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The Law of Ponzi Payouts

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NOTE

THE LAW OF PONZI PAYOUTS

*Spencer A. Winters**

When a Ponzi scheme collapses, there will typically be net winners and net losers. The bankruptcy trustee will often seek to force the net winners—those who received more money back from the Ponzi scheme than they invested—to disgorge their profits. Courts diverge on whether they should compel disgorgement in this instance. This Note argues that under prevailing fraudulent transfer law, net winners in a Ponzi scheme need not disgorge their profits. This is because the investor's dollar-for-dollar discharge of a preexisting debt constitutes the transfer of value in exchange for the payout. There are two exceptions to this rule: where the payouts are objectively excessive and where the investor is an equity holder rather than a debtholder. This framework is sound as a matter of policy, despite the fact that it is not always entirely fair, because it provides greater certainty in commercial transactions.

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INTRODUCTION

You own a home in Exeter Township, Pennsylvania. The house is worth $200,000, and the balance on your mortgage is $120,000. A silver-haired man named Wesley A. Snyder, who in his suit and tie looks convincingly

* J.D. Candidate, May 2013, University of Michigan Law School. I would like to thank Margaret L. Mettler, Joanna Rogow, Adam Teitelbaum, and the editors of the *Michigan Law Review* for helping me publish this Note. I would also like to thank Professor John Pottow for his comments and critiques. Finally, I would like to thank my parents, Don and Rosie Winters, for their support.

like an accomplished mortgage banker, approaches you with an enticing proposition dubbed the "Wrap-Around Equity Slide Down Discount Mortgage Program." He can reduce your annual mortgage rate by 1 percent, and you hardly have to do a thing. You will simply refinance your mortgage with a $140,000 loan from your local bank, say, Wells Fargo, and give the extra $20,000 to Snyder. He will invest that $20,000 for you and use a portion of the proceeds to reduce your monthly mortgage loan payments. Just have your bank forward all the bills to his firm, Image Masters, and you will make the reduced monthly payments to Image Masters directly.

This plan goes swimmingly. You make your reduced monthly payments to Snyder and put the savings in your children's college fund. Every month, Snyder's firm sends you a document detailing your reduced mortgage balance and the payments the firm has made on your behalf to Wells Fargo at your old interest rate. What a deal. But, as the saying goes, what seems too good to be true probably is. Two years later, you read in the newspaper that the U.S. Attorney has filed criminal charges against Snyder for the operation of a Ponzi scheme that defrauded 800 Pennsylvania residents of $29 million. Instead of investing your money in the capital markets and using the earnings to reduce your mortgage rate, Snyder used the proceeds of your investment to reduce the rates of other investors and to enrich himself. You still owe $140,000 to Wells Fargo on your mortgage plus the interest that has been compounding monthly on that sum at an increased rate for the past two years. You have no equity in your home, your credit rating is shot, and you are broke. Some investors, you learn, were luckier: Snyder really did pay the bank on *their* mortgages. This, or something close to it, is what hundreds of homeowners discovered on November 9, 2007.[1]

Ponzi schemes ruin lives. After the entities that operate these schemes inevitably file for bankruptcy,[2] the individual tasked in large part with mitigating the damage is the bankruptcy trustee.[3] In bankruptcy law, the trustee is the fiduciary charged with maximizing the value of the estate.[4] Frequently, the trustee seeks to retrieve or "claw back" the earnings received by inves-

1. *See* Feldman v. Chase Home Fin. (*In re* Image Masters, Inc.), 421 B.R. 164, 172–74 (Bankr. E.D. Pa. 2009); *Snyder's Sentence Upheld in Ponzi Scheme*, ALLBUSINESS (July 22, 2010), http://www.allbusiness.com/legal/trial-procedure-decisions-rulings/14839890-1.html. I have invented the details of this stylized hypothetical, but Snyder and the $29 million he stole from investors are very real. To decide for yourself whether Snyder looks like a silver-haired mortgage banker, see Don Spatz, *Berks Judge Right to Ban Workers in Wesley Snyder Ponzi-Scheme Case from Mortgage Business, Appeals Court Rules*, READING EAGLE (June 10, 2009), http://readingeagle.com/article.aspx?id=142444.

2. For a few of the many examples of Ponzi schemes that have filed for bankruptcy, see *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 231–33 (2d Cir. 2011); *Jobin v. Ripley (In re M & L Bus. Mach. Co.)*, 198 B.R. 800, 802–04 (D. Colo. 1996); and *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843, 847–49 (D. Utah 1987) (en banc).

3. For an example of a bankruptcy trustee charged with unwinding a particularly notorious Ponzi scheme, see Irving Picard, *A Message from SIPA Trustee Irving H. Pickard*, THE MADOFF RECOVERY INITIATIVE, http://madofftrustee.com/trustee-message-02.html (last visited Mar. 14, 2012).

4. Zazzali v. Swenson (*In re* DBSI, Inc.), 451 B.R. 373, 377 (Bankr. D. Del. 2011).

tors in the Ponzi scheme who were lucky enough to escape with their shirts.[5] The trustee does so in part by filing avoidance actions against these lucky investors under the fraudulent transfer provision of the Bankruptcy Code.[6] There is a significant split of authority as to the viability of these actions.[7]

Whether the net winners—those who made more than they invested—should disgorge their profits is a difficult question. The instinct is often in favor of disgorgement, and that instinct is not unfounded: the profits of the net winners were made by defrauding the other investors. The net winners, the argument goes, should give the profits back because they were wrongfully procured.[8] As a matter of policy, the situation is little different than that of the con man who pawns a watch that he procured by defrauding the original owner. When the watch's owner comes to the pawnshop demanding the return of his watch, should the pawnshop have to give it up? Although the moral question is perhaps a close one, the law in both cases chooses certainty over fairness.[9] Arguably, the fairest remedy would be to apportion the hurt evenly among the creditors, making adjustments based on degrees of negligence. However, this system would involve substantial administrative costs and could discourage the free exchange of assets.

This Note argues that the Bankruptcy Code does not and should not permit the bankruptcy trustee to claw back payouts to Ponzi investors except in limited circumstances. Part I defines the Ponzi scheme and lays out the basic fraudulent transfer avoidance framework under the Bankruptcy Code. Part II argues that the avoidability of Ponzi payouts normally turns on whether the Ponzi investor has transferred reasonably equivalent value in exchange for her payout. In the typical case, the investor transfers precisely equivalent value in the form of a dollar-for-dollar reduction in the Ponzi scheme's debt to the investor. Part III argues that there are two important limitations on this framework: when the payouts are objectively excessive or when the Ponzi scheme is an equity-type Ponzi scheme, the Code may permit clawbacks. Finally, Part IV argues that although the instinct is often that courts should compel disgorgement of Ponzi payouts, the current Ponzi scheme framework is justified as a matter of policy because it protects the free exchange of assets.

I. Avoiding Ponzi Payouts

This Section defines the Ponzi scheme and sets forth the basic framework under which a bankruptcy trustee will normally have a prima facie transfer avoidance claim against net winners in a Ponzi scheme. Section I.A

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5. *See, e.g.*, cases cited *supra* note 2.

6. 11 U.S.C. §§ 544, 548 (2006). For examples of trustees filing avoidance actions to claw back the earnings of investors in Ponzi schemes, see *supra* note 2.

7. *See infra* note 59 and accompanying text.

8. *See, e.g.*, Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 858 (D. Utah 1987) (en banc).

9. *See infra* Part IV.

defines the Ponzi scheme generally and explains two Ponzi subtypes that dictate the avoidability of payouts: fixed-income Ponzi schemes and equity-type Ponzi schemes. Section I.B sets forth the Bankruptcy Code's transfer avoidance framework and argues that a bankruptcy trustee will normally have a prima facie avoidance claim against net winners.

A. *The Ponzi Scheme and Its Types*

Although other definitions are more restrictive, this Note proposes that a Ponzi scheme is, at a minimum, an entity or group of entities that routinely finances its obligations to claimholders with the proceeds from newly issued liabilities but deceives its claimholders as to the source of the financing. A typical, more restrictive definition of the Ponzi scheme is as follows:

> A fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other than the continual raising of new funds.[10]

Not all Ponzi schemes, however, promise artificially high rates of return.[11] Some even conduct real business operations in addition to defrauding their investors.[12] Thus, the fact that an entity routinely finances its obligations by issuing new liabilities while representing otherwise to its claimholders is sufficient to qualify that entity as a Ponzi scheme.[13]

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

11. A number of the Ponzi schemes that will be discussed or cited in this Note involved promised annual rates of return in the 8.00 to 15.00% range. *See, e.g.*, Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 483–84 (D. Conn. 2002); Lustig v. Weisz & Assocs., Inc. (*In re* Unified Commercial Capital, Inc.), 260 B.R. 343, 345 (Bankr. W.D.N.Y. 2001), *aff'd*, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002); Martino v. Edison Worldwide Capital (*In re* Randy), 189 B.R. 425, 431–32 (Bankr. N.D. Ill. 1995). Although these certainly were not low rates of return, they were not necessarily inconsistent with fixed-income rates available in the market: from 1995 to 2005, the seven-year constant maturity treasury rate was between 3.52 and 6.50%, *Selected Interest Rates*, BOARD GOVERNORS FED. RES. SYS. (Apr. 13, 2011), http://www.federalreserve.gov/releases/h15/data.htm (follow "Treasury constant maturities"; then follow "7-year"; then click on "Annual"), and high-yield bonds historically trade at interest rates between 4.00 and 8.00% above this rate, *see FRBSF Economic Letter*, FED. RES. BANK S.F. (Nov. 16, 2001), http://www.frbsf.org/publications/economics/letter/2001/el2001-33.html (click "Yield spreads of junk bonds"). Thus, rates in the 8.00 to 15.00% range are not clearly outrageous.

12. *See, e.g.*, *In re Carrozzella & Richardson*, 286 B.R. at 482–84. In addition to providing actual legal services, at least at the outset, the Ponzi scheme in *In re Carrozzella & Richardson* made real, if somewhat eccentric, investments: it invested in a nut business, a race horse, and some condominiums. *Id.*

13. *See id.* at 482 n.2. The United States District Court for the District of Connecticut defined a Ponzi scheme broadly: "In a 'Ponzi' scheme, an enterprise makes payments to investors with monies received from newly attracted investors, rather than from profits of a legitimate business venture." *Id.*

It is critical to the arguments set forth in this Note to subdivide the Ponzi scheme into two types: the fixed-income Ponzi scheme and the equity-type Ponzi scheme. The eponymous Ponzi scheme, carried out by Charles Ponzi, typifies the fixed-income Ponzi scheme, wherein the debtor issues fixed-income securities to finance the illegal scheme.[14] Fixed-income securities are debt instruments, the interest rates of which are either static (e.g., 10.00% per annum or 8.00% semiannually) or pegged to some benchmark (e.g., 2.00% over the prime rate).[15] Charles Ponzi issued unsecured notes promising 50.00% interest per quarter.[16] He represented to his creditors that he was purchasing international postage stamps at a deep discount and selling them in other markets for a massive profit.[17] He raised almost $10 million.[18]

The Ponzi scheme carried out by Snyder, as described in the Introduction,[19] was also a fixed-income Ponzi scheme, although harder to recognize as such. One may question whether it was a Ponzi scheme at all or just a sophisticated form of fraud. It was, however, a Ponzi scheme because Snyder asked for an investment from his victims and promised them a return thereupon, which he paid out from the investments of other victims. The investment he requested and received was the equity that the homeowners "cashed out" of their homes by refinancing.[20] For example, a homeowner with a $120,000 loan on a $200,000 house might have refinanced with a $140,000 loan, given $120,000 to her old creditor, and remitted the extra $20,000 to Snyder. The homeowner might have had a $570 monthly payment on the old loan and, after refinancing, had a $670 monthly payment on the new loan. Snyder would then assume the obligation of paying the new loan,[21] $670 a month. In return, the victim would pay Snyder a lower rate than she had been paying on her home loan previously,[22] maybe $500 a month. In theory, Snyder would try to earn $170 a month or more on the $20,000 he received from the investor, using the $170 in investment earnings plus the $500 he received each month from the victim to pay the bank. Any excess investment earnings would serve as his compensation. Unfortunately, Snyder would not invest the $20,000 but instead would use

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14. *See infra* notes 16–18 and accompanying text.

15. FRANK J. FABOZZI & PAMELA PETERSON DRAKE, FINANCE: CAPITAL MARKETS, FINANCIAL MANAGEMENT, AND INVESTMENT MANAGEMENT 112 (2009). *See generally* LIONEL MARTELLINI ET AL., FIXED-INCOME SECURITIES 3–5 (2003).

16. Cunningham v. Brown, 265 U.S. 1, 7 (1924). The scheme from which the Ponzi scheme derived its name, then, certainly did promise an outrageous rate of return.

17. *Id.*

18. *Id.* at 8. This would be closer to $100 million today. *CPI Inflation Calculator*, BUREAU LAB. STAT., http://www.bls.gov/data/inflation_calculator.htm (last visited Mar. 2, 2012).

19. *See supra* note 1 and accompanying text.

20. Feldman v. Chase Home Fin. (*In re* Image Masters, Inc.), 421 B.R. 164, 172 (Bankr. E.D. Pa. 2009).

21. *See id.*

22. *Id.*

the money to make payments on other victims' mortgages and to enrich himself. In that way, the Snyder scheme was a fixed-income Ponzi scheme. The majority of this Note concerns itself with fixed-income Ponzi schemes, which are to this day quite common.[23]

The Bernie Madoff scheme typifies the equity-type Ponzi scheme, wherein the debtor issues securities that, rather than promising a fixed rate of return, promise only to pay out whatever earnings accrue to the investor's account. In other words, the contract between the Ponzi investor and the Ponzi scheme does not embody a promise to pay interest or repay principal. In this way, the securities issued by an equity-type Ponzi scheme resemble shares in an investment company.[24] Bernie Madoff solicited funds by allowing investors to open trading accounts with his firm's investment advisory unit, whereupon he promised to invest those funds using his "split-strike conversion strategy."[25] Unlike the original Ponzi scheme, Madoff's investors were not promised a fixed return but were instead promised whatever returns accrued to (or whatever losses were sustained by) the investment of their funds.[26] Of course, rather than pursuing any legitimate investment strategy, Madoff used investors' funds to pay earnings to other investors and to enrich himself. Although the Madoff scheme is now infamous, many Ponzi schemes instead continue in the fixed-income mold of their namesake.[27]

Finally, this Note defines two additional terms: net winners in a Ponzi scheme and net losers in a Ponzi scheme. Net winners are those investors who, upon the collapse of a Ponzi scheme, receive both their principal and some amount of earnings.[28] In other words, net winners are those Ponzi investors "lucky enough to make money."[29] Net losers, the victims of the

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23. *See, e.g.*, Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 483–84 (D. Conn. 2002); Jobin v. Ripley (*In re* M & L Bus. Mach. Co.), 198 B.R. 800, 803 (D. Colo. 1996); Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 848 (D. Utah 1987) (en banc); *In re Image Masters*, 421 B.R. at 172; Lustig v. Weisz & Assocs. (*In re* Unified Commercial Capital, Inc.), 260 B.R. 343, 345 (Bankr. W.D.N.Y. 2001), *aff'd*, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002); Martino v. Edison Worldwide Capital (*In re* Randy), 189 B.R. 425, 431–32 (Bankr. N.D. Ill. 1995); *In re* Taubman, 160 B.R. 964, 972 (Bankr. S.D. Ohio 1993).

24. *See* 45 AM. JUR. 2D *Investment Companies & Advisers* § 1 (2007) ("An investment company sells its own securities to the public and then reinvests the proceeds in a portfolio of securities which it manages on a continuous and full-time basis.").

25. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 128–29 (Bankr. S.D.N.Y. 2010) (internal quotation marks omitted), *aff'd sub nom. In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011). The split-strike conversion strategy is a bona fide, if somewhat exotic, trading strategy. *See* FRANÇOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS § 17.5 (2006). Madoff, however, did not execute it.

26. *See* Picard v. Cohmad Sec. Corp. (*In re* Bernard L. Madoff Inv. Sec. LLC), 454 B.R. 317, 325 (Bankr. S.D.N.Y. 2011).

27. *See supra* note 23.

28. *Sec. Investor Prot. Corp.*, 424 B.R. at 132.

29. Scholes v. Lehmann, 56 F.3d 750, 753 (7th Cir. 1995). The *Scholes* defendant would likely disagree that he was particularly lucky, however, given that the court ordered him to remit his earnings to the bankruptcy estate. *See id.* at 757–58.

Ponzi scheme, are those who receive only their principal or less than the full value of their principal.[30] Section I.B discusses the framework under which bankruptcy trustees attempt to claw back or avoid the earnings of net winners.

B. *Actual Fraud: The Prima Facie Case*

The power of the bankruptcy trustee to claw back the debtor's prepetition transfers via avoidance actions is an important part of the framework of creditor protection built into the Bankruptcy Code.[31] In the context of bankrupt Ponzi schemes, the avoidance action is equally important, if not more important, than it is in nonfraudulent bankruptcies. For example, the trustee in the Madoff bankruptcy has filed roughly a thousand lawsuits, many of which contain avoidance claims, in an attempt to recover billions of dollars for the estate.[32] Although this Note ultimately concludes that, with two key exceptions, the Code does not permit the trustee to claw back earnings from net winners, this Section sets forth the basic transfer avoidance framework and concludes that a bankruptcy trustee will almost always have a prima facie avoidance claim against those who receive transfers from a Ponzi scheme. Part II, however, argues that net winners will generally have a valid affirmative defense to these avoidance actions.

There are two provisions of the Bankruptcy Code under which a bankruptcy trustee may file avoidance actions against those who received prepetition transfers of cash or property from the debtor. First, section 544 allows the trustee to file avoidance actions under applicable state fraudulent transfer law.[33] Second, section 548 allows the trustee to file avoidance actions under the Code's own fraudulent transfer framework.[34] Most states have adopted either the Uniform Fraudulent Conveyance Act or its successor, the Uniform Fraudulent Transfer Act,[35] each of which contains language that is, for the purposes of this Note, substantially identical to the fraudulent transfer provisions of section 548.[36] Although this Note focuses on the

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30. *Sec. Investor Prot. Corp.*, 424 B.R. at 132.

31. Prepetition transfers are transfers that the debtor makes before filing her bankruptcy petition. The filing of a bankruptcy petition initiates a bankruptcy proceeding. 11 U.S.C. § 301 (2006). An avoidance action is a lawsuit that seeks to render void a certain transaction. A trustee may seek to avoid prepetition transfers under both state law and the Bankruptcy Code. *See id.* § 548. "Clawback" is just a colorful word for "avoid."

32. *See Bernard L. Madoff*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/people/m/bernard_l_madoff/index.html (last updated June 28, 2012). For a discussion of Irving Pickard's avoidance actions, see *Avoidance Actions*, THE MADOFF RECOVERY INITIATIVE, http://www.madofftrustee.com/avoidance-actions-05.html (last visited Mar. 17, 2010).

33. 11 U.S.C. § 544.

34. *Id.* § 548.

35. Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 483 n.3 (D. Conn. 2002).

36. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 143–44 (3d ed. 2009). *Compare* UNIF. FRAUDULENT TRANSFER ACT

section 548 fraudulent transfer provisions, the core principles of fraudulent transfer law are relatively homogenous across jurisdictions.[37]

A trustee may premise a fraudulent transfer action on two distinct theories: actual fraud and constructive fraud. The actual fraud provision of the Code states that the trustee may avoid transfers made by the debtor in the two years prepetition "with actual intent to hinder, delay, or defraud" creditors.[38] The constructive fraud provision of the Code states that the trustee may avoid transfers made by the debtor in the two years prepetition when the debtor "received less than a reasonably equivalent value in exchange" for the cash or property transferred and "was insolvent on the date that such transfer was made."[39]

The trustee will generally have a prima facie claim under the actual fraud provision because a Ponzi debtor's payouts to investors are inherently fraudulent transfers. When the court makes a factual finding that the debtor operated a Ponzi scheme, the conclusion that the debtor acted with fraudulent intent is effectively inescapable.[40] Because this finding means that the debtor was misappropriating funds from his creditors to pay other creditors, courts have recognized a presumption of fraudulent intent when the debtor operated a Ponzi scheme.[41] Part II, however, argues that the Code generally permits Ponzi investors to successfully defend against fraudulent transfer actions by asserting that they took the transfers for reasonably equivalent value and in good faith.

II. The Issue of Value

This Part argues that, where the Ponzi investors were unaware of the fraudulent nature of the entity, which is normally the case, the bankruptcy trustee will not be able to claw back Ponzi payouts because the payouts were necessarily for value. Section II.A posits that bankruptcy trustees will typically be unable to avoid transfers for value. Section II.B argues that fixed-income Ponzi payouts are necessarily for value given the plain meaning of the Bankruptcy Code, basic principles of contract law, and the fundamental economics of the transactions.

§§ 4(a)(1)–(2), 5(a)–(b), 7A (II) U.L.A. 58, 129 (1984), *and* Unif. Fraudulent Conveyance Act §§ 4–7, 7A (II) U.L.A. 318–78 (1918) (superseded 1984), *with* 11 U.S.C. § 548.

37. *In re Carrozzella & Richardson*, 286 B.R. at 483 n.3.

38. 11 U.S.C. § 548(a)(1)(A).

39. *Id.* § 548(a)(1)(B).

40. A factual finding that the debtor operated a Ponzi scheme amounts to a finding that the debtor financed its obligations to claimholders with the proceeds from newly issued liabilities but represented otherwise to its claimholders. *See supra* Section I.A.

41. Deangelis v. Rose (*In re* Rose), 425 B.R. 145, 152 (Bankr. M.D. Pa. 2010); *see also* Hayes v. Palm Seedlings Partners-A (*In re* Agric. Research & Tech. Grp., Inc.), 916 F.2d 528, 536 (9th Cir. 1990); Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 10 (S.D.N.Y. 2007).

A. *Ponzi Transfers for Value Are Generally Not Avoidable*

The value of the thing that the transferee gives to the debtor in exchange for the transfer is of the utmost importance to fraudulent transfer law. The Bankruptcy Code's fraudulent transfer provisions contain two important substantive references to the concept of value. In order for a trustee to claw-back payments to an investor, the constructive fraud provision requires that the debtor have "received less than a reasonably equivalent value in exchange" for the cash or property transferred.[42] Further, section 548(c) provides the following:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.[43]

Thus, the Code provides an affirmative defense to an investor who receives a transfer that is both for value and made in good faith. This Part provides a discussion of "for value" transfers, while the discussion of good faith is reserved for Part III.

Before proceeding, I address two issues that arise when taking a closer read of section 548. Although courts have not relied on these issues as a basis for denying a section 548(c) defense, they are worth brief acknowledgment.[44] First, based on the language of section 548(c), one might wonder if sections 544, 545, and 547 challenge the interpretation that section 548(c) provides an affirmative defense to an investor who receives a transfer for value and in good faith. They do not. Section 544 is the statutory hook, as discussed above, that allows the trustee to proceed under state fraudulent transfer law.[45] However, a trustee cannot escape section 548(c)'s affirmative defense by proceeding under state fraudulent transfer law,[46]

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42. 11 U.S.C. § 548(a)(1)(B).

43. *Id.* § 548(c).

44. To be clear, these are not arguments set forth by other authorities against the position taken in this Note but rather potential flaws in my argument or general sources of confusion that have not, to my knowledge, been addressed elsewhere.

45. *See* 11 U.S.C § 544.

46. At least thirty-seven states have enacted the Uniform Fraudulent Transfer Act ("UFTA"), and those that have not have enacted instead either the Uniform Fraudulent Conveyance Act ("UFCA") or some other version of the Statute of Elizabeth, an old English statute on fraudulent conveyance law. John E. Sullivan III, *Future Creditors and Fraudulent Transfers: When a Claimant Doesn't Have a Claim, When a Transfer Isn't a Transfer, When Fraud Doesn't Stay Fraudulent, and Other Important Limits to Fraudulent Transfers Law for the Asset Protection Planner*, 22 DEL. J. CORP. L. 955, 960 & n.7 (1997). The UFTA, the UFCA, and section 548(c) of the Code are "all direct lineal descendants of the original fraudulent conveyance laws of England." *Id.* In one of the earliest cases interpreting English fraudulent conveyance law, *Twyne's Case*, the court set forth the elements of a defense for a

because the Uniform Fraudulent Transfer Act, enacted in most states,[47] also contains a substantially identical affirmative defense.[48] Section 545 likewise does not challenge the Ponzi investor's affirmative defense because it concerns statutory liens, which are irrelevant to this Note.[49] Finally, section 547 is the Code's preferential transfer provision, which allows the trustee to claw back payments made within the ninety days prepetition for a host of reasons, many of which could apply to Ponzi investors.[50] For the purposes of this Note, however, I assume that the Ponzi investor received nothing in the ninety days prepetition.[51]

Second, the fact that the constructive fraud provision refers to "reasonably equivalent value" and the affirmative defense provision refers just to "value" is of little consequence to the argument herein. The affirmative defense provision states that a transferee who takes "for value and in good faith" may retain the transfer "*to the extent that* such transferee or obligee gave value to the debtor in exchange for such transfer or obligation."[52] In other words, under section 548, the trustee can in all cases claw back the amount by which a good faith transferee underpaid for an asset, and a good faith transferee can in all cases keep the amount that she actually paid for the asset.[53] Because this Note argues that a Ponzi investor transfers precisely equivalent value in exchange for her payout,[54] the distinction between "value" and "reasonably equivalent value" is unimportant.

It follows then that regardless of whether the trustee proceeds under the actual or constructive fraud provision, the substantive issue is the value that the investor gave in exchange for her payout. The key distinction is procedural: if the trustee proceeds under the constructive fraud provision, the burden of proof will be on the trustee to show that the investor did not give reasonably equivalent value in exchange for the transfer; if the trustee proceeds under the actual fraud provision, the burden of proof will be on the

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transferee that took in good faith and for value. *Twyne's Case*, (1601) 76 Eng. Rep. 809 (Star Chamber) (stating that a transfer is not voidable if "bona fide" and "on good consideration").

47. *See supra* note 35 and accompanying text.

48. *See* UNIF. FRAUDULENT TRANSFER ACT § 8(a), 7A (II) U.L.A. 178 (1984) ("A transfer or obligation is not voidable under [the actual fraud provision] against a person who took in good faith and for a reasonably equivalent value . . . .").

49. *See* 11 U.S.C. § 545.

50. *See id.* § 547.

51. If funds were transferred to an investor in the ninety days prepetition, the trustee would add a claim under section 547, on top of the trustee's claims under section 548, seeking to avoid the payment as a preferential transfer. Whether that claim would lie is a question I leave for subsequent work. The section 548 question is generally of greater import because its two-year window means a larger dollar amount will be at stake.

52. 11 U.S.C. § 548(c) (emphasis added).

53. For example, imagine that the defendant purchased an asset from the debtor in good faith for $1,000, but the court later finds the asset to have been worth $2,000 at the time of transfer and to have been sold by the debtor with fraudulent intent. The court would then either enter a judgment against the transferee in the amount of $1,000 or compel the transferee to return the asset to the estate while granting the transferee a $1,000 lien on the asset. *See id.*

54. *See infra* note 63 and accompanying text.

investor to show that she did give some value for the transfer.[55] Under either provision, if the trustee makes a prima facie showing, the trustee will only be able to claw back from a good faith transferee the amount that the transferee underpaid for the asset.[56] The trustee would be wise, then, to always allege both actual and constructive fraud, especially given the presumption of actual fraudulent intent that arises from a factual finding that the debtor operated a Ponzi scheme.

Let us explore a brief example: Imagine two scenarios where a bankruptcy trustee sues a Ponzi scheme investor who received $10,000 in interest in the two years preceding the debtor's bankruptcy. In the first scenario, the trustee sues under only the actual fraud provision of the Code. The trustee will likely have a prima facie case, as discussed above.[57] The investor, if her counsel is competent, will then raise the affirmative defense provided by section 548(c) that she received the transfer in good faith and for value. Assuming good faith (for now),[58] the issue will become whether she exchanged value for the payout and in what amount, and the burden to show value will be on her, the investor. In the second scenario, the trustee sues under the constructive fraud provision of the Code. Because the constructive fraud provision requires that the investor did not receive the transfer for reasonably equivalent value, the trustee will need to negate this element to make her prima facie case. In either scenario, the issue is whether and in what amount the investor gave value for the $10,000 she received from the Ponzi scheme. Thus, ignoring for now the issue of good faith, the primary issue when a trustee sues a net winner in a Ponzi scheme under the fraudulent transfer provisions of the Bankruptcy Code is whether Ponzi payouts are taken for value and in what amount. Section II.B argues that they are usually taken for precisely equivalent value.

B. *Ponzi Interest Is Transferred for Value*

There is "a sharp split of authority on the issue of whether the payment of interest by a Ponzi scheme operator can ever constitute reasonably equivalent value."[59] As set forth in Section II.A above, the resolution of this split

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55. *See* Jobin v. Ripley (*In re* M & L Bus. Mach. Co.), 198 B.R. 800, 810 (D. Colo. 1996) ("Under § 548(c), [the transferee] bears the burden of establishing that he received the transfers in good faith.").

56. *See supra* notes 52–53 and accompanying text.

57. *See supra* Section I.A.

58. See *infra* Section III.A for a discussion of the role of the good faith element of section 548(c).

59. Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 487 (D. Conn. 2002). The following cases found that Ponzi payouts are not for value: *Johnson v. Neilson (In re Slatkin)*, 525 F.3d 805, 814 (9th Cir. 2008); *Sender v. Buchanan (In re Hedged-Investments Associates, Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996); *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995); *In re M & L Business Machine Co.*, 198 B.R. at 810; *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 887–88 (D. Utah 1987) (en banc); *Noland v. Morefield (In re National Liquidators, Inc.)*, 232 B.R. 915, 918–19 (Bankr. S.D. Ohio 1998); and *In re Taubman*, 160 B.R. 964, 987 (Bankr. S.D. Ohio 1993). Only three courts, to my

effectively decides the issue of whether a bankruptcy trustee can claw back the earnings of a net winner in a Ponzi scheme under the fraudulent transfer provisions of the Bankruptcy Code. This Section concludes that payouts to Ponzi investors are for value, and thus the trustee normally cannot claw back a Ponzi investor's earnings.

The Code explicitly states that payments on debt are for value. Section 548(d)(2) defines "value" to include "satisfaction or securing of a present or antecedent debt of the debtor."[60] The Code states that "debt" means "liability on a claim."[61] Finally, the Code states that "claim" means 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."[62] Synthesizing these definitions, section 548 internally defines "value" in the context of a fraudulent transfer action to include the reduction of the balance of a right to payment of any kind—in other words, payments on debt.

Further, in an economic sense, payments on debt are for value. The thing of value transferred by the debtor when it makes an interest payment is obvious: money. The issue here, however, is whether the creditor, in return, transfers something of equivalent value to the debtor. Indeed, she does. In exchange for the interest payment, she reduces the debtor's liability to her. In other words, the value that the debtor receives in exchange for the cash she transfers to her creditor is a reduction in the amount she owes that creditor. As one court has keenly noted, the creditor does not merely transfer reasonably equivalent value: she transfers *precisely* equivalent value in the form of a dollar-for-dollar reduction in debt.[63]

It follows, therefore, that payments by a Ponzi debtor to an investor in a fixed-income Ponzi scheme are for value. As defined in Section I.A, a fixed-income Ponzi scheme is one that issues securities promising a fixed rate of return.[64] In other words, an investor in a fixed-income Ponzi scheme enters into a standard debt contract with the Ponzi scheme by purchasing notes, bonds, or other fixed-income securities.[65] Given that payments on debt are for value[66] and payments to fixed-income Ponzi investors are payments on

knowledge, have gone the other way: *In re Carrozzella & Richardson*, 286 B.R. at 492; *Feldman v. Chase Home Finance (In re Image Masters, Inc.)*, 421 B.R. 164, 181 (Bankr. E.D. Pa. 2009); and *Lustig v. Weisz & Associates, Inc. (In re Unified Commercial Capital, Inc.)*, 260 B.R. 343, 353–54 (Bankr. W.D.N.Y. 2001), *aff'd*, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

60. 11 U.S.C. § 548(d)(2)(A) (2006).

61. *Id.* § 101(12) (2006 & Supp. IV 2010).

62. *Id.* § 101(5)(A).

63. *In re Image Masters*, 421 B.R. at 179.

64. *See supra* Section I.A and note 15.

65. "Purchasing a fixed-income security" is a formal way to describe the simple act of loaning money to an entity, and the loan is referred to variably as a "note" or "bond." *See generally* RONALD W. MELICHER & EDGAR A. NORTON, INTRODUCTION TO FINANCE 241–44 (2011).

66. 11 U.S.C. § 548(d)(2)(A).

debt, the plain meaning of the statute dictates that payouts to fixed-income Ponzi investors are for value. A number of lower courts have espoused the foregoing line of reasoning to hold that Ponzi payouts are for value.[67] Other lower courts and the two federal appellate courts that have addressed the issue, however, have found that payments to Ponzi investors are not for value.[68]

The courts reaching this contrary conclusion rely primarily on three legal arguments. The first is that the contracts between the Ponzi scheme and the investors are illegal or contrary to public policy and thus unenforceable.[69] The second is that the transferee's original investment in the Ponzi scheme actually constitutes negative value and thus cannot support a good faith transferee for value defense.[70] Finally, courts argue that the transferee does give value in the amount of her original investment, but any amount paid out in excess of that original investment is also in excess of the value given.[71]

As to the first argument, it is a well-settled principle of general contract law that illegal or immoral contracts are unenforceable.[72] The problem with this line of reasoning is that contracts between Ponzi schemes and their investors are *not* illegal or contrary to public policy. A contract is illegal under three circumstances, none of which apply in the standard Ponzi case. The first is the most obvious: when the terms of the contract are illegal.[73] For

67. *See, e.g.*, Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 492 (D. Conn. 2002); *In re Image Masters*, 421 B.R. at 181; Lustig v. Weisz & Assocs., Inc. (*In re* Unified Commercial Capital, Inc.), 260 B.R. 343, 353–54 (Bankr. W.D.N.Y. 2001), *aff'd*, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

68. Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1286, 1290 (10th Cir. 1996) ("Because she had no claim against HIA Inc. for damages in excess of her original investment, HIA Inc. had no debt to her for those amounts. Therefore, the transfers could not have satisfied an antecedent debt of HIA Inc., which means HIA Inc. received no value in exchange for the transfers."); Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. 1995) ("[The investor] is entitled to his profit only if the payment of that profit to him . . . was offset by an equivalent benefit to the estate. It was not.") (citation omitted). The Ninth Circuit also addressed the general issue of avoidance of Ponzi payouts, finding that the earnings of net winners are avoidable. Johnson v. Neilson (*In re* Slatkin), 525 F.3d 805, 815 (9th Cir. 2008). However, the Ninth Circuit did not address the issue of value because, after finding actual fraud, it failed to consider the section 548(c) defense. *Id.* at 805–20.

69. *E.g.*, *In re* Taubman, 160 B.R. 964, 985–86 (Bankr. S.D. Ohio 1993).

70. *E.g.*, Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 859 (D. Utah 1987) (en banc) ("Judged from any but the subjective viewpoint of the perpetrators of the scheme, the 'value' of using others' money for such a purpose is negative.").

71. *E.g.*, Picard v. Katz, 462 B.R. 447, 451 (S.D.N.Y. 2011), *interlocutory appeal denied*, No. 11 Civ. 3605 (JSR), 2012 WL 127397 (S.D.N.Y. Jan. 17, 2012).

72. *E.g.*, Gibbs & Sterrett Mfg. Co. v. Brucker, 111 U.S. 597, 601 (1884).

73. *E.g.*, *In re* Lehman Bros., 458 B.R. 134, 139 (Bankr. S.D.N.Y. 2011) ("As a general matter, parties are entitled to agree to whatever they choose, as long as the resulting contract is not contrary to law or public policy."); Kalisch v. Maple Trade Fin. Corp. (*In re* Kalisch), 413 B.R. 115, 134 (Bankr. S.D.N.Y. 2008) ("The contract itself was not immoral or illegal, as it did not violate the law by its terms."), *aff'd*, No. 09 Civ. 1636 (PKC), 2009 WL 2900247 (S.D.N.Y. Sept. 9, 2009); Foley v. Speir, 3 N.E. 477, 478 (N.Y. 1885) (finding that, where state

example, murder is illegal in all states. Thus, a contract providing that one party kill another party in exchange for a lump sum would be void for illegality. Likewise, fraud is illegal in all states. Thus, a contract specifying that one party carry out a Ponzi scheme and pay the other a return thereupon would be void for illegality.

The second instance in which a contract is void for illegality is when *both parties* intend that the contract be put to an illegal use. For example, in *Stone v. Young*, a company with no assets took a preferred stock investment and agreed to immediately begin paying dividends.[74] The plan was to build a hotel, but construction had only just begun.[75] The court held that, because both parties knew that this would inevitably result in paying dividends from the capital stock of the corporation, which is illegal under state law, the contract was void for illegality.[76] The fact that one party has illegal plans pertaining to a contract, however, is insufficient to render the contract void for illegality.[77]

The third instance in which a contract is void for illegality is when the terms of the contract necessitate illegal conduct.[78] One could understand this variation of the illegality doctrine as a "constructive intent" version of the second variation. For example, in *Stone*, one could say that, even if the parties did not *actually intend* to pay dividends out of the capital stock of the corporation, they *should have known* that the terms of the contract would necessitate as much because the corporation had no other assets and would not have any other assets until the hotel was built.[79]

Again, none of these variations of the illegality doctrine apply to the typical Ponzi contract. The notes issued pursuant to a Ponzi scheme are simple financial instruments, specifying that the creditor will supply the principal, the debtor will use that principal for some legal investment scheme (e.g., postage stamp arbitrage), and the debtor will repay the principal with interest.[80] There is thus typically nothing illegal about the content of a Ponzi

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law prohibited political candidates from contributing to their own campaign, a contract requiring a political candidate to contribute to his own campaign was void).

74. 204 N.Y.S. 690, 690–91 (Sup. Ct. 1924), *aff'd as modified*, 206 N.Y.S. 95 (App. Div. 1924).

75. *Stone*, 205 N.Y.S. at 690–91.

76. *Id.* at 691–92 ("The company . . . was as much at fault as the defendant. It knew that the provision was repugnant to the policy of the law, and was within the prohibition of the statute.").

77. Grand Valley Water Users' Ass'n v. Zumbrunn, 272 F. 943, 947 (8th Cir. 1921) ("One who has received the benefits of the complete performance by the plaintiff of a contract . . . cannot successfully defend an action for the payment of his indebtedness which has accrued therefrom on the ground that either he or another intended to do some unlawful act . . . .").

78. *In re Kalisch*, 413 B.R. at 134 (distinguishing "cases involving contracts that were found to be illegal either because they violated the law by their own terms, or because they necessitated illegal conduct").

79. *Cf. Stone*, 204 N.Y.S. at 691 (stating that a contract that obviously is going to involve distribution of dividends from capital stock "is contrary to public policy, and is void").

80. *See, e.g.*, Cunningham v. Brown, 265 U.S. 1, 7 (1924).

contract. Further, these contracts do not necessitate illegal conduct. Instead, they normally contemplate some perfectly legal endeavor, like buying and selling securities. Finally, the investor in the Ponzi scheme normally has no intent whatsoever that the contract be used to further illegal ends. Instead, the investor's intent is merely that the debtor carry out the legal plan advertised and pay a healthy return. Thus, the illegality argument falls flat.

Finally, there is the doctrine whereby courts void contracts because they contravene public policy, but this doctrine likewise does not apply in the standard Ponzi context. Courts have long been known to void contracts that, although not strictly illegal, are contrary to public policy.[81] However, this doctrine only applies when contract terms actually contravene public policy,[82] and under no circumstance should it work against an innocent party.[83] Assuming good faith, which is discussed in Part III below, the same conclusion is again reached: the fact that one party plans to take action contrary to public policy is not sufficient to void the contract. Thus, neither the illegality doctrine nor the contravention of public policy doctrine make a typical Ponzi contract unenforceable.

The second legal argument against the conclusion espoused by this Note is that earnings payouts to Ponzi investors are not for value because the investor's money is used to perpetrate fraud against other investors and thus actually constitutes *negative* value.[84] This argument rests on two critical misconceptions. First, the transfer sought to be avoided is not the creditor's initial investment in the Ponzi scheme but rather the earnings the Ponzi scheme paid out to the investor. Thus, the use of the investor's principal has nothing to do with the value the investor transferred to the debtor. Second, the value at issue for the purposes of the section 548(c) defense is not the cash transfer (which goes to the investor from the Ponzi scheme) but instead the reduction in debt that the investor gives the Ponzi scheme. The investor *does* transfer something of value to the Ponzi scheme when she reduces the Ponzi scheme's debt obligation: the scheme now owes her less money.

Third, there is the argument that, although the investor does transfer value to the estate, the value transferred is only the amount of that investor's

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81. *See* Harris v. Runnels, 53 U.S. 79, 86 (1851) ("It is a rule, if effects and consequences shall result from an interpretation of a statute contrary and in opposition to the policy which it discloses, or substantially avoiding the infliction of a penalty upon the transgressor, that such an interpretation must be rejected.").

82. *See In re* Lehman Bros., 458 B.R. 134, 139 (Bankr. S.D.N.Y. 2011). As noted above, the *In re Lehman* court states that the content of a contract is what might make it void on the grounds of law or public policy. *Id.* ("As a general matter, parties are entitled to agree to whatever they choose, as long as the resulting contract is not contrary to law or *public policy*." (emphasis added)). As a matter of logic, there is no reason that the public policy doctrine should be any different in this regard from the illegality doctrine.

83. Bankers Trust Co. v. Litton Sys., Inc., 599 F.2d 488, 492–93 & n.2 (2d Cir. 1979) ("An innocent plaintiff may recover on an illegal agreement which is not declared void by statute. Such innocence exists where the plaintiff is justifiably ignorant of the circumstances causing the illegality." (quoting 14 SAMUEL WILLISTON & WALTER H.E. JAEGER, A TREATISE ON THE LAW OF CONTRACTS § 1631 (3d ed. 1972)) (internal quotation marks omitted)).

84. *See supra* note 70.

original investment in the fund, and thus the amount in excess thereof is avoidable. This argument relies on the language in section 548(c) that limits the affirmative defense "to the extent" of the value transferred by the transferee.[85] But this argument relies on the same misconceptions as the "negative value" argument discussed above. Namely, it focuses on the transferee's initial investment in the fund, rather than the value the investor exchanged for the earnings payout sought to be avoided. Economically, an investor transfers both her principal and the rental value of that principal, known as the time value of money, to the debtor.[86] Legally, the investor transfers the discharge of a contractual obligation in exchange for both her principal and her interest. The fact that this discharge is a source of value is unequivocally supported by the fact that the Bankruptcy Code expressly defines satisfaction of an existing debt as a form of value for the purposes of section 548.[87]

Finally, one commentator argues that courts should refine their conception of value to allow transferees to keep at least some of their profits. In a note for the *Minnesota Law Review*, Karen Nelson argues that courts should allow investors to keep their opportunity costs.[88] She suggests that courts should calculate these opportunity costs by estimating the rate that the investor would have earned on her next best investment.[89] First, given that the Code expressly defines value as the discharge of an antecedent debt,[90] it would be no less a direct abrogation of a congressional command to allow a partial clawback of interest than it would be to allow a full clawback of interest. The transferee need not rely on an economic conception of value because the Code expressly provides that the discharge of debt constitutes value. In any event, it is not clear that, even if one were to calculate an estimate of the economic value transferred to the estate, one would need look any further than the contractual rate of interest on the investor's note. After all, that is the rate the Ponzi scheme's debt instruments actually commanded in the market. Although the arguments that courts should avoid interest pay-

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85. *See, e.g.*, Picard v. Katz, 462 B.R. 447, 453 (S.D.N.Y. 2011) (quoting 11 U.S.C. § 548(c) (2006)), *interlocutory appeal denied*, No. 11 Civ. 3605 (JSR), 2012 WL 127397 (S.D.N.Y. Jan. 17, 2012). *See generally supra* notes 52–54 and accompanying text.

86. For a discussion of the economics of the transaction, see *infra* Part IV.

87. 11 U.S.C. § 548(d)(2)(A).

88. Karen E. Nelson, Note, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1485 (2011).

89. *Id.* at 1487–89. More precisely, Nelson argues that investors should keep the time value of money plus their opportunity costs. *Id.* at 1485. She advocates that courts measure the time value of money using the inflation rate and measure the opportunity costs by the rate that the investor would earn on her next best investment. *Id.* at 1487–89.

This formulation is a bit misguided. The time value of money is not accurately measured by the inflation rate, which is just one component of the base rate of interest. *See* FABOZZI & DRAKE, *supra* note 15, at 163. Regardless, the rate that an investor would earn on an alternative investment already compensates for inflation, *see id.* at 163–64, so that adding the inflation rate to the alternative investment rate would double-count inflation.

90. 11 U.S.C. § 548(d)(2)(A).

outs to Ponzi investors are not convincing, the following Part discusses some plausible limitations on the nonavoidability of Ponzi payouts.

III. Limitations on the Nonavoidability of Ponzi Payouts

This Part addresses two potential limitations on the conclusion espoused in Part II that Ponzi payouts are not avoidable. Section III.A argues that the good faith element of section 548(c) provides a colorable basis upon which to avoid Ponzi payouts. Section III.B argues that equity-type Ponzi scheme payouts, which are not founded upon a contractual right to repayment, are not for value and are thus avoidable by the trustee.

A. *Objectively Excessive Payouts*

Until now, this Note has largely ignored the issue of good faith. Part II concludes that Ponzi payments are normally for value, and thus it follows that a lack of reasonably equivalent value is not a valid basis on which to strike down a section 548(c) defense in the case of the typical Ponzi scheme. However, this Section presents trustees and courts with a plausible escape valve: some Ponzi payouts may be avoided on the basis that they were objectively excessive.

For the purposes of Ponzi transfers, "good faith" means that the transferee was not objectively negligent with regard to the fact that the funds transferred to her were procured by defrauding other investors. The Code does not define the term "good faith."[91] However, it is a well-established principle of fraudulent transfer law that a transferee acts with a lack of good faith when "the facts brought to the attention of [the transferee] were such as to awaken suspicion and lead a man of ordinary prudence to make inquiry, and he fails to make such inquiry."[92] Bankruptcy courts adhere to this general rule that a determination of good faith turns on the objective mental state of the transferee: whether she knew or should have known that the transfer was fraudulent.[93]

In the context of a Ponzi transfer, there are a number of factors that might arguably put a reasonable investor on notice that she was investing in a Ponzi scheme, although these factors are necessarily fact specific. Examples of such factors include the opacity of the entity's operations, the suspicious circumstances of its solicitation of investments, the disconnect between its past operations and the investment scheme it now advertises, and the dubious nature of its alleged investment strategy.[94]

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91. Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 861 (D. Utah 1987) (en banc).

92. Shauer v. Alterton, 151 U.S. 607, 620–21 (1894).

93. *See In re Indep. Clearing House Co.*, 77 B.R. at 862.

94. For example, the overly exclusive nature of the Madoff enterprise and the use of layers of feeder funds might have raised red flags. Jacqueline M. Drew & Michael E. Drew, *The Identification of Ponzi Schemes: Can a Picture Tell a Thousand Frauds?*, 19 Griffith L. Rev. 51, 53–54 (2010) (Austl.). Similarly, the investors in the *Daly v. Deptula (In re*

Broadly speaking, there are two difficulties in finding a lack of good faith using these factors. First, many legitimate investments share some of these characteristics. Hedge funds, for example, are notoriously opaque[95] and offer their investments through special channels.[96] Hedge funds and even mutual funds often advertise exotic investment strategies.[97] The second, related reason is that many Ponzi schemes operate for years, duping hundreds of investors and, of course, duping the authorities. It is difficult to say, then, that the investors objectively acted in bad faith, given that so many other presumably reasonable people were tricked by the scheme. Further, it is probably safe to assume that the average investor, who by definition must be the "reasonable" investor, is neither particularly reasonable nor particularly well versed in the intricacies of finance and, more specifically, the intricacies of financial fraud.

The factor that could most plausibly put an investor on notice is the excessiveness of the payouts. It is also the most plausible basis on which to defeat the affirmative defense provided by section 548(c). In Section I.A, I noted that many Ponzi schemes do not promise or pay particularly outrageous returns.[98] Some, however, do: In *Merrill v. Abbott (In re Independent Clearing House Co.)*, the court described an elaborate Ponzi scheme based in Salt Lake City, Utah, wherein the investors (ominously called "undertakers") were promised 8.40% on their investment *per month*.[99] That works out to an annual percentage rate of 163.24%.[100] In other words, if you invested $100,000 in the scheme and reinvested your monthly earnings, you would be promised a return of $263,240 at the end of the year, more than two and a half times your investment. Although an investment that promises a 163.24% return is not conclusively indicative of bad faith, in conjunction with other factors that might tend to put the investor on notice, like those discussed above, it certainly presents a strong basis on which a court could reject the affirmative defense provided by section 548(c) without coming to the erroneous conclusion that fixed-income Ponzi payouts are not for value.

Carrozzella & Richardson) Ponzi scheme might have wondered why a small law firm was soliciting investments to start a nut business. *See* 286 B.R. 480, 482–84 (D. Conn. 2002).

95. Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 12 & nn.77–79 (2006). *See generally id.* at 3–6 (defining "hedge fund").

96. *See id.* at 3–5.

97. *See id.* at 3 (pertaining to hedge funds); Eleanor Laise, *Mutual Funds Add Exotic Fare to the Mix*, WALL ST. J., Apr. 4, 2007, at D1 (pertaining to mutual funds).

98. *See supra* note 11 and accompanying text.

99. 77 B.R. 843, 848 (D. Utah 1987) ($84 per $1,000 invested).

100. I calculated this figure using the following arithmetic:

Annual percentage rate =

$(1 + \text{Rate of return per period})^{\text{Periods per annum}} - 1 =$

$(1 + 0.084)^{12} - 1 = 1.6324.$

To verify this approach, see FRANK J. FABOZZI, HANDBOOK OF FIXED INCOME SECURITIES 1457 (7th ed. 2005).

B. *The Equity-Type Ponzi Scheme*

This Note has focused on the fixed-income Ponzi scheme, which pays a fixed rate of return in the form of interest. The fixed-income Ponzi scheme is the original form of the Ponzi scheme and still, unfortunately, very common today.[101] However, what is now undoubtedly the most notorious Ponzi scheme in history, the Madoff scheme, was not a fixed-income Ponzi scheme but an equity-type Ponzi scheme.[102] Section III.A above articulates an important limitation on this Note's general conclusion that Ponzi payouts are unavoidable. This Section articulates another: in an equity-type Ponzi scheme, the payouts are avoidable because the payouts are not for value.

The distinguishing characteristic of the equity-type Ponzi scheme is that, instead of issuing fixed-income securities, the entity contracts with the investor to take custody of the investor's funds and invest them on her behalf. As discussed above, the Madoff scheme typifies this structure: "Under standardized written agreements, customers relinquished all investment authority to Madoff."[103] Investors could then withdraw the "earnings" to their account.[104] In this way, the contracts between Madoff and his investors were very different from the debt contracts that a fixed-income Ponzi scheme creates: The fixed-income Ponzi contract involves a simple promise to repay principal and to make interest payments.[105] The equity-type Ponzi contract involves the relinquishment of investment authority to the Ponzi operator and a promise to repay only the earnings that accrue (or that fail to accrue) therefrom. The question, then, is whether the payouts therefrom—we can think of them as dividends—are avoidable under section 548 of the Bankruptcy Code.

As discussed in Section II.A above, the answer to this question turns on whether the payouts are for value. The Code defines value to include satisfaction of a contingent right to payment.[106] This is precisely what the shareholder in an equity-type Ponzi scheme holds: a contingent right to payment. The right is contingent on the fund making money on its investments sufficient to make payouts to its shareholders. But a Ponzi scheme by definition does not realize this contingency. In fact, it loses money and simply misappropriates the money that it pays out. Thus, the contingency that would give rise to the investor's right to payment is not born out.

It follows, therefore, that the net winner in an equity-type Ponzi scheme does not give value for the payouts she receives. In a fixed-income Ponzi scheme, the value the investor gives in exchange for her payouts is a

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101. *See supra* note 23 and accompanying text.

102. *See supra* notes 24–27 and accompanying text.

103. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 128 (Bankr. S.D.N.Y. 2010), *aff'd sub nom. In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011).

104. *Id.* at 132.

105. *See supra* notes 14–18 and accompanying text.

106. *See supra* notes 60–62 and accompanying text.

reduction in the entity's debt to her. In an equity-type Ponzi scheme, there is no debt because the investor does not have a fixed right to repayment of principal and interest. She thus has no value to transfer to the Ponzi scheme in return for her payouts because she has no debt to reduce. Thus, equity-type Ponzi schemes represent an important exception to the rule that Ponzi payouts are not avoidable.[107]

This distinction is a nuanced one, and it is not unassailable. An equity security is arguably less a creature of contract than is a debt security.[108] But does that mean that an equity holder never has a contractual right to repayment? One might argue, for example, that although an equity holder in a corporation does not have a general right to dividends, once the board declares a dividend, the equity holder does have a contractual or some other legal right to demand payment.[109] When the corporation pays a dividend, therefore, the equity holder transfers value to the corporation in exchange for the dividend by discharging a dollar-for-dollar contractual obligation. The problem with this line of reasoning is that the contractual right to a dividend is not valid if the dividend was illegal,[110] and dividends from an insolvent corporation are illegal.[111] Because Ponzi schemes are insolvent, it would seem that the dividends they declare would never give rise to a valid contractual right.

I am not the first to make this equity-type Ponzi scheme argument. In *Merrill*, the trustee argued that "each contract between a defendant and a debtor did not create a debt on the part of the debtor but rather gave the defendant an ownership interest in the debtor's business."[112] Because these ownership interests gave the investors the right only to whatever profits the company made and because the company never made any actual profits, the trustee argued, no value was transferred by the investors in exchange for

107. The inevitable conclusion of this line of reasoning is that all payouts to shareholders in an equity-type Ponzi scheme are avoidable, not just earnings payouts. For a discussion about why full redistribution in this manner would arguably bring about the fairest result, see *infra* note 126 and accompanying paragraph.

108. Broad v. Rockwell Int'l Corp., 642 F.2d 929, 940 (5th Cir. 1981) (en banc).

109. Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1175 (Del. 1988) (finding that shareholders have a contractual right in a validly declared dividend); *see also* Marquette Bank Ill. v. Covey (*In re* Classic Coach Interiors, Inc.), 290 B.R. 631, 636 (Bankr. C.D. Ill. 2002) ("Once declared, but yet unpaid, the dividend constitutes a liability of the corporation.").

110. *See* Buchwald v. Renco Group, Inc. (*In re* Magnesium Corp. of Am.), 399 B.R. 722, 778 (Bankr. S.D.N.Y. 2009) (finding that Delaware corporate law "recognizes an existing right on the part of the corporation, presumably under common law, to recover, from a receiving shareholder, an unlawfully issued dividend"). *But see* Official Comm. of Unsecured Creditors v. Foss (*In re* Felt Mfg. Co.), 371 B.R. 589, 619 (Bankr. D.N.H. 2007) (finding to the contrary under New Hampshire law).

111. The Responsible Pers. of Musicland Holding Corp. v. Best Buy Co. (*In re* Musicland Holding Corp.), 398 B.R. 761, 783 (Bankr. S.D.N.Y. 2008) ("It is well settled that an insolvent Delaware corporation cannot pay a dividend . . . ."); *see also* Sapperstein v. Wilson & Co., 182 A. 18, 20 (Del. Ch. 1935) ("It is a general rule of law, in the absence of [a] statutory provision to the contrary, that the capital of a corporation shall not be impaired by the paying out of dividends to stockholders.").

112. 77 B.R. 843, 857 (D. Utah 1987).

their payouts.[113] The trustee effectively made the equity-type Ponzi scheme argument set forth in this Section. But the trustee's characterization of this particular Ponzi scheme as an equity-type Ponzi scheme was erroneous. The scheme promised a fixed rate of return,[114] and therefore the payments to the investors were supported by transfers of value in the form of dollar-for-dollar reductions in debt.

However, at least one case in which the court found in favor of the trustee can accurately be characterized as an equity-type Ponzi scheme, although the court did not expressly rely on this argument. In *Scholes v. Lehmann*, the company sold partnership shares and "represented to prospective investors that the limited partnerships would trade commodities and yield the limited partners a return of 10 to 20 percent per month on their investment."[115] Thus, as shareholders in the company who were promised only the returns that accrued to their investment, the company's investors were investors in an equity-type Ponzi scheme. In allowing the trustee to claw back the payouts to investors in this scheme, Judge Posner reasoned,

> [The investor] is entitled to his profit only if the payment of that profit to him, which reduced the net assets of the estate now administered by the receiver, was offset by an equivalent benefit to the estate . . . . It was not. A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues.[116]

Thus, Judge Posner tacitly but correctly held that the Ponzi payouts were not for value because the investor was a shareholder, not a debtholder, and thus had nothing of value to transfer to the Ponzi scheme.

Finally, there is the Madoff case. As discussed above, Madoff's scheme was an equity-type Ponzi scheme made to look like an investment company.[117] Unlike the other cases discussed in this Note, the Madoff case is being decided under the Securities Investor Protection Act.[118] The Act applies to most broker-dealers registered with the Securities and Exchange Commission ("SEC"),[119] including the Madoff company.[120] In the event that a

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113. *In re Indep. Clearing House Co.*, 77 B.R. at 857.

114. *Id.* at 848. Note, however, that the payouts promised by this Ponzi scheme were extravagant: $84 per month for every $1,000 invested. *Id.* This works out to a 163.24% annual rate of return. *See supra* note 100. Thus, the trustee would have been better served by relying on the objectively excessive payout argument. *See supra* Section III.A.

115. 56 F.3d 750, 752 (7th Cir. 1995).

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

117. *See supra* notes 24–27 and accompanying text.

118. For the Act, see 15 U.S.C. §§ 78aaa–78*lll* (2006 & Supp. IV 2010). For the case, see *In re Bernard L. Madoff Inv. Sec. Inc.*, 654 F.3d 229, 229 (2d Cir. 2011).

119. The Act creates a corporation called the Securities Investor Protection Corporation, *see* 15 U.S.C. § 78ccc(a)(1), and then requires that most registered broker-dealers be members of that corporation, *see id.* § 78ccc(a)(2)(A); *see also id.* § 78o (setting forth the registration requirements for broker-dealers).

120. *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 126 (Bankr. S.D.N.Y. 2010), *aff'd sub nom. In re* Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229 (2d Cir. 2011).

registered broker-dealer undergoes financial distress, the Act provides liquidation procedures that serve as an overlay on the Bankruptcy Code.[121]

In the case of broker-dealers, a special provision applies to avoidance actions. Section 546(e) of the Bankruptcy Code provides that the trustee may not avoid "settlement payments" made by brokers except under the actual fraud provision of the Code.[122] In late 2011, a district court held that this safe harbor provision protected all payments to Madoff's customers from avoidance or preferential transfer actions except those premised on actual fraud.[123] Analyzing the trustee's actual fraud claims, the court held,

> It is clear that the principal invested by any of Madoff's customers "gave value to the debtor," and therefore may not be recovered by the Trustee absent bad faith. As for transfers made by Madoff Securities to its customers in excess of the customers' principal—that is, the customers' profits—these were in excess of the "extent" to which the customers gave value, and hence, if adequately proven, may be recovered regardless of the customers' good faith.[124]

In reaching this conclusion, the court relied largely on logic that this Note has rejected.

Specifically, the court, like others described in this Note, analyzed the wrong transfer. The transfer at issue is the payout of earnings or profits to the investors in the Ponzi scheme, not the initial investments in the Ponzi scheme. The question is whether the investor transferred anything of value to the estate in exchange for the payout of profits. When the Madoff investors argued that they had transferred something of value in the form of a discharge of an antecedent debt, the court rejected the argument without serious discussion.[125] Instead, the court should have acknowledged that the Bankruptcy Code explicitly designates the discharge of debt as a form of value.[126] Equity holders, however, do not give value in exchange for invalid earnings payouts because they have no contractual right to receive the earnings payouts.

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121. *See* 15 U.S.C. § 78fff. A liquidation proceeding is initiated when the SEC or a self-regulatory organization notifies the Securities Investor Protection Corporation ("SIPC") that a registered broker-dealer is undergoing financial distress. *Id.* § 78eee(a)(1). SIPC then files an application in federal court seeking protection under the Act. *Id.* § 78eee(a)(3)(A). If the court grants this protective decree, *see generally id.* § 78eee(b)(1) (describing the circumstances in which the court shall issue a protective decree), SIPC will appoint a trustee and the case will be remanded to a bankruptcy court, *id.* § 78eee(b)(3)–(4). The bankruptcy court will then apply the Act's liquidation provisions in conjunction with the Bankruptcy Code's. *Id.* § 78fff(b).

122. 11 U.S.C. § 546(e) (2006).

123. Picard v. Katz, 462 B.R. 447, 450 (S.D.N.Y. 2011), *interlocutory appeal denied*, No. 11 Civ. 3605 (JSR), 2012 WL 127397 (S.D.N.Y. Jan. 17, 2012).

124. *Id.*

125. *See id.* at 453–54.

126. *See supra* Section II.B.

IV. Policy: Certainty and Fairness

The preceding analysis is purely legal. The law, as it stands, normally provides an affirmative defense to the recipients of Ponzi transfers. As a matter of policy, this might seem inequitable. The money received by Ponzi investors in excess of their principal was of course procured by defrauding other investors. Therefore, there is a strong instinct that they should return that money to the estate for pro rata distribution among the other investors. As strong as this instinct is, however, the law, across subject areas, has long erred in favor of encouraging finality in transactions by providing a bona fide transferee defense of the type found in section 548(c) of the Bankruptcy Code. The policy motivating this decision applies with full force to the case of the net winner in a Ponzi scheme.

The net winner in a Ponzi scheme is the holder of an asset procured by fraud. The asset is cash. The original owner of that asset is the net loser from whom it was wrongfully taken. The con man is the operator of the Ponzi scheme. When the trustee sues the net winners, she steps into the shoes of the net losers and seeks to compel the return of these fraudulently procured assets. Compare this with the con man scenario set forth in the Introduction. The con man takes the watch from the original owner by defrauding her: he writes her a bad check for the watch in a face-to-face transaction. The con man then sells the watch to the local pawnshop for $1,000 and disappears into the night. The original owner spots her watch in the pawnshop. She sues the pawnshop to compel the pawnshop to return her watch.

The pawnshop owner and the Ponzi investor are in an identical predicament as are the trustee and the watch owner. The misappropriated asset in one case is the watch and in the other is cash. In both cases, the con man is judgment proof: he is without assets and is nowhere to be found. In both cases, we are left with two innocent parties, the watch owner and the pawnshop, the net losers and the net winners. One thing that might seem different is that at least the pawnshop paid $1,000 for the watch. But, economically speaking, the Ponzi investor paid for her asset too. She paid by leasing her capital to the Ponzi scheme. That is how any investor in a financial asset "pays" for her earnings: she allows the counterparty the use of her capital. Although it is harder to see, it is no less real.

If you are still not convinced, consider the following hypothetical. If the pawnshop is not forced to return the watch, the original owner is out $1,000 because she no longer has her watch. If the pawnshop is forced to return the watch to the original owner, the pawnshop is out $1,000 because it gave $1,000 to a con man for a watch that it no longer owns. Likewise, imagine that the net winner in a Ponzi scheme invested $10,000 and received $250 of interest plus the return of her $10,000. This $250 came from the net loser, who invested $10,000 and received only $9,250 back. The other $500—the difference between the $750 the schemer misappropriated and the $250 he gave to the net winner—was pocketed by the Ponzi scheme operator and is gone.

Going forward, a number of things could happen. Trustees normally seek disgorgement of only the net earnings of the net winner—the $250 in this case. Imagine instead, however, that the trustee sought disgorgement of $1,000 from the net winner, so that the net loser would get her principal and her interest back,[127] each of which were misappropriated from her. This scenario would be identical to the action filed by the watch owner. She wants everything back that was wrongfully taken from her. In reality, the trustee will instead attempt to crudely "split the pie" by seeking disgorgement of only the interest earned by the net winner. To truly split the pie, however, the trustee would have to compel disgorgement of $500, which would put both investors at $9,750—each would be out $250 of interest that they could have earned in the bond market and $250 of principal. The same could be done in the watch case: the watch could be sold to a third party for $1,000, and the parties could part ways with $500 each, sharing equally the pain of being robbed. This would, at least on its surface, seem to effect the fairest result. After all, both parties were robbed by the same crook. Seeing now that the Ponzi scheme dilemma is economically identical to the pawnshop scenario, a brief legal analysis of the pawnshop scenario and the justifications for the law therein will inform the policy concerns associated with the Ponzi scheme.

The Uniform Commercial Code ("UCC") would govern our watch scenario, and it would dictate that the pawnshop prevail over the original owner. Article 2 of the UCC, enacted in most states, applies to the sale of goods,[128] which almost certainly includes watches. The UCC states: "A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase the purchaser has such power even though . . . the delivery was procured through fraud punishable as larcenous under the criminal law."[129] This provision applies whether or not the seller is a merchant.[130] A person who takes possession of a good via a fraudulent check or via other criminal fraud has "voidable title" to that good and can therefore transfer good title to a good faith purchaser for value.[131] Thus, in our watch scenario, the pawnshop would be permitted to retain ownership of the watch against the

127. This is of course a simplified two-creditor example that ignores the administrative costs of gathering avoided transfers in the estate and distributing them pro rata to multiple creditors. These costs, however, only strengthen the argument against this type of disgorgement action. *See infra* note 132 and accompanying text.

128. U.C.C. §§ 2–102, 1 U.L.A. 371 (2003); *see also* Auto/Video, Inc. v. Chrysler Motors Corp., No. 97-9160, 1998 WL 391424, at *1 (2d Cir. Apr. 22, 1998).

129. U.C.C. § 2-403(1), 1 U.L.A. 460.

130. 3A LARY LAWRENCE, LAWRENCE ANDERSON'S ON THE UNIFORM COMMERCIAL CODE § 2-403:4 (3d ed. 2009) ("Because U.C.C. § 2-403(1) does not refer to merchant transactions or buyers in ordinary course, the definition of a 'good-faith purchaser for value' does not require purchase from a merchant or a dealer.").

131. *Id.* at § 2-403:50 ("U.C.C. § 2-403(1) specifically provides that the purchaser has the power to pass good title to a good faith purchaser for value although the purchaser's title to the goods was obtained by . . . a dishonored check . . . [or] criminal fraud.").

original owner because the con man had voidable title and the pawnshop took the watch in good faith and for value. Of course, the Uniform Fraudulent Transfer Act and the Bankruptcy Code have similar provisions, which are the subject of this Note. The application of these provisions to Ponzi schemes is a hard question, though hopefully this Note serves to clarify the answer.

The bona fide transferee doctrine is sound as a matter of policy in both scenarios discussed above. The reason is very simple and mundane: the goal of effecting certainty in commercial transactions is deemed more important in these cases than effecting total fairness. A person should be able to purchase a thing for its fair price in what appears to be an honest transaction without fearing disgorgement. This tends to facilitate free exchange. The same can be said of financial instruments: we want to minimize the risk that when you receive interest payments, someone will later seek to claw them back from you. Disgorgement actions also have substantial transaction costs: in addition to normal administrative fees, the bankruptcy trustee takes a statutorily prescribed percentage of all the assets she claws back for the estate, which can be as high as 25 percent.[132]

No remedy is entirely fair. Totally indemnifying the victim—the original owner of the watch and the net loser in the Ponzi scheme—is as unfair to the transferee as allowing the transferee to keep her net earnings is to the victim. One seemingly fair remedy is splitting the losses between the two parties. But splitting the losses between the two parties poses the same problems, only to a lesser extent. Moreover, splitting the losses is not always completely fair: to effect total fairness, the court would have to split the losses between the two parties based on their respective culpability for the loss. Although until this point in the Note I have assumed no culpability on the part of either the victim or the transferee, the parties may have been more or less negligent relative to one another. Total fairness would be achieved by assigning percentages to each party's relative contribution to the loss and apportioning the disgorgement proceeds accordingly. For example, the watch owner might have left her doors unlocked and thus deserve only 40 percent of the value of the watch back rather than 50 percent. The Ponzi investor might have ignored red flags. But this type of haggling would only increase the litigation costs associated with these clawback actions. Further, if the investor's contributory culpability rises to the level of a lack of good faith, the investor's section 548(c) defense will fail.[133]

Finally, the net winner has a substantial reliance interest in the payouts she has received. Imagine an investor who lives on the income from her retirement fund and calibrates her expenses accordingly. At the rate of interest she earned on her Ponzi investment, she was able to make certain expenditures that would be beyond her means if she had not been earning that money. When the trustee attempts to claw back those funds, the net winner

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132. 11 U.S.C. § 326 (2006) (dictating a sliding commission from 25% to 3% as the size of the clawback increases).

133. *Id.* § 548(c). *See generally supra* Section III.A.

comes to find out that she has substantially underinvested in retirement. Thus, although at first blush it might appear otherwise, there is good reason to believe that the treatment of Ponzi payouts dictated by section 548(c) is the correct one.

CONCLUSION

This Note argues that the Bankruptcy Code generally does not allow the trustee to claw back interest payments from Ponzi scheme investors. This is because the Code provides an affirmative defense for transferees who take these payments in good faith and for value. The Code explicitly defines value to include reduction in the balance of an outstanding debt, which is exactly what the Ponzi investor transfers in return for her payouts. There are two plausible limitations on this general rule: The first is for Ponzi investors who, based on the circumstances, should have known that they were investing in a fraudulent scheme, such as when the promised rate of return was so excessive as to be preposterous. The second is for Ponzi investors who, rather than purchasing a debt instrument, took an ownership stake in the Ponzi scheme by purchasing an equity security. These investors had nothing of value to transfer in return for their payouts because they had no debt to discharge. Finally, despite the commonsense notion that the court should not permit the net winners to keep funds that were misappropriated from other investors, a closer analysis reveals that the unfairness runs both ways. Any differential in unfairness in favor of the net losers is likely outweighed by the value of providing investors with the certainty that the interest they earn will not be clawed back after the fact.