

Golden Gate University Law Review

Volume 42

Issue 4 *Symposium: A Cross-Disciplinary Dialogue:
White Collar Fraud, Asset Forfeiture, and Bankruptcy*

Article 7

June 2012

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Recommended Citation

Jessica D. Gabel, Isaac Asher, and Mary Beth Byington, *The Collapse of Financial Fraud: Measuring Bankruptcy Avoidance Action*, 42 Golden Gate U. L. Rev. (2012).
<http://digitalcommons.law.ggu.edu/ggulrev/vol42/iss4/7>

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ARTICLE

THE COLLAPSE OF FINANCIAL FRAUD: MEASURING BANKRUPTCY AVOIDANCE ACTIONS

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I. A DEFINITION OF PONZI SCHEMES

Ponzi schemes lay their foundation on fraud. Once the con is exposed, the culprits are usually stripped of their pilfered millions and sent off to jail. Unfortunately for the victims, the process of recovering any portion of the money they lost in the scam is, to put it mildly, complicated. The challenge rests, in part, in differences between federal forfeiture statutes and Bankruptcy Code principles in determining what assets can be recovered and who is entitled to a portion of the Ponzi pie. What is a Ponzi scheme (as defined by the courts rather than the media)? The Second Circuit defines a Ponzi scheme as a “fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability, thus attracting new investors.”¹ The Ninth Circuit has embraced an arguably broader description: “any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors.”² Other courts add that the scheme did not “conduct

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¹ *Ades-Berg Investors v. Breeden (In re The Bennett Funding Grp., Inc.)*, 439 F.3d 155, 157 n.2 (2d Cir. 2006) (citing BLACK’S LAW DICTIONARY 1198 (8th ed. 2004)).

² *Canning v. Bozek (In re Bullion Reserve of N. Am.)*, 836 F.2d 1214, 1219 (9th Cir. 1988) (emphasis added).

legitimate business as represented to investors.”³ In essence, a Ponzi scheme is a “money in, money out” con game.⁴

After the scheme collapses, as it inevitably does, Ponzi investors fall into two broad categories. The first is the “net losers” – investors who failed to receive a full return, or in many cases any return, on their principal investment,⁵ because their contributions were used to satisfy other investors’ expectations.

The other broad category is “net winners” – “lucky” investors who received redemption payments that exceed the value of their principal investments.⁶ Recoupment of fictitious profits may subject the net winners to disgorgement of those profits and, in some instances, even disgorgement of principal (although this largely applies only to net winners).⁷

Beyond these broad categories, there often are “feeder funds” – various hedge funds, brokerage houses, and banks that steered large pools of investors into the Ponzi scheme.⁸ Relationships with feeder funds enable the Ponzi schemer to sustain the scam over a longer period of time by sweeping in thousands of smaller investors.⁹

These victims may find two areas of law interacting to determine recovery and distribution of the Ponzi scheme assets.

II. PONZI SCHEMES UNDER FORFEITURE LAW AND BANKRUPTCY LAW

There are marked differences between forfeiture law and bankruptcy law, as applied to Ponzi schemes. Forfeiture provisions, found throughout both the federal civil and criminal codes, govern

³ See *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424 (Bankr. S.D. Tex. 1997).

⁴ *In re Int’l Mgmt. Assocs., LLC*, No. A06–62966–PWB, 2009 WL 6506657, at *9 (Bankr. N.D. Ga. Dec. 1, 2009).

⁵ *In re Smith*, 132 B.R. 73, 74 (Bankr. M.D. Fla. 1991).

⁶ *Id.*

⁷ See generally Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157 (1998) (providing a general overview of Ponzi schemes).

⁸ Nick S. Dhesi, *The Conman and The Sheriff: SEC Jurisdiction and the Role of Offshore Financial Centers in Modern Securities Fraud*, 88 TEX. L. REV. 1345, 1366 (2010).

⁹ *Id.* Various groups, including individual investors, state regulators, federal agencies, and bankruptcy trustees, may often target lawsuits and investigations at the feeder funds that invested customers’ cash into Ponzi schemes. Lawrence J. Zweifach & Sophia N. Khan, *Recent Developments in Ponzi Scheme Litigation*, 1844 PLI/Corp 99, 101 (2010). Such actions carry varying degrees of success against financial firms, as most cases turn on the question of what the investment house either knew or *should have known* about the legitimacy of the investment opportunity. *Id.*

seizure and distribution of property in response to wrongdoing.¹⁰ Similarly, the Bankruptcy Code contains statutory guidelines for when and how assets become a part of the bankruptcy estate and how those assets should be distributed. Both areas of law have their benefits, and their shortcomings.

A. FORFEITURE¹¹

“Forfeiture” is defined¹² as the divestiture of property without compensation and the loss of a right, privilege, or property because of a crime, breach of obligation, or neglect of duty.¹³ Forfeiture has three goals: punishment, deterrence, and restitution.¹⁴ In essence, forfeiture both forces a criminal defendant to disgorge ill-gotten profits¹⁵ and assures that the property is not used for illegal means.¹⁶ For some crimes, Congress has not granted any forfeiture authority at all. For others, law enforcement can confiscate only the proceeds of the offense itself,¹⁷ or only the instrumentalities used to commit the offense.¹⁸

Traditional forfeiture law, which serves as the foundation for modern civil forfeiture, dates from ancient times,¹⁹ and makes the *res* the principal focus of the action.²⁰ Civil forfeiture is an *in rem* proceeding

¹⁰ DANIEL J. FETTERMAN & MARK P. GOODMAN, DEFENDING CORPORATIONS AND INDIVIDUALS IN GOVERNMENT INVESTIGATIONS, Ch. §11:3. Governing Statutes (August 2011).

¹¹ There are three basic types of forfeiture: criminal, civil, and administrative. For a more detailed explanation of criminal forfeiture, see Sarah N. Welling & Jane Lyle Hord, *Friction in Reconciling Criminal Forfeiture and Bankruptcy: The Criminal Forfeiture Part*, 42 GOLDEN GATE U. L. REV. 551 (2012).

¹² BLACK’S LAW DICTIONARY 677 (8th ed. 2004).

¹³ *Armstrong v. Keene*, 861 N.E.2d 1198, 1201 (Ind. Ct. App. 2007).

¹⁴ See *infra* Appendix A.I.

¹⁵ *United States v. Hoover-Hankerson*, 511 F.3d 164, 171 (D.C. Cir. 2007).

¹⁶ *State of Kansas I-135/I-70 Drug Task Force v. 1990 Lincoln Town Car, Vin No. 1LNLM82F1LY694880*, 145 P.3d 921, 923 (Kan. Ct. App. 2006).

¹⁷ Proceeds of an offense comprise any property, real or personal, tangible or intangible, that the wrongdoer would not have obtained or retained, but for the crime. Appellate Brief, *United States v. Razmilovic*, Nos. 04-4543-cr(L), 04-5081-cr(CON) (2d Cir. Dec. 20, 2004), 2004 WL 3589671 at *48.

¹⁸ 18 U.S.C.A. § 981(a)(1) (Westlaw 2012).

¹⁹ Asset forfeiture can be traced to Exodus 21:28: “If an ox gore a man or a woman, that they die: then the ox shall surely be stoned, and his flesh shall not be eaten; but the owner of the ox shall be quit.” In the Middle Ages and the law of deodand, it was stated: “[W]here a man killeth another with the sword of John at Stile, the sword shall be forfeit as deodand, and yet no default is on the owner.” *United States v. Bajakajian*, 524 U.S. 321, 330 n.5 (1998) (citing 1 M. Hale, *Pleas of the Crown* 420-424 (1st Am. Ed 1847); 1 W Blackstone, *Commentaries on the Law of England*).

²⁰ *United States v. Twelve Thousand, Three Hundred Ninety Dollars (\$12,390.00)*, 956 F.2d 801, 803 (8th Cir. 1992).

against the seized property itself,²¹ designed primarily to confiscate property used in violation of law, and to require disgorgement of the fruits of illegal conduct.²² The roots of the modern criminal forfeiture system, in comparison, arose out of the RICO statutes and the federal drug laws.²³ Modern criminal forfeiture functions as an *in personam* proceeding against the party who committed the criminal acts.²⁴

Civil and criminal forfeitures are usually accomplished in a four-step process: seizure, notice, forfeiture proceedings, and recovery.²⁵ To seize the asset, the government must show probable cause to believe that the object was used in criminal activity.²⁶ The burden then shifts to the citizen to show that the property should not be subject to forfeiture.²⁷ Once forfeiture is declared, the government's title relates back in time to the commission of the criminal act.²⁸ Nevertheless, the statutory schemes for both civil and criminal forfeiture allow innocent owners²⁹ to challenge a forfeiture action, if they have standing.³⁰ While restitution is

²¹ United States v. Fleet, 498 F.3d 1225, 1231 (11th Cir. 2007).

²² Belk v. Cheshire, 583 S.E.2d 700, 704 (N.C. Ct. App. 2003).

²³ Modern criminal forfeiture is rooted in: 1) the RICO statute, 18 U.S.C.A. § 1962 (Westlaw 2012), which was enacted to combat organized crime; and 2) the federal drug laws, 21 U.S.C.A. § 853 (Westlaw 2012), which mandate forfeiture of any property derived from or involved in a federal narcotics offense.

²⁴ Fleet, 498 F.3d at 1231.

²⁵ See *infra* Appendix A.II.

²⁶ See United States v. One Parcel of Real Estate at 1012 Germantown Rd., Palm Beach County, Fla., 963 F.2d 1496, 1500-01 (11th Cir. 1992) (stating that 19 U.S.C. § 1615 gives the trial court responsibility for determining whether the government has proven probable cause (to prove probable cause, the government must convince the judge that it had a "reasonable ground for belief of guilt, supported by less than prima facie proof, but more than a reasonable suspicion") and then § 1615 shifts the burden to the claimant to prove by a preponderance of the evidence a defense to the forfeiture).

²⁷ *Id.*

²⁸ See 21 U.S.C.A. § 881(h) (Westlaw 2012) (codifying the relation back doctrine); see also *In re Thena, Inc.*, 190 B.R. 407, 411 (D. Or. 1995) (stating that "upon the defendant's conviction . . . the United States' rights in the forfeited property are deemed to relate back to the time the predicate criminal acts were committed. Until conviction . . . the United States' rights in the subject property are not vested even though the forfeiture statute may give the United States pre-conviction or even pre-indictment possessory rights over the property."); United States v. Trotter, 912 F.2d 964, 965-66 (8th Cir. 1990) (stating that the purpose of the provision is to prevent people from trying to avoid forfeiture actions through pre-conviction transfers of property that are not "arms-length"); 18 U.S.C.A. § 1963(c) (Westlaw 2012).

²⁹ See United States v. Reckmeyer, 836 F.2d 200, 207-08 (4th Cir. 1987) (stating that "if a third party can demonstrate that his interest in the forfeited property is exclusive of or superior to the interest of the defendant, the third party's claim renders that portion of the order of forfeiture reaching his interest invalid."). Note that the "innocent owner" doctrine applies to both criminal and civil forfeiture.

³⁰ See United States v. Starcevic, 766 F. Supp. 2d 937, 939-40 (S.D. Iowa 2011) (noting that 21 U.S.C. § 853(n)(2) provides that "any person, other than the defendant, asserting a legal interest

a goal of forfeiture, the United States Attorney General has discretion with respect to using the forfeited funds to compensate victims. This process is called remission or mitigation.³¹ Remission can mimic distribution in bankruptcy, but it lacks the detailed statutory distribution constructs developed under the Bankruptcy Code.³²

B. BANKRUPTCY

As noted above, the Bankruptcy Code establishes a systematic order of distribution of assets in bankruptcy cases. It also establishes a comprehensive scheme for gathering property, including property that may have left the debtor's possession prior to the bankruptcy case, either in legitimate or fraudulent payment of creditors or others. Both of these components serve the bankruptcy law goal of preventing the unjust enrichment of creditors who "run to the court." They serve instead to distribute assets in a fair and equitable way. Tension can arise, however, if anticipated distribution of assets under bankruptcy principles differs from proposed distribution under forfeiture and remission principles, particularly if the identified "victims" of fraud are different than the identified "creditors" in the bankruptcy case, or are given different priority of payment than they would receive in a bankruptcy case.³³

Whether under forfeiture law or bankruptcy law, Ponzi scheme claimants are not generally seeking payment on a mere invoice for a delivery made six months before bankruptcy. Ponzi investors share one common attribute: they are all victims of an elaborate con. But any collective identity ends there. Rather, the claimants in a Ponzi scheme have varying degrees of interests and liabilities. Ultimately, the timing and amounts of withdrawal from the scheme separate the winners from the losers.

in property which has been ordered forfeited to the United States . . . may . . . petition the court for a hearing to adjudicate the validity of his alleged interest in the property," and that "to prevail in a § 853(n) claim, a petitioner must demonstrate by a preponderance of the evidence that the petitioner is either a bona fide purchaser for value or that the petitioner possesses a right, title, or interest in the seized property that is superior to the defendant's right, title, or interest in the property."); *see also Reckmeyer*, 836 F.2d at 208 (stating that "a 'bona fide purchaser for value' must be construed liberally to include all persons who give value to the defendant in an arms'-length transaction with the expectation that they would receive equivalent value in return. If such persons are without knowledge of the potential forfeitability of the defendant's assets, they are entitled to recover under § 853(n)(6)(B).").

³¹ *Id.*

³² 11 U.S.C.A. § 726 (Westlaw 2012).

³³ Kathy Bazoian Phelps, *Handling Claims in Ponzi Scheme Bankruptcy and Receivership Cases*, 42 GOLDEN GATE U. L. REV. 567 (2012).

In *Central Virginia Community College v. Katz*,³⁴ the United States Supreme Court recognized that a core tenet of the Bankruptcy Code is a debtor's privilege to avoid fraudulent and preferential transfers.³⁵ The Bankruptcy Code provides a trustee (or a debtor in possession)³⁶ with these two crucial statutory tools that enable the trustee to claw funds back from creditors (or, investors in Ponzi schemes) who received disbursements prior to the bankruptcy.³⁷ Trustees can seek the return of transfers through either (1) preference claims that allow the trustee to avoid transfers made within 90 days of the bankruptcy filing (Bankruptcy Code section 547), or (2) fraudulent transfer claims that allow the trustee to avoid transfers more than 90 days before bankruptcy filing (Bankruptcy Code section 548).³⁸ Essentially, fraudulent transfers diminish assets of the estate without a corresponding reduction in debt or obligation; preferential transfers, which are the younger form of creditor protection, deplete assets of the estate but also reduce an obligation owing to a creditor.

³⁴ Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356 (2006).

³⁵ *Id.* at 371-72.

³⁶ In bankruptcy cases, the power to recover property for the estate is vested in either the trustee or, in chapter 11 cases, the debtor in possession. In chapter 11 business bankruptcies, the debtor company is referred to the debtor in possession as it attempts to reorganize its debts. 11 U.S.C.A. § 1101(1) (Westlaw 2012). Consequently, the debtor in possession (as represented by counsel) may initiate an avoidance action. The debtor in possession is not omnipotent, however. If the debtor in possession exhibits "fraud, dishonesty, incompetence, or gross management," a trustee may be appointed to replace the debtor in possession. 11 U.S.C.A. § 1104(a)(1) (Westlaw 2012). The trustee then may pursue any avoidance actions that the debtor in possession would have the right to. While most bankruptcy Ponzi schemes are ultimately chapter 7 liquidations because there is no legitimate business to salvage, some do begin in chapter 11. In those cases, an appointment of a trustee is immediate and necessary given the nature of business. Paul W. Bonapfel, John Mills & Todd Neilson, *The Business Bankruptcy Panel: Ponzi Schemes—Bankruptcy Court v. Federal Court Equity Receivership*, 26 EMORY BANKR. DEV. J. 207 (2010). Some practitioners and judges believe that Ponzi schemes should never be chapter 11 cases because there typically is little to nothing to reorganize. *Id.* (comments by Bonapfel, J.).

³⁷ Some Ponzi schemes fall first into a receivership and may remain there or transition into bankruptcy. Appointed receivers can successfully pursue claw backs of fraudulent transfers under state law. The drawback, however, is that receivers do not hold the bevy of powers a bankruptcy trustee does under the Bankruptcy Code. If a statutory or common law receivership of the enterprise is not in the best interests of the creditors or the estate, the receiver could initiate bankruptcy proceedings—such as happened in the *Madoff* and *Petters* cases. See Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. (*In re Bernard L. Madoff*), No. 09-11893 (BRL) (Bankr. S.D.N.Y. June 9, 2009), available at www.madoff.com/document/other/252_order.pdf.

³⁸ See *infra* Appendix B.I.

1. *Preferences: Timing is Everything*

In business situations, many creditors will experience bankruptcy through the preference lens.³⁹ A preference is a payment made on the “eve” of bankruptcy to a creditor in order to extinguish or reduce a pre-existing debt.⁴⁰ The term derives from the legal presumption that, by paying a specific creditor, an insolvent debtor has preferred that creditor to the detriment of the larger pool of creditors⁴¹ because the payee will receive a greater percentage of its claim than it would have under a pro rata general distribution together with the other creditors.⁴² Often, trustees would much rather prosecute preference claims in cases of financial fraud because there is no good faith defense and the transfers fall outside the realm of “ordinary course of business.” Unfortunately, the 90-day window on preferences is a short one, and often more than 90 days pass between the last transfers and the filing of the bankruptcy.⁴³ Preferences are voidable transactions, meaning that the trustee can decide whether to bring an avoidance action and that the creditor can raise a variety of defenses.⁴⁴ Authorizing the trustee to avoid transfers made within a short period before bankruptcy discourages creditors from sprinting to the courthouse to “dismember the debtor during his slide into bankruptcy.”⁴⁵ Preference recovery also levels the playing field among creditors by providing for more equitable distribution of the debtor’s

³⁹ Some companies may also face fraudulent transfer actions, but the average trade creditor for a debtor in bankruptcy usually finds itself on the defending end of a preference action. *See Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 371-72 (2006) (describing such a dynamic).

⁴⁰ *Dean v. Davis*, 242 U.S. 438, 443 (1917) (“Preference implies paying or securing a pre-existing debt of the person preferred” on the eve of bankruptcy); *DuBay v. Williams*, 417 F.2d 1277, 1288 (9th Cir. 1969) (describing a preference as one that is made within four months of bankruptcy, discussing prior law).

⁴¹ *Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228, 232 (9th Cir. 1995) (explaining that one of the underlying policies of a preference action is to prevent “a debtor from benefitting a particular creditor on the eve of bankruptcy”).

⁴² *Union Bank v. Wolas*, 502 U.S. 151, 160 (1991).

⁴³ *See, e.g., Daly v. Simeone (In re Carozzella & Richardson)*, 270 B.R. 325, 329 (Bankr. D. Conn. 2001) (finding that trustee established all elements of a preferential transfer); *see generally Jobin v. Matthews (In re M & L Bus. Mach. Co.)*, 184 B.R. 136, 139 (D. Colo. 1995) (discussing the policies served by preference law).

⁴⁴ *See* 11 U.S.C.A. § 547(c) (Westlaw 2012) (enumerating the defenses to a trustee’s preference action); *see also Harstad v. First Am. Bank*, 39 F.3d 898, 901 (8th Cir. 1994) (“The bankruptcy trustee has the discretionary power to avoid and to recover preferential transfers.”); *Buchwald Capital Advisors, LLC v. Metl-Span I, Ltd. (In re Pameco Corp.)*, 356 B.R. 327, 338 (Bankr. S.D.N.Y. 2006) (“A creditor against whom a preference suit is sought has the burden of proving one of the defenses in § 547(c) by a preponderance of the evidence.”).

⁴⁵ *Id.* at 161 (quoting H.R. REP. NO. 95-595, at 177-78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138) (internal quotation marks omitted).

assets.⁴⁶ Thus, any creditor that received a greater percentage payment than other similarly situated creditors may be required to disgorge that payment so that the whole may share pro rata.⁴⁷

The trustee's burden of proof in preference actions is lower than in fraudulent transfer actions because the Bankruptcy Code rebuttably presumes that any funds, whether principal or profit, paid (or withdrawn) within 90 days before the bankruptcy filing are an improper preference.⁴⁸ If the trustee satisfies the elements of a preference action, the burden shifts to the preferred investor to assert perhaps the only available affirmative defense in a Ponzi scheme: that the transaction occurred in the "ordinary course of business."⁴⁹ Moreover, the trustee may use section 547 to "recover both principal investments as well as fictitious profits earned despite any objective or subjective good-faith defense raised by the investor."⁵⁰ For those reasons, section 547 preference actions are often superior to fraudulent transfer actions.

Section 547 does not grant a good faith defense to the transferee, and the section 550 good faith defense is not available to the initial transferee of a preferential transfer.⁵¹ In Ponzi scheme proceedings to recover preferences, perhaps the only viable defense is that the withdrawal occurred in the "ordinary course of business" under section 547(c). This defense serves two purposes. First, it permits, and even encourages, creditors to engage in normal and customary business dealings with debtors on the brink of bankruptcy.⁵² Second, it discourages and rejects extraordinary debt collection actions or payment terms.⁵³ This preference defense, however, loses its social utility in the

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ 11 U.S.C.A. § 547(b) (Westlaw 2012).

⁴⁹ *See* 11 U.S.C.A. § 547(c)(2) (Westlaw 2012) (providing the elements of the ordinary course of business defense).

⁵⁰ Jerry J. Campos, *Avoiding the Discretionary Function Rule in the Madoff Case*, 55 LOY. L. REV. 587, 600 (2009) (discussing recourse for defrauded investors of Ponzi schemes during bankruptcy proceedings).

⁵¹ *See* 11 U.S.C.A. §§ 547, 550 (Westlaw 2012).

⁵² *See* Union Bank v. Wolas, 502 U.S. 151, 157 (1991) (stating that ordinary course of business defense insulates from preference attack payments made as part of a bank's ordinary course of business).

⁵³ *See* COLLIER ON BANKRUPTCY: CHAPTER 5 BANKRUPTCY CODE, CREDITORS, DEBTORS, AND THE ESTATE § 547.04[2][a] (Matthew Bender Co., Inc. ed., 15th ed. rev. 1996) (noting Congress's intent to discourage unusual action by creditors during a debtor's slide into bankruptcy).

Ponzi scheme context because the very act of paying investors facilitates the fraud rather than a legitimate business.⁵⁴

The creditor must satisfy both prongs of the ordinary course defense. First, the creditor / preference defendant must show that the debt arose in the ordinary course of business (e.g., an arm's length transaction that does not depart from the traditional or historic dealings between the parties).⁵⁵ Second, the creditor must establish that the payments were made in either: (a) the ordinary course of the parties' particular business relationship (a subjective test), or (b) the ordinary course of the business or industry in which the debtor or creditor operate (an objective test).⁵⁶

Under this defense, payments made in the ordinary course of business or financial affairs of the debtor generally escape clawback under section 547. Should this defense be applicable in a Ponzi scheme case where the ordinary course of the debtor's business is fraud?⁵⁷ To prevent net-winning Ponzi investors from using section 547(c)(2) to defeat the trustee's preference actions, some courts have adopted a blanket rule that the ordinary course of business defense is simply unavailable to "any creditor being pursued by a trustee of a Ponzi scheme."⁵⁸

Even though other courts are reluctant to adopt a wholesale ban on the defense, the net-winning investor typically fails regardless because

⁵⁴ See *Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedge-Inv. Assocs., Inc.)*, 48 F.3d 470, 476 (10th Cir. 1995) (holding that payments to investor were not in "ordinary course of business" because they were made in an ongoing Ponzi scheme).

⁵⁵ *Id.*

⁵⁶ 11 U.S.C.A. § 547(c)(2) (Westlaw 2012). The industry norm requires an examination of the relevant industry. The inquiry becomes whether the relevant industry is that of the debtor or creditor if they have merely a vendor/customer relationship. Because the creditor must affirmatively assert the defense, one might argue that the appropriate industry to consider is that of the creditor. Nonetheless, a trustee might challenge this and focus the test on the debtor's industry. Even assuming that the parties agree, proving the relevant industry practices requires expert testimony. See *Finley v. Mr. T's Apparel (In re Wash. Mfg. Co.)*, 144 B.R. 376, 380 (Bankr. M.D. Tenn. 1992) (requiring expert testimony); see also *Morris v. Kan. Drywall Supply Co. (In re Classic Drywall, Inc.)*, 121 B.R. 69, 78-79 (D. Kan. 1990) (finding that testimony of officer of preferred creditor alone was sufficient).

⁵⁷ For consumer cases, "the paragraph uses the phrase 'financial affairs' to include such nonbusiness activities as payment of monthly utility bills." S. REP. No. 95-989, at 88 (1978).

⁵⁸ Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 185 (1998); see also *Henderson v. Buchanan*, 985 F.2d 1021, 1025 (9th Cir. 1993) (stating the Ninth Circuit had previously held Ponzi schemes were not true businesses; thus any transfers related to such schemes cannot be deemed within the "ordinary course of business"); *In re Taubman*, 160 B.R. 964, 991 (Bankr. S.D. Ohio 1993) (internal citation omitted) ("Ponzi schemes are not legitimate businesses which Congress intended to protect by enactment of § 547(c)(2).").

the courts conclude that the “payments made to Ponzi investors cannot satisfy the requirement that payments must be ‘made according to ordinary business terms’ because ordinary businesses, among other things, do not pay fictitious profits.”⁵⁹

While preference law has a litany of other defenses available to the transferee, courts rarely, if ever, permit investors to take advantage of them in Ponzi scheme cases, even when it comes to return of principal.⁶⁰ This tacit policy falls short of a bright-line rule, but the result is consistent and predictable.

In contrast, the facts so fatal to a preference defense—a Ponzi scheme’s fraudulent purpose and lack of legitimate business operations—are not necessarily fatal to fraudulent transfer action defenses. Thus, that body of law remains ripe with uncertainty.

2. *Fraudulent Transfers: Intent*

Asset depletion often takes the form of gratuitous transfers for little or no value on the eve of bankruptcy. Regardless of a Ponzi investor’s status as a victim of the scheme (and any related recovery they might receive as a result of a forfeiture action), bankruptcy trustees routinely use section 548 to recover payments made to the investors and reallocate those recoveries to the larger universe of defrauded investors, which may or may not include those persons who the government considers to be victims.⁶¹

For a fraudulent transfer claim to succeed in recovering assets that left the debtor’s estate prior to bankruptcy, under section 548, a bankruptcy trustee may proceed under a theory of either actual fraud⁶² or constructive fraud.⁶³ The trustee must show either that the transferor’s

⁵⁹ McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. at 185; see also Jobin v. McKay (*In re M & L Bus. Mach. Co.*), 84 F.3d 1330, 1339-40 (10th Cir. 1996) (rejecting a bright-line rule that section 547(c)(2) should never apply in the context of Ponzi schemes, but holding that the payments were not in the ordinary course of business); Inskeep v. Grosso (*In re Fin. Partners, Ltd.*), 116 B.R. 629, 637-38 (Bankr. N.D. Ill. 1989) (holding that Ponzi investors were not protected by ordinary course of business defense).

⁶⁰ See, e.g., *Grosso*, 116 B.R. at 637-38 (holding that Ponzi investors were not protected by ordinary course of business defense).

⁶¹ See, e.g., Floyd v. Dunson (*In re Ramirez Rodriguez*), 209 B.R. 424, 434 (Bankr. S.D. Tex. 1997) (applying section 548 to Ponzi investors).

⁶² See 11 U.S.C.A. § 548(a)(1)(A) (Westlaw 2012) (providing for avoidance of transfer made with actual intent to defraud).

⁶³ See 11 U.S.C.A. § 548(a)(1)(B) (Westlaw 2012) (providing for avoidance of transfer for less than reasonably equivalent value).

actual or imputed intent was to “hinder, delay, or defraud” creditors⁶⁴ or that the transferor was under a certain kind of financial distress when she made the transfer and did not receive reasonably equivalent value for the transfer.⁶⁵ As an equitable objective, the latter recognizes that any significant disparity between the value received and the value surrendered will significantly harm innocent creditors.”⁶⁶ This approach considers the substance rather than the form of the transaction⁶⁷ by recognizing that, even absent conspiratorial intent, paying a net-winner Ponzi investor will impair other investors because the “profit” represented by the payment was either imaginary or simply robbed from Peter to pay Paul.⁶⁸

In practice, the distinction between constructive and actual fraud seems insignificant. Constructive fraud takes more legwork (i.e., discovery) to prove, but the result would seem to be the same in either case: the innocent investor must return funds.⁶⁹

The “actual fraud” theory requires that the trustee prove that the Ponzi operator (i.e., debtor) made the transfers to the investor “[w]ith actual intent to hinder, delay, or defraud” the creditors (i.e. the losing investors).⁷⁰ Unlike the garden variety fraudulent transfer action where proving actual intent can be a time-intensive process, “[t]he mere existence of a Ponzi scheme is sufficient to establish actual intent” to defraud.⁷¹ Ponzi scheme operators often admit, sometimes in a plea

⁶⁴ See, e.g., *Bauman v. Bliese (In re McCarn’s Allstate Fin., Inc.)*, 326 B.R. 843, 848, 852 (Bankr. M.D. Fla. 2005) (finding that trustee successfully established debtor’s intent to defraud under section 548(a)(1)(A)).

⁶⁵ 11 U.S.C.A. §§ 548(a)(1)(B)(i)-(ii)(II) (Westlaw 2012).

⁶⁶ *In re Dayton Title Agency, Inc.*, 292 B.R. 857, 874 (Bankr. S.D. Ohio 2003).

⁶⁷ See, e.g., *Cooper v. Centar Inv. Ltd. (In re TriGem Am. Corp.)*, 431 B.R. 855, 862 (Bankr. C.D. Cal. 2010) (reasoning that it was necessary to look at the entire substance of the transaction in evaluating whether earmarking doctrine applied to fraudulent transfer action).

⁶⁸ In a Ponzi scheme, “[t]he fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.” *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n.1 (9th Cir. 1991).

⁶⁹ See *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 483 n.3 (Bankr. D. Conn. 2002) (discussing the two theories under which a trustee can pursue fraudulent transfers).

⁷⁰ 11 U.S.C.A. § 548(a)(1)(A) (Westlaw 2012).

⁷¹ *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 704 (9th Cir. 2008) (internal quotations and citation omitted).

agreement, the “actual intent” element.⁷² Thus, a Ponzi scheme provides a presumptive element of actual fraud.⁷³

In contrast, the “constructive fraud” theory is a two-part analysis. First, it requires that the trustee demonstrate that the transfer (payment) to the investor occurred for less than “reasonably equivalent value” in exchange for the payment.⁷⁴ Profits that the debtor disburses via collections from later investors cannot amount to a “reasonably equivalent” exchange for the winning investor’s principal investment.⁷⁵ The second part of “constructive fraud” requires that the trustee demonstrate that one of four financial events occurred: (1) the debtor was insolvent on the date of the payment or was rendered insolvent because of it, (2) the debtor was engaged or about to engage in business for which the assets remaining after the payment constituted “unreasonably small capital,” (3) the debtor intended to incur debts beyond its ability to pay them at maturity, or (4) the debtor made the transfer to or for the benefit of an insider under a separate agreement and not in the ordinary course of business.⁷⁶

The insolvency component of constructive fraud⁷⁷ is somewhat straightforward as courts regularly hold Ponzi schemes to be insolvent from inception.⁷⁸ Under this theory, recovery of distributions made to an investor in excess of the investment are generally recoverable.⁷⁹ The constructive fraud theory may nevertheless insulate some or all of the net winner’s principal investment. For payouts less than or equal to the amount of the creditor’s principal investment, courts often conclude that

⁷² See, e.g., *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 433 (Bankr. S.D. Tex. 1997) (“[T]he criminal conviction of [the defendant] based on the debtors’ operation of a Ponzi scheme conclusively establishes fraudulent intent . . .”).

⁷³ See *In re AFI Holding, Inc.*, 525 F.3d at 704 (explaining that a Ponzi scheme by itself is enough to establish transfers were made with actual fraudulent intent).

⁷⁴ *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec., LLC)*, 440 B.R. 243, 261 (Bankr. S.D.N.Y. 2010); *Stone v. Ottawa Plant Food, Inc. (In re Hennings Feed and Crop Care, Inc.)*, 365 B.R. 868, 874 (Bankr. C.D. Ill. 2007).

⁷⁵ See generally 11 U.S.C.A. § 548(a)(1)(B)(i) (Westlaw 2012) (providing for avoidance of transfer for less than reasonably equivalent value).

⁷⁶ 11 U.S.C.A. §§ 548(a)(1)(B)(ii)(I)–(IV) (Westlaw 2012).

⁷⁷ See 11 U.S.C.A. § 548(a)(1)(B)(ii)(I) (requiring that transferor was insolvent at time of transfer or became insolvent as a result).

⁷⁸ See, e.g., *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 650 (Bankr. S.D. Ohio 2006) (“[G]iven the undisputed evidence that Canyon was operating a Ponzi scheme from the time it commenced operations, the Court may find as a matter of law that the Debtor intended to incur debts beyond its ability to repay.”).

⁷⁹ See, e.g., *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 843 (Bankr. S.D.N.Y. 2008) (finding that each transfer of fictitious profits was for less than a reasonably equivalent value in exchange), *aff’d in part, rev’d in part*, 439 B.R. 284 (S.D.N.Y. 2010).

the creditor gave reasonably equivalent value,⁸⁰ such that the trustee may recover only the net profits paid to the investor under the constructive fraud theory, unless the trustee can establish that the investor lacked good faith.⁸¹

Under section 548(c), a transferee may retain a transfer if the transferee (1) takes for value and (2) takes in good faith (typically limited to return of principal). The defendant / transferee must prove both “good faith” and “value.” In *Bayou III*, “value” was not at issue, but the court devoted considerable analysis to section 548(c)’s “good faith” prong.⁸² The court observed that “good faith” is not defined in the Bankruptcy Code or in worthwhile legislative history.⁸³ Instead, the court examined case law to define and apply “good faith.”⁸⁴

According to *Bayou III*, the “good faith” element of section 548(c) is determined by objective inquiry; a transferee’s subjective good faith is irrelevant.⁸⁵ This objective perspective asks what the transferee objectively knew or should have known in deciding whether the transferee accepted a payment in good faith.⁸⁶ Objective good faith does not exist if (i) the surrounding circumstances would place a reasonable person on inquiry notice of the debtor’s fraudulent objective, and (ii) diligent inquiry would have revealed the fraud.⁸⁷ Under this approach, the *Bayou III* court embraces the *Manhattan Fund* test, which “requires either that: (1) the transferee was not on ‘inquiry notice’; or (2) if on notice, the transferee was ‘diligent in its investigation’ of the transferor.”⁸⁸

In determining what constitutes “inquiry notice,” an investor in a Ponzi scheme is presumed to be on inquiry notice if she “knew or should know of information” or a “red flag” placing her “objectively ‘on alert

⁸⁰ *Fisher v. Sellis (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 872 (Bankr. N.D. Ill. 2000) (internal citations omitted) (“[T]o the extent of invested principal, payments from the debtor are deemed to be made in exchange for reasonably equivalent value. . . . Payments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity.”).

⁸¹ For an example of a court adopting this holding, see *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008).

⁸² *In re Bayou Grp., LLC*, 396 B.R. at 844.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* (citing *Bear Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund)*, 397 B.R. 1, 23 (Bankr. S.D.N.Y. 2007)).

⁸⁶ *Id.* at 845 (quoting *Hayes v. Palm Seedlings Partners (In re Agric. Research and Tech. Grp., Inc.)*, 916 F.2d 528, 535-36 (9th Cir. 1990)).

⁸⁷ *Id.*

⁸⁸ *Id.* (citing *In re Manhattan Inv. Fund*, 397 B.R. at 22).

that there was a potential problem with the Fund' such that the transferee 'should have attempted to learn more.'"⁸⁹ The investor transferee need not have actual knowledge of some underlying fraud to be on inquiry notice.⁹⁰

Notwithstanding the purportedly objective nature of the good faith defense, the *Bayou III* court recognized that good faith cannot exist in a vacuum: "[T]o disregard objective evidence of the transferee's subjective good faith intent would fundamentally distort the concept of good faith."⁹¹ The court identified several factors that would negate a finding of good faith for purposes of section 548, which merge elements of inquiry notice and diligence. Those factors include whether: (1) the transferee knew the fraudulent purpose of the transfer; (2) there was underlying fraud; (3) the transferor had an unfavorable financial condition or was insolvent; (4) the nature of the transfer was improper; or (5) the transfer was voidable.⁹² In essence, as a matter of law, the transferee bears the burden of establishing that he or she was not on inquiry notice.⁹³

Despite the societal tendency to label Ponzi scheme investors "victims," courts have been reluctant to construe the inquiry notice prong broadly in a manner that parallels the concept of strict liability in tort law.⁹⁴ Once the inquiry notice prong is satisfied, a transferee's failure to conduct a "diligent investigation" negates the good faith defense. In other words, an investor on inquiry notice must mitigate presumptive notice by performing a thorough investigation.⁹⁵ Simply ignoring the warning signs defeats the good faith defense.⁹⁶

Moreover, the "diligent investigation" prong of section 548(c) cannot be met simply by speaking with the Ponzi operator.⁹⁷ After all, those individuals have a tremendous incentive to obscure truth, and, in some cases, have perfected the art of placating investors. *Bayou III* held that an "inconclusive diligent investigation" that failed to uncover the

⁸⁹ *Id.* at 845 (quoting *In re Manhattan Inv. Fund*, 397 B.R. at 23).

⁹⁰ *Id.*

⁹¹ *Id.* at 849.

⁹² *Id.* at 845-46.

⁹³ *Id.*

⁹⁴ See *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1335-36 (10th Cir. 1996) (holding that the presence of any circumstance placing the transferee on inquiry notice with respect to the financial condition of the transferor may be a contributing factor in depriving the transferee of the good faith defense) (internal citation omitted).

⁹⁵ *In re Bayou Grp., LLC*, 369 B.R. at 846.

⁹⁶ *Id.* at 847.

⁹⁷ *Id.*

fraud will not, on its own, prove good faith.⁹⁸ The investor must demonstrate that the reason he withdrew funds was “not because he had some information that there was some infirmity in the fund, but because of some other reason personal to him and extraneous to the well-being of the fund and its remaining investors.”⁹⁹ In summary, in order to pass the *Bayou III* good faith hurdle, a Ponzi investor would need to show the following two items. First, an investor must establish that she made a diligent inquiry, the results of which signaled the “all clear.” Second, she has to show that the withdrawal was the product of some extraneous purpose wholly unrelated to red flags.¹⁰⁰

As to the second item, *Bayou III* listed specific examples of extraneous circumstances that would tend to demonstrate a good faith purpose for withdrawing funds (which would permit an investor to retain her principal investment while nevertheless returning any fictitious profits):¹⁰¹ (1) a pension plan liquidating its Bayou investment (along with other investments) to comply with ERISA; (2) a trust withdrawing funds for the sole purpose of funding a home purchase; (3) a partnership requesting a redemption as part of a liquidation of assets in advance of a partner’s death; (4) a parent withdrawing funds to cover expenses of a newborn child and private school tuition expenses; (5) Bayou returning an investment and closing an account after an investor’s balance fell below the minimum levels accepted by Bayou; and (6) a fund seeking a partial satisfaction of its Bayou investment to fulfill withdrawal requests from its own investors and to pay a bank loan.¹⁰²

Bayou III’s diligence and objectivity requirements perhaps went farther than other courts in denying the good faith defense.¹⁰³ But *Bayou III* also provided an arbitrary set of exceptions, which seem to drift back toward subjective motivations for withdrawing funds. For example, using withdrawals to fund the purchase of a home or the birth of a child may be laudable, if not sympathetic, reasons. But the court also

⁹⁸ *Id.* at 851.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 850.

¹⁰¹ *Id.*

¹⁰² *Id.* at 853.

¹⁰³ Some courts have, however, strayed in that direction. *See Smith v. Suarez (In re IFS Fin. Corp.)*, 417 B.R. 419, 427 (Bankr. S.D. Tex. 2009) (holding that defendants were not good faith transferees where evidence indicated that they knew or should have known of the illegitimacy of the investments and that board member acted as siblings’ “agent” such that, under agency law, his knowledge of fraud was imputed to the principal); *see also* Memorandum in Opposition to Defendants’ Motion for Partial Summary Judgment at 16, *Wing v. Nathenson*, No. 2:09-cv-109-DB (D. Utah Sept. 4, 2009), 2009 WL 5129177 (arguing that the transferee must undertake a diligent investigation when put on inquiry notice of suspicious circumstances).

permitted a feeder fund to pay off its own bank loan. The court initially defined something arguably close to strict liability in Ponzi scheme redemptions, but then whipsawed, carving out exceptions for a select few types of withdrawals. While the court's gesture was an attempt to soften the hardship of losing money by inserting a scintilla of fairness, it still resulted in disparate treatment. The judgment merely realigned the "haves" and the "have-nots."

Several articles have harshly criticized *Bayou III* for placing restrictions on the good faith defense's applicability in Ponzi schemes.¹⁰⁴ Notably, commentators object to what they perceive as *Bayou III*'s wholesale rejection of "decades of tradition interpreting fraudulent transfer law since its inception in the Statute of Elizabeth"¹⁰⁵ and laying the foundation for eliminating the good faith defense under section 548(c). Critics argue that the *Bayou III* configuration of the good faith defense causes investors to lose the defense if they fail to ask the right questions. But that is perhaps the best result, and one that unifies investors instead of creating factions. Indeed, a healthy dose of Schadenfreude¹⁰⁶ calms the maddening crowd by spreading shared blame and shared pain among all. Nor should the good faith defense be limited because of burden on the courts, which would have to adjudicate the massive amount of claw back actions. The good faith defense's elimination is fortified by the fact that it will achieve equity among all creditors.¹⁰⁷

Regardless, *Bayou III*'s influence on the good faith defense would be short-lived. The jilted investors appealed to the district court, and the result was *Bayou IV*.¹⁰⁸ While the district court affirmed many of the bankruptcy court's holdings, it categorically rejected the good faith analysis.¹⁰⁹ The district court held that, when considering red flags of

¹⁰⁴ For an example of that critique, see Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28-APR AM. BANKR. INST. J. 16 (2009) (critiquing *Bayou III*'s treatment of the good faith defense); see also Kathy L. Yeatter, *Investors Beware: Bankruptcy Court Decision Takes Narrow View of "Good Faith" Under § 548(C)*, 28-Feb. AM. BANKR. INST. J. 38, 49 (2009) (arguing that the facts of *Bayou III* supported the good faith defense).

¹⁰⁵ Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28-APR AM. BANKR. INST. J. at 16.

¹⁰⁶ "Schadenfreude" is where pleasure is derived from the misfortune of others. *Schadenfreude Definition*, OXFORD DICTIONARIES, www.oxforddictionaries.com/definition/schadenfreude?view=uk (last visited May 13, 2012).

¹⁰⁷ Cf. *Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (discussing the Bankruptcy Court's broad equitable powers).

¹⁰⁸ *Christian Bros. High Sch. v. Bayou No Leverage Fund, LLC (In re Bayou Grp., LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).

¹⁰⁹ *Id.* at 316-17.

fraud in connection with the investor's related conduct, courts should evaluate the specific circumstances of each transfer.¹¹⁰ Consequently, *Bayou IV* reformulated the good faith analysis as whether a transferee reasonably should have known of the fraudulent intent underlying the transfer.¹¹¹

Bayou IV also concluded that the objective reasonable investor standard applies to both the inquiry notice and diligent investigation prongs of the good faith defense. The district court determined that the bankruptcy court's analysis of "red flags" that included "some infirmity in Bayou or the integrity of its management," was overly broad and untenable.¹¹² Rather, it is "information suggesting insolvency or a fraudulent purpose in making a transfer that triggers inquiry notice."¹¹³

Furthermore, *Bayou IV* rejected the bankruptcy court's interpretation of the good faith defense's diligent investigation prong.¹¹⁴ The district court concluded that the good faith defense could not be forced into a strict box of requiring the investor to prove that she withdrew funds for a purpose unrelated to any red flags of fraud.¹¹⁵ Insisting on such rigidity, according to the district court, ignores the good faith defense's historical objectivity and would force judges to measure the transferee's subjective motivations and intentions.¹¹⁶ Instead, the district court ruled that if "the transferee can meet its burden of demonstrating that a diligent investigation would not have led to discovery of the fraud, it may prevail on [the diligent investigation prong]," and defeat the specter of inquiry notice.¹¹⁷

Despite the district court's more generous construction of the good faith defense, the defendant-funds still lost when the issue proceeded to

¹¹⁰ *Id.* at 313.

¹¹¹ *Id.* at 311.

¹¹² *Id.* at 314 (quoting *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 848 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010)).

¹¹³ *Id.*

¹¹⁴ *Id.* at 315-17.

¹¹⁵ *Id.* at 317.

¹¹⁶ *Id.*

¹¹⁷ *Id.* There are other defenses available in fraudulent transfer actions aside from the good faith defense embodied in section 548(c), including the *in pari delicto* doctrine, which is the common law notion that "a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim." *Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 64, 78 (S.D.N.Y. 2008) (internal citation omitted). Growing in its success rate, it and any other defenses outside of good faith are beyond the scope of this Article.

trial.¹¹⁸ The jury found that the funds failed to make the required investigation, and the court ordered the funds to return the entire amount paid to them.¹¹⁹

The scope of the good faith defense, however, remains unsettled as the Southern District of New York continues to consider its application in Ponzi schemes. In a case that expands the defense to its widest berth yet, *Picard v. Katz*,¹²⁰ a *Madoff* by-product, the district court staunchly rejected the objective, or inquiry notice, approach, at least in the context of a Securities Investor Protection Act (“SIPA”) trusteeship.¹²¹ The court noted that, in cases involving bankrupt securities firms, bankruptcy law incorporates certain elements of securities law.¹²² Consequently, the court concluded that the “safe harbor” provision of section 546(e) barred the SIPA trustee, Irving Picard, from pursuing *any* claims based upon either preference law or constructive fraud.¹²³

The trustee was left only with the actual fraud claims under section 548(a)(1)(A), which the court then narrowly construed.¹²⁴ With respect to intent, the court held, where a SIPA trustee was involved, the trustee must meet the level of scienter required in a securities fraud case: “proof of more than negligent nonfeasance.”¹²⁵ Focusing on the plain language of the Bankruptcy Code, the court rejected Picard’s argument that applying the safe harbor ran counter to the legislative goals.¹²⁶ The court also concluded that the aims of the legislation would be served because the recovery actions in the *Madoff* case threatened the sort of market upheaval SIPA was designed to avoid.¹²⁷

Addressing the good faith defense, the court reasoned that although securities law will not protect an investor from “willful blindness” to obvious fraud, “[a] securities investor has no inherent duty to inquire

¹¹⁸ Joel Rosenblatt, *Bayou Group Estate Wins \$13 Million from Hedge Funds for Fraud Investors*, BLOOMBERG (May 12, 2011, 9:08 PM), www.bloomberg.com/news/2011-05-13/bayou-group-estate-wins-13-million-from-hedge-funds-for-fraud-investors.html.

¹¹⁹ *Id.*

¹²⁰ *Picard v. Katz*, No. 11 Civ. 3605 (JSR), 2011 WL 4448638, at *1 (S.D.N.Y. Sept. 27, 2011).

¹²¹ *Id.* at *5. When a brokerage firm fails, the Securities Investor Protection Corporation (“SIPC”) transfers the failed brokerage’s accounts to a different securities brokerage firm. If the SIPC is unable to arrange the accounts’ transfer, the failed firm is liquidated. *See* 15 U.S.C.A. §§ 78aaa *et seq.* (Westlaw 2012) (detailing the procedure by which SIPC winds up a failed brokerage). In the *Madoff* case, the liquidation began under SIPA and flowed into the bankruptcy court.

¹²² *Katz*, 2011 WL 4448638, at *2.

¹²³ *Id.*

¹²⁴ *Id.* at *1.

¹²⁵ *Id.* at *5 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 215 (1976)).

¹²⁶ *Id.* at *2–3.

¹²⁷ *Id.* at *3.

about his stockbroker, and SIPA creates no such duty.”¹²⁸ According to the court’s formulation, the good faith defense remains available even if an investor encounters “suspicious circumstances” but fails to investigate further.¹²⁹ Nonetheless, the case ultimately settled with Picard bringing in more than \$160 million in the *Katz* case.¹³⁰

Katz directly conflicted with another Southern District of New York opinion in the *Madoff* case, *Picard v. Merkin*,¹³¹ decided only a month earlier. In *Merkin*, the district court ruled that the complaint—which alleged fraudulent transfers based on both actual and constructive fraud—could survive the defendant’s motion to dismiss. In contrast to Judge Rakoff (in *Katz*), Judge Wood (in *Merkin*) determined that both the Bankruptcy Code and New York state fraudulent transfer law focus squarely on the intent of the debtor-transferor and *not* the intent of the transferee.¹³² The court concluded that the consideration of the section 546(e) safe harbor defense was premature, as the court had not yet crossed that bridge.

Given two wildly different interpretations of the good faith defense within the confines of the same case, the only thing that is clear is the unpredictability and inconsistency of the application of the good faith defense. A litigant attempting to ascertain the legal landscape of the good faith defense in Ponzi schemes would be no worse off if she flipped a coin.

What is clear is that the actual fraud theory may be used to recover the entire amount paid to the investor, whereas constructive fraud may be unable to reach some, or all, of a victim’s principal investment. Where a transfer is avoided as a constructive fraud, the trustee’s recovery is limited to the profits the investor received over and above the principal investment,¹³³ unless the trustee proves that the innocent investor lacked

¹²⁸ *Id.* at *5.

¹²⁹ *Id.* at *6.

¹³⁰ Richard Sandomir & Ken Belson, *Mets’ Owners Agree to Settle Madoff Suit for \$162 Million*, N.Y. TIMES, Mar. 19, 2012, at A1, available at www.nytimes.com/2012/03/20/sports/baseball/mets-owners-pay-162-million-to-settle-madoff-suit.html?pagewanted=all.

¹³¹ *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec., LLC)*, No. 11 MC 0012(KMW), 2011 WL 3897970 (S.D.N.Y. Aug. 31, 2011).

¹³² *Id.* at *8-13. Under New York state law, however, the transferee’s intent (or lack thereof) can be considered an affirmative defense.

¹³³ See *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 483 (D. Conn. 2002) (discussing the trustee’s attempt to recover interest payments under a constructive fraud theory); 11 U.S.C.A. § 548(c) (Westlaw 2012); see also *Kapila v. TD Bank, N.A. (In re Pearlman)*, 440 B.R. 900, 905-06 (Bankr. M.D. Fla. 2010) (stating an affirmative “good faith” defense is available to individuals in actual fraud cases); *Cuthill v. Greenmark, LLC (In re World Vision Entm’t, Inc.)*, 275 B.R. 641, 648 (Bankr. M.D. Fla. 2002) (“All recipients of avoidable transfers from a debtor operating a Ponzi scheme are entitled to raise good faith as a defense.”).

good faith, in which case the trustee may use constructive fraud to recover the investor's principal.¹³⁴ The law of preferences contains no corresponding good faith caveat.¹³⁵

3. Calculating "Value" into the Good Faith Equation of Section 548(c)

The two most recent *Madoff* cases discussed in the preceding section examined the "good faith" prong of section 548(c) without touching upon the "for value" component of the defense, the application of which itself remains unclear in Ponzi cases. This is perhaps due to the fact that "value" is defined in section 548(d). Value was an issue in one Ponzi scheme case where the bankruptcy court considered whether equity-denominated investments (as opposed to the more traditional debt investments) that were repaid qualified as "value" for purposes of the section 548(c) defense. *In re International Management Associates, LLC* ("IMA")¹³⁶ illustrates the different notions and interplay of defenses in fraudulent transfer actions in Ponzi schemes. Given the lack of authority on "for value" in the context of equity investments, *IMA* would later be catapulted to the Eleventh Circuit Court of Appeals by route of the rarely used direct appeal.¹³⁷

Recall that a transferee is entitled to keep the transfer if she can prove that she acted in "good faith" and that she provided the transferor "value" in exchange for the transfer.¹³⁸ To limit its focus to the "value" question, the court assumed that that trustee had established his *prima facie* avoidance case under federal and state law.¹³⁹

By the language of section 548(c), the typical fraudulent transfer defendant can establish an affirmative defense to a trustee's avoidance

¹³⁴ See, e.g., *Donell v. Kowell*, 533 F.3d 762, 771 (9th Cir. 2008) ("Under the constructive fraud theory, the receiver may only recover 'profits' above the initial outlay, unless the receiver can prove a lack of good faith, in which case the receiver may also recover the amounts that could be considered return of principal.").

¹³⁵ See 11 U.S.C.A. § 547 (Westlaw 2012) (allowing recovery of any transfer that provided the transferee with more than he would have recovered otherwise).

¹³⁶ *In re Int'l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6506657 (Bankr. N.D. Ga. Dec. 1, 2009), *aff'd*, 661 F.3d 623 (11th Cir. 2011).

¹³⁷ *In re Int'l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6498191 (Bankr. N.D. Ga. Dec. 1, 2009) (order certifying case for direct appeal to the Eleventh Circuit Court of Appeals).

¹³⁸ 11 U.S.C.A. § 548(c) (Westlaw 2012).

¹³⁹ The relevant facts included: (a) that the investor defendant tendered an essentially worthless equity interest to the debtor in exchange for the transfer; and (b) that the investor defendant held an unasserted claim against the debtor that arose at the time the investor defendant originally invested as an equity holder in the debtor. *In re Int'l Mgmt. Assocs., LLC*, 2009 WL 6506657, at *8-9.

action by showing that it provided “value” in exchange for any transfer received from the debtor. The “value” inquiry exists independently of the question of “good faith.”¹⁴⁰ In Ponzi schemes, however, investor defendants are not typical defendants. The transfer is made on account of the investor defendant’s equity interest, an interest that arguably never had any value (contrasted to a debt investment, where the principal investment does constitute value). Consequently, the availability of the section 548(c) defense is in doubt in Ponzi schemes because any cognizable value disappears to the inescapable bottom of a black hole. The bankruptcy court in *IMA* correctly questioned whether an exchange for value with respect to an equity interest is ever possible in a Ponzi scheme.¹⁴¹ In *IMA*, the court adopted the well-established money-in, money-out principle that a “defrauded Ponzi scheme investor has a claim for the return of its principal investment based on fraud and that the satisfaction of this fraud claim through transfers, at least up to the amount of principal, constitutes ‘value’ for purposes of the defense to a fraudulent transfer claim under Section 548(c) and equivalent state laws.”¹⁴² But the trustee sought an exception to the general rule when the victim’s principal investment is in the form of equity. The trustee argued that, in a Ponzi scheme, a transfer on account of an equity interest cannot be an exchange for value: the distinction between *IMA* and the “run of the mill” Ponzi rests in the equity nature of the fraudulent investments that the debtors offered in their capital contribution structure.¹⁴³

The trustee’s argument has some attractive features, especially its promotion of the equality of distribution. Ponzi victims would be placed in a one-size-fits-all box without regard to the strategic positioning of who got what out and when. The bankruptcy court found the trustee’s foothold persuasive but not authoritative. Ultimately, the court had to decide between equal application (principal Ponzi payments constitute

¹⁴⁰ See *id.* at *8 (stating that an adverse ruling on trustee’s motion for partial summary judgment, seeking a ruling “that, as a matter of law, an investor who made an equity investment in the debtors and received payments did not receive the payments ‘for value,’” did not “fully negate the Trustee’s ability to defeat the [section 548(c)] defense, because the defense also requires that the transfer be in ‘good faith’”).

¹⁴¹ See *id.* at *9 (acknowledging the trustee’s argument that the general rule “that the victim of a Ponzi scheme has a claim for the return of the principal it invested based on fraud and that payments up to the amount of the invested principal are made in exchange for ‘value’” does not apply in situations where the “victim’s investment takes the form of an equity investment,” but concluding “that interpretation of the fraudulent transfer laws has made no distinction based on the form of the investment.”).

¹⁴² *Id.* at *10.

¹⁴³ *Id.* at *9.

value) and equal distribution (Ponzi equity participation and debt receive identical treatment) under the law.¹⁴⁴ The court held that the former rule prevailed, and that the investors received “value” to the extent of the invested principal.¹⁴⁵ Although the court noted the fairness of an alternate rule favoring equal distribution regardless of whether the investments took the form of debt or equity,¹⁴⁶ the court found no authority to support such a rule. Rather, the bankruptcy court in *IMA* followed the lead of the only United States Court of Appeals that had discussed the question.¹⁴⁷

Nevertheless, given the importance of the issue and the glut of Ponzi scheme cases in the United States,¹⁴⁸ the bankruptcy court certified the question for direct appeal to the United States Court of Appeals for the Eleventh Circuit.¹⁴⁹ The bankruptcy court justified the direct appeal by suggesting that numerous judges, trustees, receivers, and parties need guidance and a definitive rule,¹⁵⁰ that current law requires court to fall back on a general default rule established for debt investments to conclude that “investors who held equity interests in the fraudulent scheme from the outset could assert the ‘value’ defense,”¹⁵¹ and that it would be useful for the court of appeals to establish the rules of play for equity interests in Ponzi schemes.¹⁵² Whether the equity holders constitute a special team, the *IMA* court believed that every investor should get equal play time and distributions.

In *IMA*, the parties fundamentally disagreed whether equity interests should be analyzed differently than debt-based claims.¹⁵³ The Eleventh Circuit ultimately affirmed the bankruptcy court’s decision that equity and debt-based claims in Ponzi schemes are on par with one another.¹⁵⁴ Given the specificity of the issue as it pertains to equity claims, the court punted on whether section 548(c) should be available to the universe of

¹⁴⁴ “[T]he Court concludes that no principled basis exists for a different result depending on the technical form of the fraudulent investment.” *Id.* at *10.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at *9.

¹⁴⁷ See *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700, 706-07 (9th Cir. 2008) (discussing “reasonably equivalent value”).

¹⁴⁸ *Id.* at *3.

¹⁴⁹ *In re Int’l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6498191, at *1 (Bankr. N.D. Ga. Dec. 1, 2009).

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *In re Int’l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6506657, at *9-10 (Bankr. N.D. Ga. Dec. 1, 2009), *aff’d*, 661 F.3d 623 (11th Cir. 2011).

¹⁵⁴ *Perkins v. Haines*, 661 F.3d 623 (11th Cir. 2011).

Ponzi scheme investment clawbacks, irrespective of equity or debt status. Given the expanding universe of Ponzi schemes and defrauded investors, the “value” component is as much a recurring issue as good faith.¹⁵⁵ Under *IMA*, substance governs over the transaction’s form to permit Ponzi victims to retain payment of and submit claims for funds up to the amount of the principal investment,¹⁵⁶ such that fraudulent transfer law reallocates losses equally among all Ponzi victims. Notions of equity and fairness may, counter-intuitively, dictate disparate treatment for equity investments. An equally compelling argument is that investors should not be penalized for the manner in which a Ponzi fraudster perpetrated the scheme.

Either way, the general rule—that the repayment of principal constitutes value in exchange for the transfer irrespective of whether the investment was debt or equity—may be running into overtime. Judicial discontent from *Bayou* to *IMA* has generated some congressional conversations about rulemaking in Ponzi cases. Currently, given the number of jurisdictions and the growth in the Ponzi scheme largesse, there is a “potential for inconsistent results, delayed adjudication, and skyrocketing costs.”¹⁵⁷

The demolition of the good faith defense for investors in cash-in, cash-out Ponzi schemes (where “debts were incurred as part of an extraordinary and unlawful enterprise and payments came from other people’s money”)¹⁵⁸ leaves a sour taste in the mouth. Yet, to implement a primary purpose of the Bankruptcy Code (i.e., equality of the distribution), it is a necessary evil that ensures that all creditors—not just the most friendly, necessary, lucky and/or aggressive creditors—recover at least part of their claims.

In determining the good faith of “innocent” investor-victims, the key practical question is often: were the investors expecting a commercially reasonable rate of return, for “equivalent value and good faith,” or were they relying on promises that were, in essence, “too good

¹⁵⁵ See, e.g., Karen E. Nelson, Note, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1480-89 (2011) (arguing that courts should expand the definition of value to account for both the time value and opportunity costs of withdrawals in order to arrive at a more equitable solution for winning investors).

¹⁵⁶ *In re Int’l Mgmt. Assocs., LLC*, 2009 WL 6506657, at *10; see *Pepper v. Litton*, 308 U.S. 295, 305 (1939) (noting that bankruptcy courts “have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done”).

¹⁵⁷ Tally M. Weiner, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 236 (2009) (discussing clawbacks, preferences, and fraudulent transfers in the Madoff Ponzi scheme).

¹⁵⁸ *Id.* at 224.

to be true”¹⁵⁹ In *In re Carrozzella & Richardson*, a Connecticut district court found that guaranteed 15% interest payments were reasonable and treated the payments as favorably as any other trade creditor, like the utility company.¹⁶⁰ An Ohio bankruptcy court, however, found returns of 12% to 24% to be an unreasonable rate of return in the context of a Ponzi scheme.¹⁶¹ This split between the courts perpetuates inconsistency and unpredictability. For some investors, section 548(c) provides a total shield from a clawback action, but for others the defense is more of a brass ring hanging just out of reach.

On another aspect of investor responsibility, analogous to good faith, some courts assign different levels of responsibility depending on the role the investor plays in the overall scheme.¹⁶² Sometimes, courts justify clawbacks in part by viewing typical investors as partially responsible for perpetuating a Ponzi fraud.¹⁶³ Courts raise the bar of responsibility even higher for brokers that feed hungry investors into Ponzi schemes. While brokers may be unknowing co-conspirators, they do earn commissions for placing customers with the fraudulent funds. The commissions they receive from Ponzi funds are subject to avoidance actions, and some courts reject a good faith defense as applied to commissions earned by steering investors to Ponzi funds.¹⁶⁴ In *World Vision*, not only did the court reject the brokers’ good faith defense, but it also deemed their actions of soliciting new investors, which perpetuated the illegal Ponzi scheme, to be fraudulent.¹⁶⁵

As *IMA*, *World Vision*, *Bayou III*, and *Bayou IV* demonstrate, the applicability and even definition of good faith is in flux. Additionally, the iterations of good faith from these cases fail to address the reality that early investors benefit from the misfortunes of subsequent investors. Holding fast to the antediluvian concepts of good faith effectively hardly approaches a solution. The status quo contributes to drawn-out litigation

¹⁵⁹ *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 491 (D. Conn. 2002).

¹⁶⁰ *Id.* at 483-84, 484 n.7, 490-91.

¹⁶¹ *See In re Taubman*, 160 B.R. 964, 972, 985-86 (Bankr. S.D. Ohio 1993) (finding that the investors did not give reasonably equivalent value).

¹⁶² *See, e.g., In re Int’l Mgmt. Assocs., LLC*, No. A06-62966-PWB, 2009 WL 6498191, at *3-4 (Bankr. N.D. Ga. Dec. 1, 2009) (discussing the potential different levels of responsibility of debt and equity investors).

¹⁶³ *E.g., In re Carrozzella & Richardson*, 286 B.R. at 488 (“Further, by helping the debtor perpetuate his illegal scheme, the transfers between the debtor and investors only exacerbated the harm to the debtor’s creditors by increasing the amount of claims, while diminishing the debtor’s estate.”).

¹⁶⁴ *See Cuthill v. Greenmark, LLC (In re World Vision Entm’t, Inc.)*, 275 B.R. 641, 658-61 (Bankr. M.D. Fla. 2002) (rejecting such a defense).

¹⁶⁵ *Id.* at 657.

over the standards, customs, practices, sophistication, and experience generally possessed by the individual investors—and that is just to establish inquiry notice. Once the investor is on inquiry notice, there is still another layer of litigation remaining that considers whether a “diligent investigation” would have discovered the fraudulent purpose of the transfer. The *Bayou* good faith litigation boiled down to a question over the investors’ knowledge or suspicions about “some potential infirmity” that would trigger an investigation into their investment.¹⁶⁶ But questioning what a “reasonably prudent institutional hedge fund investor” would do diminishes an already starved estate. In contrast, eliminating the good faith defense focuses on the real problem of maximizing those assets for the benefit of all investors. The *Madoff* case typifies how the bacteria of good faith can infect even the fundamental chore of calculating loss.

III. CRIMINAL FORFEITURE AND BANKRUPTCY AVOIDANCE ACTIONS

The differences between the Bankruptcy Code and federal forfeiture schemes are most clearly observed when civil or criminal forfeiture actions are initiated against property that is in the debtor’s estate, or when involuntary bankruptcy is filed after the forfeitures have been filed.¹⁶⁷ If the conflicting interests—criminal and bankruptcy—can create an arrangement that effectively segregates property, then the problem would be an easy one. Unfortunately, in many cases, early diplomatic negotiations are the exception and not the rule.

The first problem for the bankruptcy trustee in these cases is one of timing. After the government has seized property, the time limit for the bankruptcy trustee to file avoidance actions will likely run out while the trustee is waiting for his claims to the forfeited property to be heard.¹⁶⁸

The second problem is one of proof. Once assets of the estate are seized in forfeiture, the trustee must try to challenge the forfeiture openly or in an ancillary proceeding. Because the trustee is a bona fide purchaser for value, he will likely be successful in an ancillary

¹⁶⁶ *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Grp., LLC)*, 396 B.R. 810, 848 (Bankr. S.D.N.Y. 2008), *aff’d in part, rev’d in part*, 439 B.R. 284 (S.D.N.Y. 2010).

¹⁶⁷ *United States v. Rothstein*, No. 09-60331-CR, 2010 WL 4064809, at *2-3 (S.D. Fla. Oct. 14, 2010) (noting that the trustee showed the accounts belonged to RRA (not defendant) but that government argues that third party cannot have superior claim to proceeds of fraud).

¹⁶⁸ *See United States v. Frykholm*, 362 F.3d 413, 417 (7th Cir. 2004) (“Those payments could have been reclaimed under the trustee’s avoiding powers and made available to all of the bilked investors.”).

proceeding. But if other parties have an interest in the property, it remains the province of the judge to decide who receives the property; hence, the difficulties the trustee faces in amassing the estate.¹⁶⁹

The trustee's action is structured to stop the "run on the bank" mentality of creditors, and to put them in an orderly line. While the forfeiture statutes do provide a resource for restitution, they do not delineate a broad system for gathering and distributing those assets among the victims.¹⁷⁰ Also, because only small subsets of victims file third party claims against forfeited property, there is high potential for inequitable results.

To further complicate matters, the distinction between civil and criminal forfeiture seems to be not well defined in Ponzi scheme cases. Because of expansion and modification of forfeiture powers under the amendments passed in 2000, and the fact that civil forfeiture need not await conviction, the government typically includes a civil forfeiture allegation in a criminal indictment. In many cases the government will seize property from many persons, commence a civil forfeiture proceeding, file a criminal indictment, name the property in the indictment, and subsequently abandon the civil forfeiture actions.¹⁷¹ The forfeiture procedures found in the RICO statutes, which are often applied in Ponzi scheme cases, also allow for the forfeiture of items obtained with both legal and illegal money.¹⁷²

When the government is the one distributing the seized cash in Ponzi cases, conflicts may arise among "creditors" and "victims." The business used to perpetrate fraud may be quasi-legitimate with real

¹⁶⁹ See generally Appellant Brief, Herbert Stettin, as Chapter 11 Trustee of Rothstein Rosenfeldt Adler, P.A., v. United States, No. 11-10676-B (S.D. Fla. Apr. 5, 2011); see also Appellant Brief, Herbert Stettin, as Chapter 11 Trustee of Rothstein Rosenfeldt Adler, P.A. v. United States, No. 11-10676-B (S.D. Fla. July 27, 2011).

¹⁷⁰ *Fryholm*, 362 F.3d at 417.

¹⁷¹ This was the procedure in the Scott Rothstein case. The government seized personal property as well as assets titled in the name of the law firm. The court placed the burden of proof on the trustee to prove that the funds from the law firm were derived from a legitimate source. This is pending on appeal to the Eleventh Circuit. *United States v. Rothstein*, No. 09-60331-CR, 2010 WL 4064809, (S.D. Fla. Oct. 14, 2010).

¹⁷² See generally 18 U.S.C.A. § 984 (Westlaw 2012) (relieving the government of the burden of tracing such criminal proceeds in certain cases, but only within a short time period). *But see* *United States v. Black*, 526 F. Supp. 2d 870, 889 (N.D. Ill. 2007) (stating that once a defendant has commingled legitimate funds with illegitimate funds in money-laundering such that they cannot be divided without difficulty, the government must satisfy its forfeiture judgment through the substitute asset provision of 21 U.S.C. § 853(p)). This could be bothersome because under 18 U.S.C. § 983(a)(3)(C) the government could seize an asset using civil forfeiture and put it in a criminal indictment and possibly prevent another party from contesting it until the issue has been resolved under 21 U.S.C. § 853(k).

clients and customers whose money was not used illegally, but they are still out cash. Also, every business has to sign contracts for legitimate purposes such as leases, contractors, copiers, the office refrigerator, etc. If the government is the one doling out the cash, these legitimate creditors may not be entitled to file a claim as victims, and may have to hope for leftovers from the bankruptcy trustee when it is all over.

In some recent cases, the judges allowed the trustee to handle the distribution of funds.¹⁷³ Restitution and remission proceedings essentially mimic the bankruptcy proceedings but rest upon different statutory and substantive procedures than bankruptcy distribution. Some judges find greater efficiency in the bankruptcy proceedings. The Eleventh Circuit explained this in *United States v. Shefton*, when it said:

We recognize the government argues that the Fund is not entitled to a constructive trust because the Fund has an adequate remedy at law based on the Attorney General's authority, pursuant to § 853(i)(1), to remit forfeiture "in the interest of justice." However, § 853(i)(1) remission is a non-judicial remedy left entirely to the discretion of the Attorney General. *DSI Assocs. LLC v. United States*, 496 F.3d 175, 186-87 (2d Cir. 2007); *United States v. Lavin*, 942 F.2d 177, 185-86 (3d Cir. 1991). Under Georgia law, equitable remedies, such as constructive trusts, are not precluded by the existence of an alternate remedy that is "not as complete or effectual as the equitable relief." O.C.G.A. § 23-1-4. Given that § 853(i)(1) leaves to the government, which holds the forfeited property, full and unreviewable discretion as to whether it will release some or all of it, § 853(i)(1) remission is certainly not as complete or effectual as the equitable relief of a constructive trust. Thus, we conclude that the Fund has, under these facts, established an entitlement to a constructive trust on the Forfeited Property.

In this case, restitution was better left to state law on constructive trusts rather than forfeiture proceedings. A partnership between the government and bankruptcy trustee must be forged to exploit the strengths of both. The government is good at identifying the fraud, seizing the assets, and bringing the prosecution. One court has implied that bankruptcy proceedings are the more efficient means of dealing with

¹⁷³ People with an interest in the forfeited property will most likely be creditors of the estate; but, it is important to note that people may receive more from the forfeiture proceeding than from the bankruptcy case, either through retaining the property or through restitution proceedings, hence their incentive to challenge bankruptcy distribution.

the estate,¹⁷⁴ but these cases are not one-size-fits all, and it remains that forfeiture may be the better course in some cases while bankruptcy gains the advantage in another.

CONCLUSION

Forfeiture statutes are helpful for collecting assets in Ponzi schemes. Once fraud enters the picture, the government has the long arm of the law on its side and it can, almost immediately, begin to seize assets related to the Ponzi scheme. But bankruptcy avoidance actions can also marshal and distribute property of the estate. Both sets of rules can in many instances create a fair division between all creditors and victims. The two sides may never agree on who should win, but at least there is recognition between the two camps that more can be done to reconcile the approach of two very different systems in the same case.

¹⁷⁴ *Frykholm*, 362 F.3d at 417 (“Neither side paid much attention to the effect of the fraudulent conveyance, likely because both sides are represented by forfeiture specialists and have focused on the language of § 853 and opinions interpreting that statute. Everything would have been clearer had the United States initiated an involuntary bankruptcy proceeding against Frykholm [the Fraudster]. That not only would have brought to the fore § 548 of the Bankruptcy Code but also would have provided a *superior* way to marshal [the fraudster’s] remaining assets and distribute them to her creditors. Although § 853(n)(1) allows the Attorney General to use forfeited assets for restitution, it *does not* create a comprehensive means of collecting and distributing assets. Bankruptcy would have made it pellucid that Cotswold [the creditor] cannot enjoy any priority over the other victims and cannot reap a profit while [the fraudster’s] other creditors go begging. Moreover, bankruptcy would have enabled the trustee to recoup the sums distributed to the first generation of investors Those payments could have been reclaimed under the trustee’s avoiding powers and made available to all of the bilked investors. It is too late to pursue the profits . . . , but it is not too late to prevent the preferential distribution of any further assets to favored investors.” (emphasis added)).

APPENDIX AI. RESTORATION AND GRANTING OF REMISSION AND MITIGATION¹

(3)

(xi) Restoration of proceeds from sale

(A) A petition for restoration of the proceeds from the sale of forfeited property, or for the appraised value of forfeited property when the forfeited property has been retained by or delivered to a government agency for official use, may be submitted by an owner or lienholder in cases in which the petitioner:

(1) Did not know of the seizure prior to the entry of a declaration of forfeiture; and

(2) Could not reasonably have known of the seizure prior to the entry of a declaration of forfeiture.

(B) Such a petition shall be submitted pursuant to paragraphs (j)(3)(ii) through (v) of this section within ninety (90) days from the date the property is sold or otherwise disposed of.

(4) Petitions in judicial forfeiture cases—

(i) **Procedure for filing petition.** If the forfeiture proceedings are judicial, a petition for remission or mitigation of a judicial forfeiture shall be addressed to the Attorney General; shall be sworn to by the petitioner or by the petitioner's attorney upon information and belief, supported by the client's sworn notice of representation pursuant to 28 U.S.C. 1746; and shall be submitted to the United States Attorney for the district in which the judicial forfeiture proceedings are brought. A petitioner also shall submit a copy of the petition to the Chief Postal Inspector if the Postal Inspection Service was the seizing agency.

(ii) **Ruling.** Department of Justice regulations on petitions for remission or mitigation in judicial forfeiture cases are stated in 29 CFR § 9.4.

¹ 39 C.F.R. §§ 233.7(j)(3)(xi), (4), (5) (Westlaw 2012).

(5) Criteria governing administrative remission and mitigation—

(i) Remission.

(A) The Ruling Official shall not grant remission of a forfeiture unless the petitioner establishes that:

(1) The petitioner has a valid, good faith and legally cognizable interest in the seized property as owner or lienholder as defined in these regulations; and

(2) The petitioner is innocent within the meaning of the innocent owner provisions of the applicable civil forfeiture statute, is a bona fide purchaser for value without cause to believe that the property was subject to forfeiture at the time of the purchase, or is one who held a legally cognizable interest in the seized property at the time of the violation underlying the forfeiture superior to that of the defendant within the meaning of the applicable criminal forfeiture statute, and is thereby entitled to recover his or her interest in the forfeited property by statute. (If the applicable civil forfeiture statute contains no innocent owner defense, the innocent owner provisions applicable to 21 U.S.C. 881(a)(4) shall apply.) Unless otherwise provided by statute, in the case of petitioners who acquired their interest in the property after the time of the violation underlying the forfeiture, the question of whether the petitioner had knowledge of the violation shall be determined as of the point in time when the interest in the property was acquired.

(B) The knowledge and responsibilities of petitioner's representative, agent, or employee in paragraph (j)(5)(i)(A)(2) of this section are imputed to the petitioner where the representative, agent, or employee was acting in the course of his or her employment and in furtherance of the petitioner's business.

(C) The petitioner has the burden of establishing the basis for granting a petition for remission or mitigation of forfeited property, a restoration of proceeds of sale or appraised value of forfeited property, or a reconsideration of a denial of such a petition. Failure to provide information or documents and to submit to interviews, as requested, may result in a denial of the petition.

(D) The Ruling Official shall presume a valid forfeiture and shall not consider whether the evidence is sufficient to support the forfeiture.

(E) Willful, materially false statements or information, made or furnished by the petitioner in support of a petition for remission or mitigation of forfeited property, the restoration of proceeds or appraised value of forfeited property, or the reconsideration of a denial of any such petition, shall be grounds for denial of such petition and possible prosecution for the filing of false statements.

(ii) Mitigation.

(A) The Ruling Official may grant mitigation to a party not involved in the commission of the offense underlying forfeiture:

(1) Where the petitioner has not met the minimum conditions for remission, but the Ruling Official finds that some relief should be granted to avoid extreme hardship and that return of the property combined with imposition of monetary and/or other conditions of mitigation in lieu of a complete forfeiture will promote the interest of justice and will not diminish the deterrent effect of the law. Extenuating circumstances justifying such a finding include those circumstances that reduce the responsibility of the petitioner for knowledge of the illegal activity, knowledge of the criminal record of a user of the property, or failure to take reasonable steps to prevent the illegal use or acquisition by another for some reason, such as a reasonable fear of reprisal; or

(2) Where the minimum standards for remission have been satisfied but the overall circumstances are such that, in the opinion of the Ruling Official, complete relief is not warranted.

(B) The Ruling Official may in his or her discretion grant mitigation to a party involved in the commission of the offense underlying the forfeiture where certain mitigating factors exist, including, but not limited to: The lack of a prior record or evidence of similar criminal conduct; if the violation does not include drug distribution, manufacturing,

or importation, the fact that the violator has taken steps, such as drug treatment, to prevent further criminal conduct; the fact that the violation was minimal and was not part of a larger criminal scheme; the fact that the violator has cooperated with federal, state, or local investigations relating to the criminal conduct underlying the forfeiture; or the fact that complete forfeiture of an asset is not necessary to achieve the legitimate purposes of forfeiture.

(C) Mitigation may take the form of a monetary condition or the imposition of other conditions relating to the continued use of the property, and the return of the property, in addition to the imposition of any other costs that would be chargeable as a condition to remission. This monetary condition is considered as an item of cost payable by the petitioner, and shall be deposited into the Postal Service Fund as an amount realized from forfeiture in accordance with the applicable statute. If the petitioner fails to accept the Ruling Official's mitigation decision or any of its conditions, or fails to pay the monetary amount within twenty (20) days of the receipt of the decision, the property shall be sold, and the monetary amount imposed and other costs chargeable as a condition to mitigation shall be subtracted from the proceeds of the sale before transmitting the remainder to the petitioner.

II. FORFEITURE PROCESS

(A) The steps of forfeiture are:

- (1) Seizure²
- (2) Notice³
- (3) Forfeiture Proceeding⁴
- (4) Recovery⁵

² See 18 U.S.C.A. § 981 (b)(2)(A) (Westlaw 2012).

³ See also 39 C.F.R. § 233.7 (Westlaw 2012).

⁴ See Criminal and Civil forfeiture proceedings *supra*.

⁵ See *Infra* Appendix A.III.

III. ANCILLARY PROCEEDINGS⁶

(c) Ancillary Proceeding; Entering a Final Order of Forfeiture

(1) **In General.** If, as prescribed by statute, a third party files a petition asserting an interest in the property to be forfeited, the court must conduct an ancillary proceeding, but no ancillary proceeding is required to the extent that the forfeiture consists of a money judgment.

(A) In the ancillary proceeding, the court may, on motion, dismiss the petition for lack of standing, for failure to state a claim, or for any other lawful reason. For purposes of the motion, the facts set forth in the petition are assumed to be true.

(B) After disposing of any motion filed under Rule 32.2(c)(1)(A) and before conducting a hearing on the petition, the court may permit the parties to conduct discovery in accordance with the Federal Rules of Civil Procedure if the court determines that discovery is necessary or desirable to resolve factual issues. When discovery ends, a party may move for summary judgment under Federal Rule of Civil Procedure 56.

(2) **Entering a Final Order.** When the ancillary proceeding ends, the court must enter a final order of forfeiture by amending the preliminary order as necessary to account for any third-party rights. If no third party files a timely petition, the preliminary order becomes the final order of forfeiture if the court finds that the defendant (or any combination of defendants convicted in the case) had an interest in the property that is forfeitable under the applicable statute. The defendant may not object to the entry of the final order on the ground that the property belongs, in whole

⁶ FED. R. CRIM. P. 32.2(c). The Advisory Committee Note to Rule 32.2. states that as soon as practicable after a verdict or finding of guilty “the court must determine what property is subject to forfeiture under the applicable statute.” This is known as the preliminary order of forfeiture. The preliminary order of forfeiture is a prerequisite to the commencement of the ancillary hearings where the third party rights are adjudicated. The preliminary order of forfeiture becomes a final order if no party brings a successful ancillary challenge. The purpose of the ancillary proceeding is to prevent “the inadvertent forfeiture of property in which the defendant had no interest.” See *United States v. Marion*, 562 F.3d 1330, 1338 (11th Cir. 2009), *cert. denied*, 130 S. Ct. 347 (2009) (citing a statement in *United States v. Elmes*, 532 F.3d 1138, 1144 n.7 (11th Cir. 2008) that “[a]lthough not binding, the interpretations in the Advisory Committee Notes are nearly universally accorded great weight in interpreting federal rules.”).

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or in part, to a codefendant or third party; nor may a third party object to the final order on the ground that the third party had an interest in the property.

APPENDIX BI. FRAUDULENT TRANSFERS AND OBLIGATIONS⁷

(a)

(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(A) made such transfer or incurred 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; or

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii)(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;

(ii)(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

(ii)(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.

⁷ 11 U.S.C.A. § 548 (Westlaw 2012).

(2) A transfer of a charitable contribution to a qualified religious or charitable entity or organization shall not be considered to be a transfer covered under paragraph (1)(B) in any case in which—

(A) the amount of that contribution does not exceed 15 percent of the gross annual Income of the debtor for the year in which the transfer of the contribution is made; or

(B) the contribution made by a debtor exceeded the percentage amount of gross annual income specified in subparagraph (A), if the transfer was consistent with the practices of the debtor in making charitable contributions.

(b) The trustee of a partnership debtor may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

(c) 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.

(d)

(1) For the purposes of this section, a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer is made immediately before the date of the filing of the petition.

(2) In this section—

(A) “value” means 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;

(B) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency that receives a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, takes for value to the extent of such payment;

(C) a repo participant or financial participant that receives a margin payment, as defined in section 741 or 761 of this title, or settlement payment, as defined in section 741 of this title, in connection with a repurchase agreement, takes for value to the extent of such payment;

(D) a swap participant or financial participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer; and

(E) a master netting agreement participant that receives a transfer in connection with a master netting agreement or any individual contract covered thereby takes for value to the extent of such transfer, except that, with respect to a transfer under any individual contract covered thereby, to the extent that such master netting agreement participant otherwise did not take (or is otherwise not deemed to have taken) such transfer for value.

(3) In this section, the term “charitable contribution” means a charitable contribution, as that term is defined in section 170(c) of the Internal Revenue Code of 1986, if that contribution—

(A) is made by a natural person; and

(B) consists of—

(i) a financial instrument (as that term is defined in section 731(c)(2)(C) of the Internal Revenue Code of 1986); or

(ii) cash.

(4) In this section, the term “qualified religious or charitable entity or organization” means—

(A) an entity described in section 170(c)(1) of the Internal Revenue Code of 1986; or

(B) an entity or organization described in section 170(c)(2) of the Internal Revenue Code of 1986.

(e)

(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(D) the debtor made such transfer 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, indebted.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by—

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78l, 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. § 77f).