme acquires the funds used to run his scheme through fraud and therefore cannot claim legitimate title to the property.[56] To accept this defense, a court must determine that the funds held by a Ponzi scheme were in a "constructive trust" in which the Ponzi-scheme operator had no property rights.[57] The principal flaw of the constructive trust theory is that an investor-defendant is required to show that the money redeemed from the debtor-Ponzi scheme constitutes the exact funds as the initial investment.[58] With most Ponzi scheme cases, funds from investors are commingled so that tracing a particular investment from a specific investor is impossible. Thus, "Ponzi-scheme defendants therefore will nearly always be unable to establish that the funds they received are not property in which the debtor had an interest."[59]

The next element (though this element is outlined as the third requirement in the first paragraph of this section) of constructive fraud revolves around the reduction in value of the assets held by the Ponzi scheme as compared to the liabilities of the scheme. Generally, this element requires proof that transferring funds from the Ponzi scheme

54 *Id.* § 548(a)(1)(B)(ii).

55 McDermott, *supra* note 6, at 161.

56 Jobin v. Youth Benefits Unlimited, Inc. (*In re* M & L Bus. Mach. Co.), 59 F.3d 1078, 1081 (10th Cir. 1995).

57 *See* Berger, Shapiro & Davis, P.A. v. Haeling (*In re* Foos), 183 B.R. 149, 154 (Bankr. N.D. Ill. 1995).

58 McDermott, *supra* note 6, at 163.

59 *Id.* at 164.

would leave it insolvent. Transfers that render an entity insolvent are deemed to be fraudulent,[60] and, as most Ponzi schemes are by their very nature insolvent (the liabilities to their investors always outpace their assets), transfers from a Ponzi scheme typically satisfy this element. This element, however, can be difficult to demonstrate if a Ponzi scheme started as a legitimate investment business. Here, the actual date of insolvency must be determined by forensic accountants,[61] as insolvency must be shown for each transfer the trustee wants to invalidate and collect.[62] Some jurisdictions have alleviated this problem by creating the assumption that if a Ponzi scheme is shown to exist, then it is deemed to be insolvent from its beginning.[63] Nevertheless, the actual existence of a Ponzi scheme must be shown either through guilty pleas of the conspirators or through forensic accounting.[64]

The last element of constructive fraud requires that the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation."[65] "[V]alue" is defined in the Bankruptcy Code as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."[66] When analyzing a transfer from the debtor–Ponzi scheme, the court focuses on what the debtor has received from the investor in exchange for the transfer to that investor. If, in transferring funds to an investor, the debtor–Ponzi scheme failed to receive consideration that was "reasonably equivalent" in value, then the transfer will be deemed fraudulent and void.[67]

Courts, when examining this element, clearly delineate between what exactly is being transferred from the debtor–Ponzi scheme to investors: return of investment principal or fictitious profits.[68] Courts are uniform

60 11 U.S.C. § 548(a)(1)(B)(ii)(I) (2006).

61 Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 835–42 (Bankr. S.D.N.Y. 2008). A comprehensive financial analysis was performed by a forensic accountant to determine when the Bayou Fund became insolvent. *Id.*

62 § 548(a)(1)(B)(ii)(I).

63 *See* Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 871 (D. Utah 1987).

64 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 704 (9th Cir. 2008) ("Here, [the Ponzi scheme perpetrator's] plea demonstrates the existence of fraudulent intent and a Ponzi scheme . . . ."); *see In re Bayou Group, LLC*, 396 B.R. at 843. The court uses guilty pleas and forensic accounting to show the existence of a Ponzi scheme. *Id.*

65 11 U.S.C. § 548(a)(1)(B)(i) (2006).

66 *Id.* § 548(d)(2)(A).

67 Scholes v. Lehmann, 56 F.3d 750, 756 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995). *See* § 548(a)(1)(B)(i).

68 *See Scholes*, 56 F.3d at 757; Hayes v. Palm Seedlings Partners–A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 539 (9th Cir 1990); McDermott, *supra* note 6, at 164–65.

in allowing trustees to recoup the fictitious profits paid out to investors, determining that the debtor–Ponzi schemes have not received reasonably equivalent value for these transfers.[69] Acting to the contrary would "incorrectly [assume] that there is something of value in a Ponzi scheme when in fact the whole series of transactions has been a sham."[70]

The return of principal to investors is viewed differently. Courts accept that the aggrieved investors have a tort claim for restitution against the debtor–Ponzi scheme in the amount of their principal investment.[71] Some jurisdictions have liberally applied a rule that all transfers from the debtor–Ponzi scheme to investors should first pay down the existing restitution claims for the return of investors' principal investments, regardless of the characterization of the transfers.[72] Thus, every payment by the debtor–Ponzi scheme to investors prior to bankruptcy, whether termed profits or return of capital, would be applied to an investor's principal investment and subsequently reduce the restitution claim. Other jurisdictions, however, have ignored such attempts, determining that "a Ponzi investor [is] not entitled to set off payments received in excess of an initial investment against losses incurred in subsequent related investments because the claims [arise] out of [an] independent [transaction]."[73] Despite this jurisdictional split, all courts agree on one point: a bankruptcy trustee bringing an action under the constructive fraud statutes is limited to the recoupment of fictitious profits that are paid above the investor's initial investment.

2. *Actual Fraud and Fraudulent Transfer Law*.— Besides the initial element shared by constructive and actual fraud under § 548,[74] actual fraud has only one more requirement: the debtor must make the "transfer or [incur] such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."[75] Actual fraud differs from constructive fraud, as there must be actual intent on the part of the debtor to "hinder, delay, or defraud" creditors.[76] Additionally, a bankruptcy trustee

69 *Scholes*, 56 F.3d at 757; Wyle v. C.H. Rider & Family (*In re* United Energy Corp.), 944 F.2d 589, 595 n.6 (9th Cir. 1991); Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 831 (Bankr. S.D.N.Y. 2008).

70 McDermott, *supra* note 6, at 168.

71 *See In re Bayou Group, LLC*, 396 B.R. at 831 n.6; McDermott, *supra* note 6, at 165–66.

72 Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 853 n.14 (D. Utah 1987).

73 McDermott, *supra* note 6, at 169 n.49.

74 11 U.S.C. § 548(a)(1) (2006); *see* McDermott, *supra* note 6, at 160.

75 11 U.S.C. § 548(a)(1)(A) (2006).

76 *Id.*; *see also* Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995).

does not have to show that the debtor–Ponzi scheme received "less than a reasonably equivalent value in exchange for [a] transfer or obligation"[77] because under actual fraud, transfers are "deemed fraudulent even if [they are] in exchange for 'valuable' consideration."[78] The most substantial difference between the two recovery theories is that while recovery under constructive fraud allows for the collection of fictitious profits only, actual fraud allows a bankruptcy trustee to recover both fictitious profits and an investor–defendant's principal investment.[79]

Proving the additional element of actual fraud can be simple when a court has determined that the debtor is a bankrupt Ponzi scheme. A number of jurisdictions hold that the mere presence of a Ponzi scheme is sufficient to show that there was "actual intent to hinder, delay, or defraud creditors under 11 U.S.C. § 548(a)."[80] Other courts have found the fraudulent intent element of actual fraud on lesser proof.[81] Yet, bankruptcy trustees continue to primarily rely on forensic accounting and guilty pleas to demonstrate the existence of a Ponzi scheme.[82]

The final advantage of showing actual fraud under § 548 is that once the trustee has demonstrated that the transfers were made with "actual intent to hinder, delay, or defraud"[83] creditors, all past transfers made by the debtor–Ponzi scheme are deemed fraudulent and may be avoided by the trustee.[84] Unless the redeeming investor asserts a defense in the bankruptcy trustee's suit, the fictitious profits and the initial investment must be returned to the bankrupt estate.

77 11 U.S.C. § 548(a)(1)(B)(i) (2006).

78 *Scholes*, 56 F.3d at 757.

79 McDermott, *supra* note 6, at 173.

80 Johnson v. Neilson (*In re* Slatkin), 525 F.3d 805, 814 (9th Cir. 2008); *see* Hayes v. Palm Seedlings Partners–A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 534–35 (9th Cir. 1990); Conroy v. Shott, 363 F.2d 90, 92 (6th Cir. 1966), *cert. denied*, 393 U.S. 1018 (1969).

81 *See* Coleman Am. Moving Servs., Inc. v. First Nat'l Bank & Trust Co. (*In re* Am. Props., Inc.), 14 B.R. 637, 643 (Bankr. D. Kan. 1981) (where the court did not require "overt intent" in its application of § 548(a)(1)).

82 *See* Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 702 (9th Cir. 2008). The guilty plea of a Ponzi scheme perpetrator demonstrates the existence of a Ponzi scheme. *Id.*; *Johnson*, 525 F.3d at 810. The court used guilty pleas and forensic accounting to show the existence of a Ponzi scheme. Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 843 (Bankr. S.D.N.Y. 2008).

83 11 U.S.C. § 548(a)(1)(A) (2006).

84 *See Hayes*, 916 F.2d at 531; *In re Bayou Group, LLC*, 396 B.R. at 843. The court in *Hayes* notes the district court's decision to void all transfers from the debtor–Ponzi scheme when actual fraud was shown. *Hayes*, 916 F.2d at 531. The Ninth Circuit Court of Appeals upholds the lower court's decision. *Id.* The court in *In re Bayou Group, LLC* also concluded that upon an adequate showing of actual fraud under § 548, the plaintiff–bankruptcy trustee was entitled to the full amount of redemption payments from all defendants, subject to affirmative defenses. *In re Bayou Group, LLC*, 396 B.R. at 843.

B. The Good Faith Defense to Constructive and Actual Fraud

When a bankruptcy trustee seeks to recover fraudulent transfers, investor–defendants are left with one primary defense: the good faith defense. If a prima facie case for actual or constructive fraud is made by a bankruptcy trustee, the burden is thrust upon the investor–defendant "to establish [his] affirmative defense under [§] 548(c)."[85] Under the good faith defense

> [an investor–defendant] may retain the transfer (the redemption payment) if both of two conditions are met: (i) if the [investor–defendant] "takes for value . . ." but only "to the extent that such [investor–defendant] . . . gave value to the [debtor–Ponzi scheme] in exchange for such transfer;" and (ii) if the [investor–defendant] "takes . . . in good faith."[86]

If the investor can set forth both elements, then the bankruptcy trustee must transfer the investment principal to the investor. Without both elements, the good faith defense necessarily fails.

1. *Taking in Good Faith.*— Good faith under § 548(c) is an objective good faith standard under which the investor–defendant has the burden of proof.[87] The court must determine whether an investor redeemed an investment in a Ponzi scheme because the investor subjectively knew or was aware of enough facts to be put on "inquiry notice" that the debtor was operating a Ponzi scheme.[88] If either is true, then "the investor fails to carry his burden of proving that he accepted sums from the debtor in good faith, and the trustee is entitled to recover all amounts the investor received from the debtor."[89]

The good faith defense cannot be satisfied if the investor–defendant had actual knowledge of the fraud; however, a bankruptcy trustee is generally in a situation where the investor was on "inquiry notice."[90] Courts have considered a variety of factors[91] in determining whether an investor should

85 *In re Bayou Group, LLC*, 396 B.R. at 844.

86 *Id.*; *see also* 11 U.S.C. § 548(c) (2006); Stephen P. Harbeck & Karen A. Caplan, *Work For a Ponzi Scheme—and Keep Your Commissions?*, 13 J. BANKR. L. & PRAC. 3 (2004).

87 *Hayes*, 916 F.2d at 535–36; McDermott, *supra* note 6, at 176–77.

88 McDermott, *supra* note 6, at 176–77.

89 *Id.* at 177.

90 *Id.* at 176–78.

91 *Id.* at 178–79. Courts have considered, among other factors, the following: (1) "the investor's level of business knowledge," (2) "the disparity between prevailing market rates of

have been "objectively 'on alert that there was a potential problem with the [investment scheme].'"[92] If these factors give rise to inquiry notice, then "[i]n order to prove 'good faith,' [a] 'diligent investigation'" by the investor who received the transfer "must ameliorate the issues that placed the transferee on inquiry notice in the first place."[93] If the court determines that the investigation is inadequate, then the good faith defense will fail.[94]

2. *Taking for Value under the Good Faith Defense.*— The second prong of § 548(c) mandates that a "transferee or obligee" may only successfully assert the good faith defense to the extent that value is given for the transfer.[95] Thus, a court focuses on whether the debtor–Ponzi scheme received *something of value* in exchange for the distribution to investors.[96] The requirement for giving "reasonably equivalent value" is found only in the constructive fraud elements and not within the statutory language of the good faith defense.[97] Though there is debate among some, "giving value" under the good faith defense and "giving reasonably equivalent

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return and the rates of return promised by the debtor," (3) "how the investor learned of the debtor's investment scheme," and (4) "the type of due diligence investigation the investor made of the debtor's investment scheme." *Id.*

92 Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 845 (Bankr. S.D.N.Y. 2008) (quoting Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund, Ltd.), 397 B.R. 1, 17 (S.D.N.Y. 2007)).

93 *Id.* at 846 (quoting Jobin v. McKay (*In re* M & L Bus. Mach. Co.), 84 F.3d 1330, 1335-36 (10th Cir. 1996)).

94 *Id.* at 846–47. Courts have also determined that "taking no steps at all would [amount] to 'willful ignorance,' which would [defeat] the good faith defense." *Bear, Stearns Sec. Corp.*, 397 B.R. at 19 n.39 (quoting Gredd v. Bear, Stearns Sec. Corp. (*In re* Manhattan Inv. Fund Ltd.), 359 B.R. 510, 525 (Bankr. S.D.N.Y. 2007)).

Some courts have recognized an exception to "inquiry notice." Under this exception, the good faith defense would not fail even if an investor–defendant withdrew funds from a Ponzi scheme–investment while on inquiry notice. As laid out by Judge Adlai Hardin, an investor–defendant could

> establish his [good faith] defense if he [could] prove by a preponderance of the *credible objective* evidence that his request . . . was in fact the result of a good faith reason other than his knowledge of "red flags," even if he was on inquiry notice and did not make inquiry before redeeming.

In re Bayou Group, LLC, 396 B.R. at 848–49. However, this exception is difficult for an investor–defendant to demonstrate, as it requires a specific reason for redemption. *See id.* at 854–56. The good faith defense was upheld where an investor–defendant redeemed its investment because the original investment had been a part of a particular swap transaction and the investor's exposure to the swap risk was terminated. *Id.* This was determined to be a satisfactory reason to redeem funds invested even while on inquiry notice that the investment scheme may have been fraudulent. *Id.* This exception, however, is beyond the scope of this Note.

95 *See* 11 U.S.C. § 548(c) (2006).

96 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 707 (9th Cir. 2008).

97 *Compare* 11 U.S.C. § 548(a)(1)(B)(i) (2006), *with* 11 U.S.C. § 548(c).

value" under constructive fraud are similar, if not identical, elements.[98] Regardless, without value being given, the good faith defense will fail and the transfer will be voided.

As stated earlier, "value" is set forth in § 548 as "property, or satisfaction or securing of a present or antecedent debt of the debtor."[99] The question of whether value has been given turns on what the debtor–Ponzi scheme received in return for the transfer to the investor–defendant. Where an investment fund is determined to be a Ponzi scheme, such as the fraud perpetrated by Mr. Madoff, courts typically find that transfers from the debtor–Ponzi scheme to investor–defendants constitute value.[100] The presence of fraud entitles the investor–defendant to a tort claim of restitution against the debtor–Ponzi scheme, but payments by the debtor–Ponzi scheme to the investor reduce this restitution claim, with any transfers over the initial investment deemed to be fictitious profits and thereby returned to the trustee. These restitution claims arise from the already–existing creditor relationship the investors enjoy with an investment fund.

While a typical investor's monetary interest in a Ponzi scheme gives rise to a general creditor relationship, a limited partner in a failed Ponzi scheme partnership is not afforded such a status. A limited partner's right to collect property from a failed Ponzi scheme partnership is viewed as secondary to the collection rights of general creditors. This subordination occurs because a partnership interest held by an investor, whether a general partnership interest or a limited partnership interest, is merely an equity interest.[101] Equity interests also include the ownership interests of stockholders.[102] Courts adhere to the rule that "less than reasonably equivalent value is received when a company redeems the equity interests of its principal."[103] As the redemption of an equity interest does not constitute value, and

98 *In re AFI Holding, Inc.*, 525 F.3d at 707 ("We find no reason, in statute or case law, to treat 'reasonably equivalent value' differently for each of the Code's provisions. Both the prima facie case for constructively fraudulent transfers under [§ 548(a)(1)(A)], and the affirmative defense to actually fraudulent transfers under [§ 548(c)] require the determination of whether 'reasonably equivalent value' was transferred from the transferee to the debtor.").

99 11 U.S.C. § 548(d)(2)(A) (2006).

100 Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810, 844 (9th Cir. 2008).

101 11 U.S.C. § 101(16)(B) (2006). The definition of "equity security" includes the "interest of a limited partner in a limited partnership." *Id.*

102 *Id.* § 101(16)(A).

103 Tomsic v. Pitocchelli (*In re* Tri–Star Techs. Co.), 260 B.R. 319, 326 (Bankr. D. Mass. 2001); *see, e.g.*, Murphy v. Robinson (*In re* Ipswich Bituminous Concrete Prods., Inc.), 79 B.R. 511, 516–17 (Bankr. D. Mass. 1987); Buncher Co. v. Official Comm. of Unsecured Creditors of GenFarm Ltd. P'ship IV, 229 F.3d 245, 252–53 (3d Cir. 2000); Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 136 (Bankr. D. Mass. 1989); Consove v. Cohen (*In re* Roco Corp.), 701 F.2d 978, 982 (1st Cir. 1983); Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935).

value is a requirement to avoid a constructively fraudulent transfer[104] and to assert the good faith defense in an actual fraudulent transfer,[105] the equity interest-holders must await the redemption of creditors before taking under the bankruptcy laws. In California, the state in which *AFI Holding* was decided, it is plainly stated that "[a] limited partner shall not receive from a general partner or out of partnership property any part of his contribution until... [a]ll liabilities of the partnership... have been paid or there remains property of the partnership sufficient to pay them."[106]

Notwithstanding this statutory language, *AFI Holding* held that exchanging an equity-partnership interest for an equivalent restitution claim could give sufficient value to satisfy the good faith defense under § 548(c). How was the Ninth Circuit able to reconcile this decision with past precedent and the Bankruptcy Code, which have stated to the contrary?

III. BACKGROUND OF *AFI HOLDING*

On October 22, 2001, Advance Finance, Inc., AFI Holding, Inc., and a number of partnerships, all controlled by Gary A. Eisenberg, filed for bankruptcy protection in Los Angeles, California.[107] This marked the collapse of a fraudulent investment scheme that had been operating since 1994.[108] Attracting investors by promising them 9% to 18% returns per year, Mr. Eisenberg sold limited partnerships to investors with a minimum investment of $50,000.[109] Ostensibly, investors' funds were to be used as collateral against which small- to medium-sized companies could borrow (the money would be held in accounts known as "factoring accounts").[110] About 200 investors nationwide, many of them the friends and family of Mr. Eisenberg, invested approximately $21 million in the scheme.[111]

As early as 1996, several of Mr. Eisenberg's partnerships had loaned investor money to questionable businesses resulting in several defaults on payments due to the AFI partnerships.[112] Furthermore, AFI employees had approved loan agreements with risky businesses in return for kickbacks.[113] Despite these setbacks and the knowledge that his investment scheme

104 11 U.S.C. § 548(a)(1)(B)(i) (2006).

105 *Id.* § 548(c).

106 CAL. CORP. CODE § 15516(1)(a) (West 2006).

107 Complaint for Violations of the Federal Securities Laws, SEC v. Eisenberg, No. 02-6479 (C.D. Cal. Aug. 20, 2002), *available at* http://www.sec.gov/litigation/complaints/comp17691.htm.

108 *Id.*

109 *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 *Id.*

was operating at a significant loss, Mr. Eisenberg deceived investors by describing the partnerships as financially successful.[114] Between 1994 and 2001, at least $9.8 million of new investor money was used to pay investors their promised returns and to cash out other investors (the trademark of a Ponzi scheme).[115] Following the bankruptcy filing, Mr. Eisenberg pled guilty to federal securities and mail fraud charges.[116] In his plea agreement, he admitted to operating a Ponzi scheme.[117]

After establishing claims against Mr. Eisenberg, the bankruptcy trustee brought lawsuits against AFI investors who had received distributions prior to the scheme's collapse.[118] Keith Mackenzie, having withdrawn his principal investment and fictitious profits before the bankruptcy filing, was one of the 170 investors targeted by the bankruptcy trustee, and he became the principal litigant in *AFI Holding*.[119] The trustee sought to recover the transfers pursuant to the fraudulent transfer laws of California, which mirror § 548 of the Bankruptcy Code.[120] The lower bankruptcy court granted summary judgment in favor of the trustee, voiding the transfers made by the AFI partnerships to Mr. Mackenzie.[121] On appeal, the district court overturned the judgment in part.[122] It reasoned "that Mackenzie had exchanged his purported partnership interest for a proportionately reduced restitution claim," thereby transforming the "equity interest [of] a limited partner" to the claim of a creditor.[123] The district court then remanded the case to the bankruptcy court to determine if Mr. Mackenzie had received the transfer in good faith.[124] The bankruptcy trustee appealed this decision to the Ninth Circuit Court of Appeals.[125]

IV. EXCHANGING PARTNERSHIP INTERESTS FOR RESTITUTION CLAIMS

A. *Analysis of the Ninth Circuit in* AFI Holding

The focus of the argument in the district court was the same at the court of appeals level: whether a limited partnership interest (an equity

114 *Id.*

115 *Id.*

116 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 702 (9th Cir. 2008).

117 *Id.*

118 *Id.*

119 *Id.*

120 *Id.* (actions brought under 11 U.S.C. § 544(b) and § 550, using the California statutes, CAL. CIV. CODE §§ 3439.04, .08 (West 1997 & Supp. 2009)).

121 *Id.*

122 *Id.*

123 *Id.*

124 *Id.*

125 *Id.*

security interest) would preclude an investor–defendant from raising the good faith defense in § 548(c) because it did not constitute value.[126] The bankruptcy trustee and Mr. Mackenzie seized upon two cases that had been decided earlier by the Ninth Circuit: *In re United Energy Corp.*[127] (hereinafter *United Energy*) and *In re Agricultural Research and Technology Group, Inc.*[128] (hereinafter *Agretech*).[129] The bankruptcy trustee likened *Agretech* to the facts of *AFI Holding*, as the court in *Agretech* voided transfers from a partnership to a group of limited partners because, under the applicable state law, the "taking for value" requirement[130] could not be met where the transfer was to satisfy limited partnership interests.[131] The *Agretech* court determined that "limited partnership interests [were] classified as 'equity [securities].'"[132] For the investor–defendants, Mr. Mackenzie analogized *AFI Holding* to *United Energy*, where the Ninth Circuit upheld an investor's right to rescind a contract propagated by a Ponzi scheme.[133] According to the court, this right to restitution "could be exchanged on a dollar–for–dollar basis for payments received under the investors' contracts with [the debtor–Ponzi scheme]."[134] Thus, investors could keep the amount they received before the bankruptcy filing to offset the rescission claim each investor had in the sum of their principal investment.

From this preliminary description, the *Agretech* facts seem more akin to the matter confronted by the court in *AFI Holding*. *Agretech* dealt specifically with partnership interests and whether they were to be treated as equity securities.[135] The court in *Agretech* used the definition of "equity security" in the Bankruptcy Code to demonstrate that a limited partnership is an equity security rather than a creditor interest.[136] In doing so, the Ninth Circuit aligned itself with at least one other circuit.[137] Furthermore, while

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126 *Id.* at 704, 706. Other issues were decided by the court, such as whether Mackenzie was entitled to the fictitious profits. *Id.* at 703–04. Discussions of these side issues are beyond the scope of this Note.

127 Wyle v. Rider (*In re* United Energy Corp.), 944 F.2d 589 (9th Cir. 1991).

128 Hayes v. Palm Seedlings Partners-A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528 (9th Cir. 1990).

129 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 704–09 (9th Cir. 2008).

130 11 U.S.C. § 548(c), (d)(2)(A) (2006).

131 *In re AFI Holding, Inc.*, 525 F.3d at 705 (citing Hayes v. Palm Seedlings Partners–A (*In re* Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 540 (9th Cir. 1990)).

132 *Hayes*, 916 F.2d at 540 (citing 11 U.S.C. § 101(15) (which has since been changed to 11 U.S.C. § 101(16))).

133 Wyle v. Rider (*In re* United Energy Corp.), 944 F.2d 589, 591 (9th Cir. 1991).

134 *Id.*

135 *Hayes*, 916 F.2d at 540.

136 *Id.* at 540 (citing 11 U.S.C. § 101(15) (which has since been changed to 11 U.S.C. § 101(16))).

137 *See* Buncher Co. v. Official Comm. of Unsecured Creditors of GenFarm Ltd. P'ship IV, 229 F.3d 245, 252 (3d Cir. 2000).

United Energy touched upon the definition of "debt" and the apparent congressional intent to expand its definition, the case did not directly deal with partnership interests and their classification as an equity or debt instrument.[138]

Mr. Mackenzie's appellate brief sought to demonstrate that the *United Energy* position was "consistent with the decisions of other courts across the nation in the [P]onzi setting."[139] The appellant pointed to three cases that examined partnership interests in the context of Ponzi schemes:[140] *Sender v. Hannahs* (*In re Hedged Investments Associates, Inc.*) [hereinafter *Hedged Investments*],[141] *Sender v. Simon*,[142] and *Drenis v. Haligiannis*.[143] Although these cases are similar to some degree, none confront the primary issue of *AFI Holding*: whether the exchange of an equity interest for a creditor's restitution claim constitutes value under the good faith defense of § 548(c).

In *Sender v. Simon*, the court analyzed the rights of limited partners to rescission and restitution against a partnership operated as a Ponzi scheme.[144] The court ultimately determined that a partnership did not exist because it was created under fraudulent pretenses.[145] As only a partnership planning to operate in "lawful business" could be created under the partnership statutes of Colorado, the court concluded that the common law provided for restitution and rescission claims against the defunct partnership.[146] Without a partnership, the issues of equity securities and value did not arise. The court in *Drenis v. Haligiannis* also provided limited partners with a restitution claim against the partnership;[147] however, whether an equity interest constituted value under the good faith defense was not decided by the court.[148] The *Hedged Investments* court also did not confront the issue of

138 *Wyle*, 944 F.2d at 595–96. In this case, the court found that the Bankruptcy Code "does not require that a 'debt' be a contractual liability." *Id.* at 595. Instead, the court pointed to the definition of "claim" in stating that a debt was "a liability on a 'right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.'" *Id.* at 595–96 (quoting 11 U.S.C. § 101(5)(A)). This definition helped the court to find that the claims of rescission and restitution existed with or without a contractual right to the principal. *Id.* at 596.

139 Appellee/Cross-Appellant Keith Mackenzie's Opening Brief at 26, Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700 (9th Cir. 2008).

140 *See id.*

141 Sender v. Hannahs (*In re* Hedged Inv. Assocs.), 176 B.R. 214 (D. Colo. 1994).

142 Sender v. Simon, 174 B.R. 601 (D. Colo. 1994).

143 Drenis v. Haligiannis, 452 F. Supp. 2d 418 (S.D.N.Y. 2006).

144 *Simon*, 174 B.R. at 603.

145 *Id.* at 604.

146 *Id.* at 603–04.

147 *Drenis*, 452 F. Supp. 2d at 428.

148 *See id.*

whether converting a partnership interest into a creditor's claim constituted value,[149] even though Mr. Mackenzie's brief insinuated that the good faith defense was at work in the case.[150] The appellant's bottom line was that, while cases in other circuits had skirted the questions of Ponzi schemes and fraudulent transfer law, none discussed the issue in *AFI Holding* directly.

Despite marked similarities with *Agretech* and the explicit statutory definition classifying a partnership interest as an equity security, the court in *AFI Holding* saw more persuasive similarities in *United Energy*.[151] The court distinguished *Agretech* from *AFI Holding* by stating that it had only examined the "equity interest" in the former case with regard to the capital contributions made by the limited partners, instead of focusing on the restitution rights of the partners.[152] The court also noted that *Agretech* had been examined entirely from the "taking in good faith" prong of § 548(c); therefore, the *Agretech* court had not afforded the "taking for value" requirement an appropriate analysis.[153] The most relevant distinction between *Agretech* and *AFI Holding* for the court was that the limited partners in *AFI Holding* were enticed into the investment through fraud.[154] The court determined that this difference was significant enough to ignore the language in *Agretech* that stated that a partnership interest was strictly an equity security.[155]

B. Effect of the Decision in AFI Holding

For the court in *AFI Holding*, transforming an equity security into an interest with the rights of a creditor seemed to rest on the presence of fraud in the creation of the partnership interest. The court noted that "[a]lthough circumstances of the exchange were cloaked in terms of a partnership interest, we delve beyond the 'form' to the 'substance' of the transaction."[156] The "substance over form" argument may be the only hook the Ninth Circuit has to hang its hat on. As Professor Schechter simply states, "An outstanding equity interest is not a 'debt.'"[157] Because fraud victims typically become tort creditors, fraud may be the only explanation for the equity–to–creditor transformation: the investor–defendants could collect

149 *See* Sender v. Hannahs (*In re* Hedged Invs. Assocs., Inc.), 176 B.R. 214 (D. Colo. 1994).

150 *See* Appellee/Cross–Appellant Keith Mackenzie's Opening Brief, *supra* note 139, at 26.

151 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 708–09 (9th Cir. 2008).

152 *Id.* at 705.

153 *Id.* at 707–08.

154 *Id.* at 708.

155 *See id.*

156 *Id.*

157 Schechter, *supra* note 14.

their redemptions on their partnerships not as equity payments but instead as "fraud restitution payments."[158] The problem with this rationale is that with or without the presence of fraud, exchanging a partnership interest for a restitution claim runs afoul of the explicit "giving value" requirement of § 548(c)[159] and the common law principle that the redemption of an equity security does not constitute value.[160]

An explicit problem with the decision in *AFI Holding* is that the court does not grapple with the practical effects of advancing limited partners' interests to creditors' interests. Using a hypothetical situation illustrated in *Collier on Bankruptcy*, a "[lender] who has made a loan to [a financial enterprise] to enable the latter to extricate himself from a financial morass by paying off pressing obligations is entitled to be regarded as a [general creditor]."[161] Applying this example to *AFI Holding*, the investors holding limited partnership interests would collect at the same priority level as unsecured creditors who either loaned money or provided goods and services to the scheme without receiving sufficient collateral. So long as neither the investor nor the unsecured lender had knowledge or believed that the enterprise was a fraud,[162] a court following the precedent in *AFI Holding* would give them an equal claim to assets.

Laying out the clear ramifications of *AFI Holding* with this hypothetical situation harkens the words of Professor Schechter that a creditor has a "'right' to payment" while an equity participant in an enterprise only maintains a "'hope' of payment."[163] The presence of the fraudulent deception in the investment scheme, unfortunate as it is, does not alter the *underlying rights* the lender and the investor believed they possessed upon injecting funds into the enterprise. A creditor who gave money, goods, or services to an investment scheme naturally assumes that his priority rights under the Bankruptcy Code would trump those of an equity participant. Though the advancement of equity participants in *AFI Holding* may alleviate the negative impact of the fraudulent scheme, these parties knew that losing their investment was a real possibility. The fact that their investment was lost through fraud should indeed provide them with a remedy, but not one

158 *Id.*

159 11 U.S.C. § 548(c) (2006).

160 Tomsic v. Pitocchelli (*In re* Tri-Star Techs. Co.), 260 B.R. 319, 326 (Bankr. D. Mass. 2001). *See, e.g.*, Murphy v. Robinson (*In re* Ipswich Bituminous Concrete Prods., Inc.), 79 B.R. 511, 517 (Bankr. D. Mass. 1987); Buncher Co. v. Official Comm. of Unsecured Creditors of GenFarm Ltd. P'ship IV, 229 F.3d 245, 252 (3d Cir. 2000); Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 136 (Bankr. D. Mass. 1989); Consove v. Cohen (*In re* Roco Corp.), 701 F.2d 978, 982 (1st Cir. 1983); Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935).

161 5 COLLIER ON BANKRUPTCY, *supra* note 25, at ¶ 548.07[2][c].

162 *Id.*

163 Schechter, *supra* note 14.

that would give them the rights of a creditor who *expected* the return of his capital. In the court's search for an equitable remedy for the limited partners in *AFI Holding*, the reasonable expectations of unsecured creditors have been undermined for the benefit of the equity participants.

The court in *AFI Holding* additionally runs the risk of graying the bright lines set forth in the Bankruptcy Code. The definition set out in 11 U.S.C. § 101(16)(B) states that an interest in a limited partnership is an equity security.[164] Equity securities do not give rise to a "debt or antecedent debt" so as to be included under the definition of "value" in § 548. Although decisions by various courts provide ammunition to those who would read the term "debt" very broadly,[165] there have been no cases construing the term "equity security" so broadly. Furthermore, strict construction of the Bankruptcy Code has been consistently employed by all levels of federal courts. The Supreme Court has on multiple occasions interpreted the Bankruptcy Code strictly[166] and embraced the "plain meaning" analysis when construing certain statutes.[167]

Despite the aforementioned precedent, the court in *AFI Holding* invokes rather succinctly the policy of substance over form in drawing its conclusion.[168] Such a liberal interpretation of a statutory definition leaves open the question of what other bright line rules are flexible in the context of an investment fraud. Closely-held corporations may be the next frontier with decisions like *AFI Holding*. As closely-held corporations share many similarities with partnerships,[169] the Ninth Circuit's decision could be used to convert the equity ownership rights of a closely-held corporation to those rights of a creditor.[170]

There may be alternative explanations for the decision in *AFI Holding*.

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164 11 U.S.C. § 101(16)(B) (2006).

165 *See* FCC v. Nextwave Pers. Commc'ns, Inc., 537 U.S. 293, 302 (2003). The Court states that "[u]nder the Bankruptcy Code, 'debt' means 'liability on a claim,'... and 'claim,' in turn, includes any 'right to payment,' .... [The Supreme Court has] said that '[c]laim' has 'the broadest available definition.'" *Id.*

166 *Id.* at 302 (stating that "where Congress has intended to provide regulatory exceptions to provisions of the Bankruptcy Code, it has done so clearly and expressly."). *See also* Diana L. Hayes, Comment, *Bankruptcy Law: An Exercise in Statutory Interpretation—Staying True to the Broad Aim of the Code or Ignoring Plain Meaning and Purpose?*, 59 FLA. L. REV. 697, 699 (2007) ("Historically, in interpreting the Bankruptcy Code, the Court has considered the equal distribution purpose of the statute to mandate strict construction.").

167 *See* Nancy Haller, Comment, *Cybergenics II: Precedent and Policy vs. Plain Meaning*, 56 ME. L. REV. 365, 404 (2004).

168 Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 708 (9th Cir. 2008).

169 *See generally* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 694-97 (3d ed. 1983). Closely-held corporations have even been known as "incorporated partnership[s]" or "chartered partnership[s]." *Id.* at 694.

170 Shares of stock are defined as a form of equity security. 11 U.S.C. § 101(16)(A) (2006).

The advancement of equity interests in the case could be an anomaly where the limitations of fraudulent transfer law have intersected with the complexities of twenty–first century finance; however, the drafters of the Bankruptcy Code were well aware that fraudulent transfers in the context of partnerships needed special attention. Section 548(b) of the Code was created specifically to avoid transfers "to a partner by a partnership that is insolvent or will be thereby rendered insolvent."[171] The drafters saw fit to abrogate the requirements that (1) there be actual intent or knowledge of insolvency by the partners at the time of the transfer and that (2) the partnership receive in exchange for the transfer an item of reasonably equivalent value.[172] This provision allows for avoidance of transfers from the partnership by the trustee on the showing that "the partnership was insolvent at the time of or as a result of the transfer."[173] This special treatment of partnerships under the fraudulent transfer statutes can be largely attributed to the accounting principles that govern how partnership assets are calculated.[174]

An in–depth understanding of § 548(b) is immaterial for the purposes of this Note. What is of significance is that the drafters of the Bankruptcy Code recognized that partnerships and transfers of their assets merited specific and special attention. While using inaction to demonstrate legislative intent admittedly has questionable value, that the drafters specifically singled out partnership interests offers evidence that if the drafters meant to treat partnership interests as creditor interests in specific instances, such a notation would have been made. This is especially true given that the definition of "equity security" explicitly includes limited partnership interests.[175]

Other sections of the Bankruptcy Code indicate that the drafters of the Code did not intend equity claims to be transformed into creditors' claims. Section 510(b) of the Bankruptcy Code "authorizes the bankruptcy court, in ordering distribution of assets, to subordinate all or any part of any claim to all or any part of another claim, regardless of the priority ranking of either claim."[176] The Code section arose from the concerns of bankruptcy scholars Professors John J. Slain and Homer Kripke that bankruptcy "claims for rescission of securities purchases" were being classified as "general unsecured debts or . . . as secured debts [which] undermined the

171 5 COLLIER ON BANKRUPTCY, *supra* note 25, at ¶ 548.08.

172 *Id.*

173 *Id.*

174 *Id.* Assets of a partnership include the assets of the individual partners. Therefore, a transfer from the partnership to a partner would not render the partnership insolvent, but that transfer may nevertheless harm creditors because of personal exemption rights of individual property in bankruptcy. *Id.*

175 11 U.S.C. § 101(16) (2006).

176 11 U.S.C. § 510(b) (2006); S. REP. No. 95–989, at 10 (1978).

absolute priority rule" that equity claims were subordinate to the claims of creditors.[177] Interestingly enough, Professors Slain and Kripke proposed this rule because American courts were granting rescission claims to equity participants (stockholders) "in the context of securities fraud."[178] Section 510(b) of the Bankruptcy Code ensures that creditors are reimbursed before investors seeking rescission of their securities purchases, even if the claim for rescission possessed by the investor in the context of securities fraud gives the investor and the creditor the same level of priority.[179]

Section 510(b) of the Bankruptcy Code demonstrates clear legislative intent that rescission claims by equity participants in the context of securities fraud should be subordinated to other creditors' claims. Such a mandate indicates that the Ninth Circuit was incorrect in deciding that the rescission claims of a defrauded investor were equal to the creditor claims of a bankruptcy trustee. For Professors Slain and Kripke, subordinating defrauded stockholders' rescission claims was grounded in the "inherent... nature of the shareholder/creditor contract that the shareholder should bear relatively greater risk of business failure."[180] The decision in *AFI Holding* turns this fundamental tenet on its head, shifting some of the risk that equity participants are ordinarily faced with to the creditors by changing the typical absolute priority rules of the Bankruptcy Code.

Another explanation for the court's decision may be more benign than its desire to rewrite the definition of "equity security." Courts have frequently and consistently held that a "compromise of a dispute can supply the element of consideration."[181] Decisions rendered after *AFI Holding* that employed its logic and cited to it have not focused on the equity/creditor aspect of the case, but instead on the rule that the "giving value" element of the good faith defense in § 548(c) could be satisfied where an "[investor–defendant] had received a release in exchange for a valid restitution claim."[182] Therefore, the argument could be fostered that *AFI Holding* was simply an affirmation that the reduction of an investor's restitution claim against the partnership in exchange for return of the investor's principal investment is "value" as defined under the good faith

177 Christopher W. Frost, *Subordination of Securities Claims in Bankruptcy: What is the Scope of Section 510(b)?*, 27 No. 2 BANKR. L. LETTER 1, 1 (Feb. 2007).

178 *Id. See* Oppenheimer v. Harriman Nat'l Bank & Trust Co. of New York, 301 U.S. 206 (1937).

179 *See* 11 U.S.C. § 510(b).

180 Frost, *supra* note 177, at 3.

181 Schaps v. Just Enough Corp. (*In re* Pinto Trucking Serv., Inc.), 93 B.R. 379, 389 (Bankr. E.D. Pa. 1988).

182 Indep. Trust Corp. v. Fidelity Nat'l Title Ins. Co. of New York, 577 F. Supp. 2d 1023, 1044 (N.D. Ill. 2008) (citing Barclay v. Mackenzie (*In re* AFI Holding, Inc.), 525 F.3d 700, 708 (9th Cir. 2008)). *See also* Jordan v. Kroneberger (*In re* Jordan), 392 B.R. 428, 442–44 (Bankr. D. Idaho 2008).

defense.

"Cancelation of" or "the settlement of" a legal claim can indeed be sufficient consideration to satisfy the "reasonably equivalent value" requirement of § 548(a) and the "giving value" element of § 548(c). It can be seen as similar to the cancelation of future indebtedness which has been held to be "good and valuable consideration for a transfer."[183] Nevertheless, the courts that have recently relied upon the precedent in *AFI Holding* were confronted with legal claims against the debtor arising not from partnership interests, but from other contractual relationships.[184] Furthermore, while the Ninth Circuit in *AFI Holding* could have seen the issue as whether the release of a claim constituted sufficient value for § 548(c), the trustee's argument to the court centered on the lack of value in partnership interests under the fraudulent transfer law.[185] While implicitly dealing with the reduction of a legal claim as constituting value, *AFI Holding* is and should be viewed as a decision predicated on the transformation of an equity security to a creditor's claim.

The final question is whether the decision undermines the "equality of distribution" policy which is the bedrock of a bankruptcy trustee's power?[186] Some could construe *AFI Holding* as allowing limited partnership interest–holders to retain distributions they receive before the collapse of a debtor–Ponzi scheme. If this were the case, then that construction may favor the lucky partners who withdraw their funds ahead of the collapse over the unlucky investors who are wiped out by a Ponzi scheme. Conversely, this holding may only mark a movement by the Ninth Circuit to treat victims of Ponzi schemes predicated on a partnership interest the same as investors who were duped by schemes without the purchase of an equity interest.[187]

By allowing investors who withdrew their principal investment before the collapse of the Ponzi scheme to offset that amount against a potential restitution claim, the sum of money a bankruptcy trustee will be able to collect will be curtailed. This limits the amount available to Ponzi scheme victims who find themselves in the hapless position of investors at the scheme's collapse, while defrauded investors holding a non–equity investment vehicle are afforded the use of the good faith defense because surrendering their tort claims against the scheme provides adequate value under § 548(c). Allowing Ponzi scheme victims who held equity stakes in

183 5 COLLIER ON BANKRUPTCY, *supra* note 25, at ¶ 548.05[1][b].

184 *See Indep. Trust Corp.*, 577 F. Supp. 2d at 1025–26; *In re Jordan*, 392 B.R. at 434–37.

185 *In re AFI Holding, Inc.*, 525 F.3d at 706.

186 *See* Schechter, *supra* note 14.

187 *See* Bayou Accredited Fund, LLC v. Redwood Growth Partners (*In re* Bayou Group, LLC), 396 B.R. 810 (Bankr. S.D.N.Y. 2008). Here, the investments in this particular investment fund created a right to rescission for each investor, a right that neither the debtor–Ponzi scheme nor the investor–defendants questioned. The investors did not have partnership interests or other equity claims against the fund. *Id.*

the enterprise the same good faith defense would not disrupt the equality of distribution policy that buttresses fraudulent transfer law. In both cases, investors who are left holding the bag when the Ponzi scheme fails cannot collect from a previously-withdrawn investor who can successfully assert the elements of the good faith defense. Allowing equity participants to enjoy the defense would simply equalize the rights of all fraud victims after a Ponzi scheme's collapse. Nevertheless, allowing the defense in this case is a blatant disregard of the definition of "equity security" in the Bankruptcy Code and of the theory that partnership interests redeemed by a partner do not constitute value under § 548(c).

CONCLUSION

Ponzi schemes and their perpetrators take a horrible toll on the savings of the investors they defraud. Many of the victims of Bernard Madoff's investment fraud lost their entire life savings, and their only remedy now is the chance to collect a few thousand dollars through the fraudulent transfer laws.[188] Ponzi schemes also affect market-wide investor confidence and faith in market regulatory agencies, and they stand as a testament to the worst kinds of human greed. In the famous fraud orchestrated by Charles Ponzi, nearly all of his victims were poor Italian immigrants who could least afford to have what little they had earned disappear.[189] Unfortunately, this is a pattern that appears with regularity in Ponzi schemes: the most vulnerable are the ones most often hurt.

Providing relief for the near victims of a Ponzi scheme through the good faith defense is a laudable goal for the courts to undertake. After all, the decision in *AFI Holding* provides investor-defendants of failed Ponzi schemes the same protection that would be afforded them had the scheme been structured not as a partnership but instead as an investment fund like Bernard Madoff's. To provide this protection, however, the Ninth Circuit abrogated the value element of the good faith defense, morphing an equity interest into a creditor's claim. Through these actions, the Ninth Circuit risks creating a precedent of blurring the other bright line rules of the Bankruptcy Code when a particular outcome appears inequitable.

The Bankruptcy Code and bankruptcy courts should provide equal remedies to similarly situated parties, just not at the expense of ignoring clearly-termed statutory definitions.

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188 Kevin McCoy, *Madoff Client's Lawsuits Look to Others for Recompense; Legal Strategy Targets Securities and Exchange Commission, Money Managers, Banks*, USA TODAY, Mar. 4, 2009, at MONEY6A.

189 *See* WALSH, *supra* note 30, at 3.