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Victimized Again: The Use of an Availability Presumption and the Objective Standard of Good Faith to Deprive Ponzi Victims of Their Defenses

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COMMENT

VICTIMIZED AGAIN: THE USE OF AN AVOIDABILITY PRESUMPTION AND THE OBJECTIVE STANDARD FOR GOOD FAITH TO DEPRIVE PONZI VICTIMS OF THEIR DEFENSES

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I. INTRODUCTION

Robert Kowell and his mother Edna were looking for a way to invest their money.[1] Robert learned that an American company, J.T. Wallenbrock & Associates, was offering an opportunity to invest in accounts receivable.[2] The company explained that Malaysian latex glove manufacturers regularly had to wait eighty to ninety days to be paid on shipped goods.[3] Wallenbrock purchased "these manufacturers' accounts receivables at a significant discount, providing the glove manufacturers with immediate access to working capital. Wallenbrock investors, in turn, would enjoy a 20 percent return when Wallenbrock collected the receivables from glove purchasers in due time."[4] The Kowells invested roughly $23,000 with the company and received the payments as promised.[5] The Kowells' investment eventually earned about $50,000, and, satisfied with their earnings, the Kowells redeemed the principal and terminated the investment.[6] The Kowells had received payments just as the company had represented, and nothing about the transactions suggested to Robert and Edna that the opportunity was not a legitimate investment.[7]

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† *Symposium Editor*, LIBERTY UNIVERSITY LAW REVIEW, Volume 8. J.D. Candidate, Liberty University School of Law (2014); B.A., Education, The Evergreen State College (1991). My sincere thanks to attorney Bertrand A. Zalinsky, who encouraged my research in this area and patiently listened to my ideas. The purpose of this Comment is to provide solid legal arguments for victims of Ponzi schemes who are drawn into an adversarial proceeding by a bankruptcy trustee intent on clawing back through the fraudulent transfer provisions what little the victims received from the debtor.

1. Donell v. Kowell, 533 F.3d 762, 766 (9th Cir. 2008).
2. *Id.* at 767.
3. *Id.*
4. *Id.*
5. *Id.* at 773.
6. *Id.*
7. *Id.* at 766.

The Kowells were shocked, therefore, to receive a letter years later[8] from Wallenbrock's receiver[9] informing them that Wallenbrock "had been declared a Ponzi scheme."[10] The receiver, citing no legal authority, demanded that they repay nearly $70,000 in "profits" from the scheme.[11] The receiver urged the Kowells to "take advantage of this one-time offer to settle with the Receivership estate for 90% of the profit you received" by executing a settlement agreement and enclosing a check.[12] Robert Kowell expressed disbelief that Wallenbrock was a fraudulent company and questioned how he could be liable to other investors when he didn't know it was a fraudulent scheme.[13] He questioned how he could have received "profits" if his investment was "$.00."[14] Further, Robert confessed that "the money received in payments had been spent long ago" and that payment to the receiver of nearly $70,000 would force him to declare bankruptcy.[15] By return letter, the receiver threatened:

> If you refuse to work out a settlement agreement with us, we will sue you and that will be your only option. It is not what we want for either you or your mother, however .... If you hire an attorney, you may certainly file a motion to bar the Receiver from collecting money from those that profited. Both the Receiver and the SEC would file objections and it would probably take about $20,000.00 in legal fees for you to file such a motion.[16]

Robert, outraged and incredulous, refused to sign the settlement; the receiver filed an adversarial complaint in federal district court.[17] Four years

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8. The record is not clear as to when the Kowells terminated their relationship with Wallenbrock. The investigation by the SEC began in 2002 and the Kowells received the letter from the receiver two years after that. *Id.* at 768.

9. The company was placed in receivership when the Securities and Exchange Commission began investigating the company. *Id.*

10. *Id.*

11. *Id.* The letter claimed the Kowells had invested "$.00" dollars in principal and therefore demanded return of $69,546.70 in profits. *Id.* The letter calculated the settlement to be 90% of that figure—$62,592.03. *Id.*

12. *Id.*

13. *Id.*

14. *Id.* Kowell had paid federal income tax on the "profits" he had received. *Id.* at 773.

15. *Id.* at 768.

16. *Id.* (ellipsis in the original).

17. *Id.* at 768–769.

later, the Ninth Circuit Court of Appeals affirmed the district court's grant of summary judgment against Robert and Edna. The court ordered them to pay $26,396 in profits and then granted the receiver's request for an additional $5,159 levied against the Kowells for pre-judgment interest.[18]

One might be tempted to condemn Ponzi scheme victims as being "greedy dopes" who gambled on an investment that was too good to be true.[19] But many modern Ponzi schemes are sophisticated and are perpetrated by well-known professionals. The Madoff scheme, which accrued an estimated $50 billion in investor losses, ranks as the largest Ponzi scheme to date.[20] Madoff Securities was a registered and insured securities brokerage firm, and Bernard Madoff had a reputation earned in a legitimate business.[21] Until the Madoff scheme imploded, the Petters scheme was the largest.[22] Thomas Petters ran a decade-long scheme that accrued losses to investors of $3.8 billion. Petters used some of the Ponzi funds to acquire legitimate companies, including Polaroid Corporation.[23] The Bayou scheme involved investment funds serving both individuals and financially sophisticated institutional investors.[24] Bayou's annual financial statements contained certification from a certified public accounting firm, attesting to the accuracy of the information.[25] Unfortunately, the accounting firm was fictitious.[26] The Bayou funds collapsed in 2005, after a nine-year run,[27] and the bankruptcy trustee "brought 131 separate adversary

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18. *Id.* at 766. Although the record does not state the attorney fees expended by the Kowells, one can realistically expect that four years of litigation and appeal to the Ninth Circuit Court exceeded all of the "profits" the Kowells made on their investment.

19. Richard Posner, *Bernard Madoff and Ponzi Schemes—Posner's Comment*, BECKER-POSNER BLOG, (December 21, 2008), http://www.becker-posner-blog.com/2008/12/bernard-madoff-and-ponzi-schemes--posners-comment.html. (characterizing Ponzi scheme victims as "greedy dopes" conned by "ludicrous pitches" and "the least sophisticated, or those most blinded by greed").

20. Clarence L. Pozza, Jr. et al., *A Review of Recent Investor Issues in the* Madoff, Stanford *and* Forte *Ponzi Scheme Cases*, 10 J. BUS. & SEC. L. 113, 115 (2010).

21. Posner, *supra* note 19.

22. Mychal A. Bruggeman, Polaroid *Expands Ponzi Presumption*, 31-JUL AM. BANKR. INST. J. 22, 22 (2012).

23. *Id.*

24. *In re* Bayou Grp., LLC, 439 B.R. 284, 291 (S.D.N.Y. 2010).

25. *Id.*

26. *Id.*

27. *Id.*

proceedings" against investor victims.[28] The Bennett scheme investors, including a number of banks, never dreamed they were investing in a Ponzi scheme because the conservative rate of return was well below the legal maximum.[29] The Bennett bankruptcy trustee sued 10,000 individual investor victims.[30] Attorney Scott Rothstein perpetrated a scheme selling fictitious legal settlements to investors, who eventually lost $1.2 billion when the fraud collapsed.[31] Allen Stanford scammed $8 billion from investors through the sale of certificates of deposit by Stanford International Bank.[32]

Recent Ponzi schemes have victimized even prudent and experienced investors.[33] Many investors face significant financial loss—only to discover that they are being sued by the bankruptcy trustee.[34] In any bankruptcy, by definition, the debtor's assets will not cover the debtor's liabilities, and some creditors will not get what the debtor contractually promised. In a Ponzi scheme, there may be hundreds or thousands of innocent investor creditors, who may have lost their life savings and may be facing bankruptcy themselves as a result of the fraud. In the face of widespread financial catastrophe, courts have two options. They can either adhere to the well-established legal doctrine of fraudulent transfer and "allow the losses to rest where they fell,"[35] or they can create new judicial rules to deal with Ponzi schemes—rules that seem more "equitable." Many courts have chosen the second approach.

The Bankruptcy Code gives to bankruptcy trustees two tools to enlarge the pool of funds from which to pay creditors by avoiding, or undoing, certain transfers between the perpetrator of the scheme and the investor transferee. Under the preference provision,[36] the bankruptcy trustee may

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28. Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28-APR AM. BANKR. INST. J. 16, 78 (2009).

29. David F. Kurzawa II, *When Fair Consideration Is Not Fair*, 11 CORNELL J.L. & PUB. POL'Y 461, 463 (2002). The rate of return was 8–12%, well below the maximum rate of 16% allowed by banking law. *Id.*

30. *Id.*

31. Louis R. Davis & Linus Wilson, *Good Timing? How One Bank Cut Its Link to A $1.2 Billion Ponzi Scheme*, 18-OCT J. LEGAL ECON., 1, 2 (2011).

32. Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis*, 72 TEX. B.J. 922, 924 (2009).

33. Pozza, *supra* note 20, at 114.

34. *Id.* at 120.

35. Donell v. Kowell, 533 F.3d 762, 776 (9th Cir. 2008).

36. *See* 11 U.S.C. § 547 (2006); *see also infra* Part II.B.3 (discussing the scope of § 547).

avoid all transfers made to creditors so that the court may redistribute those funds to other creditors. Preference avoidance seeks equality of distribution but is limited to transfers made within ninety days of bankruptcy.[37] Under the fraudulent transfer provision,[38] the bankruptcy trustee may avoid transfers where the transferee gained a windfall at the expense of the debtor and, therefore, the creditors.[39] It is critical to note that the issue of avoidance does not address the question of whether an investor who lost money in a Ponzi scheme is entitled to recover her money from the debtor. Rather, avoidance seeks to claw back[40] from the investor those funds she *already received* from the debtor. Part II of this Comment traces the evolution of fraudulent transfer doctrine and highlights Supreme Court precedent interpreting the preference and fraudulent transfer provisions.

In recent years, courts have rejected the application of traditional fraudulent transfer doctrine to Ponzi schemes. Most courts now *presume* that all transfers in a Ponzi scheme are avoidable under the fraudulent transfer provision.[41] Application of this avoidability presumption gives the bankruptcy trustee complete power to claw back from innocent victims money they previously received from the debtor. This presumption destroys an innocent investor victim's first line of defense—the ability to argue that the transfer is not avoidable. Where courts apply the avoidability presumption, an investor victim's only hope is the "good faith defense." Most courts, however, now apply an objective standard, rather than the traditional subjective standard to good faith.[42] The objective standard effectively destroys an investor victim's second line of defense—the chance

37. *See* § 547; *see also In re* Carrozzella & Richardson, 270 B.R. 92, 99 (Bankr. D. Conn. 2001) *aff'd*, 286 B.R. 480 (D. Conn. 2002) (distinguishing between distributional equality as the goal of preference statutes and distributional enhancement as the goal of fraudulent transfer statutes).

38. *See* 11 U.S.C. § 548 (2006); *see also infra* Part II.B.3 (discussing the scope of § 548).

39. *See* § 548; *Carrozella*, 270 B.R. at 99 (noting that the goal of fraudulent transfer avoidance is distributional enhancement of the estate).

40. The term "claw back" refers to the trustee's power to avoid transfer and "claw back" that property into the estate. *See* NORTON BANKR. L. & PRAC. 3d DICT. OF BANKR. TERMS § C55.

41. *See, e.g., In re* IFS Fin. Corp., 417 B.R. 419, 439 (Bankr. S.D. Tex. 2009) *subsequently aff'd*, 669 F.3d 255 (5th Cir. 2012) ("The Fifth Circuit and other circuits have repeatedly held that the existence of a fraudulent scheme itself is sufficient to find that a transfer made in furtherance of that scheme was made with fraudulent intent.").

42. *See In re* Teleservices Grp., Inc., 444 B.R. 767, 773 (Bankr. W.D. Mich. 2011) (noting that "[r]ecent case law strongly favors an objective approach to assessing a transferee's good faith" but nevertheless rejecting the objective standard).

to prove lack of culpability. Part III of this Comment analyzes the insufficient legal basis for adopting the avoidability presumption and the objective standard of good faith. Additionally, Part III analyzes some of the inequitable results of courts' adoption of these doctrines. Part IV suggests a simple process to correctly apply fraudulent transfer doctrine to Ponzi schemes.

II. BACKGROUND

Fraudulent transfer doctrine, including the principle that a transferee acting in good faith should be immune from avoidance, became well-established in our nation's bankruptcy jurisprudence through decades of analysis by courts and commentators. Part A *infra* traces the establishment of a uniform bankruptcy code, noting the emergence of a codified fraudulent transfer provision. Part B *infra* discusses the nature of fraudulent transfers through analysis of United States Supreme Court opinions and scholarly authority. Part B concludes with an analysis of the current Bankruptcy Code provisions covering avoidance of transfers. Part C *infra* traces the relatively recent spread of new interpretations of fraudulent transfer doctrine that are at odds with prior well-established principles.

A. *National Bankruptcy Laws*

The drafters of the Constitution viewed bankruptcy primarily as a business and interstate commerce issue. During discussion of the Full Faith and Credit Clause,[43] a delegate from South Carolina suggested that Congress be given the power to establish uniform bankruptcy laws.[44] A few days later, the Bankruptcy Clause was adopted with virtually no debate,[45] and two weeks after that, the proposed Constitution was signed and sent to

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43. U.S. CONST. art. IV, §1.

44. 1 WILLIAM L. NORTON, JR., NORTON BANKR. L. & PRAC. 3D § 1:3 (2013). The delegate, Charles Pinkney, recommended the following language: "To establish uniform laws upon the subject of bankruptcies and respecting the damages arising on the protest of foreign bills of exchange." *Id.* Another South Carolinian, John Rutledge, recommended that the clause be placed immediately after the Naturalization Clause in Article I, Section 8, Clause 4. *Id.*

45. *Id.* The bankruptcy clause was approved on September 3. *Id.* The delegate from Connecticut alone voted against the bankruptcy clause; he feared the power granted would allow Congress to legislate the death penalty for bankruptcy, as some early English law had done. *Id.* The final version of the clause states, "To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST., art. I, § 8, cl. 4.

the states for ratification.[46] The Bankruptcy Clause vests in Congress the power "to establish ... uniform laws on the subject of bankruptcies throughout the United States."[47]

1. Constitutional Purpose of the Bankruptcy Clause

The drafters of the Constitution intended the federal government to be one of enumerated powers only; therefore, each power granted to Congress is designed for a specific purpose. The purpose of many Article I, Section 8 powers, including the Bankruptcy Clause, is to remove from the states and grant to Congress those powers which benefit commerce.[48] The drafters of the Constitution understood that the issue of bankruptcy is an integral part of interstate commerce.[49] For example, James Madison supported the Bankruptcy Clause because uniform laws would protect creditors and facilitate the smooth flow of interstate commerce.[50]

The Founders did not seek to ensure justice in any particular case of bankruptcy or for individuals *per se*.[51] Rather, their goal was to establish a uniform system of bankruptcy that would "give security to all contracts, stability to credit, uniformity among the States in those things which materially concern the foreign commerce of the country, and [the States'] own credit."[52] Although the Bankruptcy Clause grants Congress the power to enact "uniform Laws on the subject of Bankruptcies,"[53] the Constitution goes even further. The Constitution specifically prohibits states from

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46. U.S. CONST. art. VII. The Constitution was signed on September 17. *Id.*

47. Hanover Nat. Bank v. Moyses, 186 U.S. 181, 183 (1902) (quoting U.S. CONST, art. I, § 8, cl. 4).

48. F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 90 (William S. Hein & Co. ed. 2003) (1919) ("The obvious purpose of the architects of the *Constitution* in [Article I, section 8] was to confer complete control on the Congress of any power which contributes to the benefit of commerce in general."). The drafters' goal was a unified national economy. *Id.*

49. NORTON, *supra* note 44, § 1:3.

50. Ry. Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 465–66 (1982) ("As James Madison observed, '[T]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question.'").

51. NOEL, *supra* note 48, at 92.

52. *Id.*

53. U.S. CONST. art. I, § 8, cl. 4 ("To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States").

impairing the obligation of contracts.[54] Since bankruptcy involves the discharge of debt, which necessarily impairs the obligation of contracts, states are prohibited from enacting bankruptcy law.[55] Both the Bankruptcy and Obligation of Contracts clauses preserve the integrity of contracts and thereby help to create a stable and uniform national economy.[56]

2. Bankruptcy Acts from Ratification to 1898

In spite of persistent calls to fulfill the congressional mandate to "establish . . . uniform laws," Congress took more than a decade to create the first national bankruptcy act.[57] Even in the early attempts, the issue of innocent transferees surfaced. For example, the proposed House of Representatives version of the Bankruptcy Act of 1798 included a section addressing fraudulent transfers and the rights of transferees.[58] The Senate rejected the provision and the final bill did not include it.[59] When President

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54. U.S. CONST. art. I, § 10, cl. 1. ("No State shall . . . coin money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.").

55. *See* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935) ("Under the bankruptcy power Congress may discharge the debtor's personal obligation, because, unlike the states, it is not prohibited from impairing the obligations of contracts.").

56. NOEL, *supra* note 48, at 92.

57. *Id.* at 124.

58. *Id.* at 128. The tenth section of the bill stated, "In case a bankrupt sold any of his property, the assignees are empowered to demand back such property, on payment of the purchase money." *Id.* This would essentially be rescission of the transfer by the bankruptcy estate. The proposed act required that the transferee receive back the payment given even though the English bankruptcy system, on which the bill was based, considered any transfer of property by the debtor in the six months prior to bankruptcy as presumed collusion. *Id.* The English system valued uniformity and was willing to occasionally sacrifice justice for individuals for the "greater good." *Id.* The American proposal, however, required the bankruptcy estate to repurchase the property at a "fair price." *Id.* at 129. Another proposed amendment to the 1798 bill would have allowed a transferee to additionally petition the court to recover the entire amount expended for any improvements or accretions on the land, in addition to the purchase price. *Id.*

59. *Id.* A proposed Senate amendment provided "[t]hat in case of a *bona fide* purchase, made before the issuing of the commission from or under such bankrupt, for a valuable consideration, by any person *having no knowledge, information, or notice*, of any act of bankruptcy committed, *such purchase shall not be invalidated, or impeached.*" *Id.* (emphasis added). A subjective standard (actual knowledge, information, or notice) would have applied to the transferee of a bona fide (good faith) purchase. This amendment was also excluded from the final bill. *Id.*

Adams signed the bill into law in 1800, it had a five-year term,[60] but Congress repealed it after only three years.[61]

For almost forty years, the United States had no national bankruptcy laws.[62] During that time period, bankruptcy was handled by the states, which often passed statutes that dealt more leniently with debtors than had the previous federal statutes.[63] Although a bankruptcy act was barely passed in 1841, it was repealed a mere eighteen months later.[64]

During the Civil War era, southern states threatened the stability of interstate commerce by cancelling debts owed by their state citizens to northern creditors.[65] Realizing once again the need for a national bankruptcy law, Congress passed one in 1867, which was signed by President Johnson.[66] This comprehensive act featured fifty sections organized under headings, one of which was "Preferences and Fraudulent Conveyances Declared Void."[67] The Act was amended six times and finally repealed altogether in 1878.[68] Twenty years later, a comprehensive

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60. *Id.* at 130.

61. NORTON, *supra* note 44, § 1:5. One reason for the repeal may have been the dramatic shift in power from the Federalists under Presidents Washington and Adams to the Anti-Federalists under President Jefferson.

62. *Id.*

63. *Id.* Because of the prohibition against impairing the obligation of contracts (*see supra* note 54 and accompanying text), states could not discharge a debtor's debts without the consent of the creditors. The states could, however, eliminate remedies available to creditors under insolvency laws. For an analysis of the interplay between bankruptcy laws and insolvency laws, see generally Adams v. Storey, 1 F. Cas. 141, 142–49 (C.C.D.N.Y. 1817).

64. NOEL, *supra* note 48, at 138. The vote was 26 to 23 in the Senate and 110 to106 in the House of Representatives. *Id.* at 138 n.13. The 1841 act allowed, for the first time, debtors to initiate voluntary bankruptcy and opened bankruptcy to debtors of all occupations, not just merchants. NORTON, *supra* note 44, § 1:5. The Act maintained the provision that a majority of creditors could block discharge of the debtor's debts. *Id.*

65. NOEL, *supra* note 48, at 145–47. The tension increased as assets in the south were destroyed by the war, leaving little collateral for debts. By 1863, the liabilities on southern debt exceeded the asset values of the collateral by over $750 billion. *Id.* at 147. The loss in value caused bankruptcy for both debtors in the south and creditors in the north. *Id.*

66. *Id.* at 153.

67. NORTON, *supra* note 44, § 1:6. Although the consent of a majority of creditors was required for discharge, a creditor could not veto discharge if he received a statutorily set minimum payment. Debtors could initiate the proceedings and receive a direct discharge of debt. *Id.*

68. *Id.*

bankruptcy code, which is the basis for the modern code, was approved.[69] Unlike its predecessors, the Bankruptcy Act of 1898 directly addressed the issue of innocent transferees. The Bankruptcy Act contained a provision allowing avoidance of transfers made "with the intent and purpose on [the debtor's] part to hinder, delay, or defraud his creditors" except from "purchasers in good faith and for a present fair consideration."[70]

Before the Bankruptcy Act was enacted, state law governed fraudulent transfers. State courts relied on the English common law, especially the statutes of Elizabeth, which were incorporated as specific legislation or through reception statutes.[71] England promulgated the statutes of Elizabeth to combat the problem of fraudulent transfers that defrauded creditors and purchasers.[72] Significantly, under both the statutes of Elizabeth and American application of the statutes, a transfer was not voidable if the transferee paid fair value without knowledge of the fraud.[73] Even after the Bankruptcy Act was passed in 1898, courts, including the United States Supreme Court, continued to refer to the statutes of Elizabeth.[74]

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69. *Id.* at § 1:7.

70. *In re* Teleservices Grp., Inc., 444 B.R. 767, 804 (Bankr. W.D. Mich. 2011) (quoting Bankruptcy Act of 1898, § 67e).

71. *See, e.g.*, Bennett v. Ellison, 23 Minn. 242, 247 (1876) ("The validity of this assignment must be tried by the laws of the state- *i. e.*, by the common law as affirmed by the statutes of Elizabeth-since there is no statute of the state relating to transfers of personal property made with intent to hinder, delay, or defraud creditors."); Tubb v. Williams, 26 Tenn. 367, 371 (1846) ("The statutes of Elizabeth, and our act of 1801, enable the creditor to subject the specific property, fraudulently conveyed while in the hands of the fraudulent donee or vendee, to the satisfaction of his claim, but they do not enable him to claim the proceeds of such property.").

72. Clayborn v. Hill, 1 Va. 177, 183 (1793) ("This inconvenience produced the Statutes of *Elizabeth* respecting fraudulent conveyances. The preamble recites the mischief which resulted from the possession remaining in one person, whilst the property was transferred to another, whereby creditors, and purchasers, were defrauded; and the Judges stretched as far as they well could, to carry this Statute into full effect."). The "mischief" cited here, that of debtors "selling" property but remaining in possession, matches the first paradigm of fraudulent transfer under an analysis of modern statutes, which is discussed *infra* at Part II.B.4.c.

73. Grumbles v. Sneed, 22 Tex. 565, 577 (1858) (noting "the settled American doctrine" that "a *bona fide* purchaser, for a valuable consideration, is protected under the statutes of 13 and 27 Elizabeth, as adopted in this country, whether he purchases from a fraudulent grantor, or a fraudulent grantee").

74. See, for example, Coder v. Arts, 213 U.S. 223 (1909), where the Court observed that the phrase "hinder, delay, or defraud creditors" "was used at the common law, and in the

Twenty years after the Bankruptcy Act was passed, the Uniform Fraudulent Conveyance Act (UFCA) was proposed to abrogate common law provisions and create uniformity between the Bankruptcy Act and the fraudulent transfer statutes in the various states.[75] UFCA's purpose was to provide a uniform treatment of fraudulent transfers under non-bankruptcy state statutes in order to facilitate interstate commerce.[76] Fraudulent transfer avoidance under the common law required a creditor to prove that the transfer was made with actual intent on the part of the debtor to "hinder, delay, or defraud" creditors.[77] Because subjective intent is often difficult to prove, state courts developed circumstantial indicators, called badges of fraud, by which they could infer actual intent.[78] The UFCA attempted to unify the disparate badges of fraud and to make them more objective.[79]

The Chandler Act, passed by Congress in 1938, "modernized" the Bankruptcy Act.[80] The actual fraud component stayed almost the same, merely substituting a "bona fide" purchaser paying "present fair equivalent value" for "purchasers in good faith and for a present fair consideration."[81] More importantly, the Chandler Act added "constructive fraud as an alternative means for avoiding transfers under that section."[82] Under the actual fraud provision, the consideration paid was an indicator of good faith, and the test for good faith was "the extent to which [the transferee] was implicated in the debtor's plan, first to get the money and then to put it

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statute of Elizabeth" and held that Congress intended the phase as used in the Bankruptcy Act to have its common law meaning. *Id.* at 242. *Coder* is discussed *infra* at Part II.B.1.a.

75. Fraudulent Transfer Act Summary, UNIFORM LAW COMMISSION: THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, http://uniformlaws.org/ActSummary.aspx?title=Fraudulent%20Transfer%20Act (last visited Dec. 21, 2012). The UFCA especially sought to abrogate statute 13 Elizabeth, which dealt with fraudulent transfers. *Id.*

76. Paul Sinclair, *supra* note 28, at 16.

77. *See, e.g.*, Bennett v. Ellison, 23 Minn. 242, 247 (1876) ("The validity of this assignment must be tried by the laws of the state- *i. e.*, by the common law as affirmed by the statutes of Elizabeth-since there is no statute of the state relating to transfers of personal property made with intent to hinder, delay, or defraud creditors.").

78. Sinclair, *supra* note 28, at 16.

79. *Id.* at 16. The UFCA's badges of fraud became the basis of the modern fraudulent transfer statute. *Id. See also infra* note 187 (quoting § 548).

80. NORTON, *supra* note 44, § 1:7.

81. *In re* Teleservices Grp., Inc., 444 B.R. 767, 804 (Bankr. W.D. Mich. 2011).

82. *Id.*

beyond the reach of creditors."[83] The constructive fraud provision followed the UFCA in providing "badges of fraud" as objective markers of fraudulent intent rather than leaving courts to infer intent from varied circumstances.[84] So long as the transfer was for equivalent value, the debtor's estate was not diminished and the transfer could not be avoided, regardless of the motives of the debtor or the transferee.[85] Under the constructive fraud provision a transfer could be avoided, however, if the objective badges of fraud were present—namely if the debtor was insolvent and the transferee gave less than equivalent value—regardless of the innocence of the parties.[86] Therefore, Congress also added a new defense for innocent transferees who gave less than equivalent value.[87] Instead of using the term "good faith," however, Congress provided the defense for transferees who acted without "actual fraudulent intent."[88] Just as Congress changed other words to close equivalents in its modernization of the Act,[89] Congress likely viewed "without actual fraudulent intent" as a synonym for "good faith."

During the seventy-year period following the enactment of the Bankruptcy Act, major social, economic, and technological changes occurred in the nation. Transportation changed from horse and buggy to jet airplanes.[90] The economy changed from an agrarian one to a predominantly industrial one.[91] Two significant changes signaled the critical need for bankruptcy reform. First, consumer credit became a significant force in the economy.[92] Second, the Uniform Commercial Code began to create a uniform business environment that required a uniform bankruptcy process.[93]

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83. 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 259 (William S. Hein & Co, Inc. ed. 2001) (1940). The deviation in some modern courts from this subjective definition of good faith is discussed *infra* at Part III.C.

84. Sinclair, *supra* note 28, at 77.

85. GLENN, *supra* note 83, § 300. *See* Part II.B.2.

86. *Teleservices Grp.*, 444 B.R. at 805–806.

87. *Id.*

88. *Id.* The significance of these changes is discussed *infra* at Part III.C.2.a.

89. For example, Congress substituted "bona fide" for "good faith" and "present fair equivalent value" for "present fair consideration." *Id.* at 804.

90. NORTON, *supra* note 44, § 2:1

91. *Id.*

92. *Id.* During a twenty-year period from 1950 to 1970, the number of bankruptcies increased by 1000%. *Id.* §2:2.

93. *Id.* § 2:1. The drafters of the Constitution included the Bankruptcy Clause so that Congress could facilitate the free flow of interstate commerce. *See supra* Part II.A.1.

Congress responded by passing the Bankruptcy Reform Act in 1978, which became known as the Bankruptcy Code.[94] The Code as amended[95] is the current national bankruptcy law. The current fraudulent transfer statute is codified as 11 U.S.C. § 548.[96] The UFCA was also revised, creating the Uniform Fraudulent Transfer Act (UFTA).[97]

B. *Well-Established Principles of Fraudulent Transfer Doctrine*

From the enactment of the Bankruptcy Act in 1898 to its abrogation by the Bankruptcy Code in 1978, the principles of fraudulent transfer remained fairly constant. Early cases and commentators laid the foundation upon which modern analysis is built.

1. United States Supreme Court Opinions

a. *Coder v. Arts*

Preferences and fraudulent transfers are fundamentally different. As early as 1909, the United States Supreme Court emphasized the distinction between the two in *Coder v. Arts*.[98] "A consideration of the provisions of the bankruptcy law as to preferences and [fraudulent] conveyances shows that there is a wide difference between the two, notwithstanding they are sometimes spoken of in such a way as to confuse the one with the other."[99]

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94. NORTON, *supra* note 44, § 2:3. The Bankruptcy Code is codified as Title 11 of the U.S.C.

95. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a subsection to the preference statute providing a $5000 safe harbor for non-consumer loan payments and a new section requiring that any avoidance action for an amount under $10,000 (and transferred to a non-insider) be filed in the district in which the transferee resides. WILLIAM HOUSTON BROWN & LAWRENCE R. AHERN III, 2005 BANKRUPTCY REFORM LEGISLATION WITH ANALYSIS 2D 162–63 (2006).

96. *See* discussion *infra* Part II.B.3.

97. Fraudulent Transfer Act Summary, Uniform Law Commission: The National Conference of Commissioners on Uniform State Laws, http://uniformlaws.org/ActSummary.aspx?title=Fraudulent%20Transfer%20Act (last visited 12/21/2012).

98. Coder v. Arts, 213 U.S. 223 (1909).

99. *Id.* at 241. As discussed *infra* Part III.A.3., courts still "confuse the one with the other." The Court was analyzing two sections of the 1898 Bankruptcy Act. Section 60(b), the precursor to the modern preference statute 11 U.S.C. § 547, states:

> If a bankrupt shall have given a preference, and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee, and he may recover the property or its value from such person.

The Court stressed that "[i]n construing the bankruptcy act this distinction [between preferences and fraudulent conveyances] must be kept constantly in mind."[100] "An attempt to prefer is not to be confounded with an attempt to defraud, nor a preferential transfer with a fraudulent one."[101] The Court further reasoned,

> The mere fact that one creditor was preferred over another, or that the conveyance might have the effect to secure one creditor and deprive others of the means of obtaining payment, was not sufficient to avoid a conveyance; but it was uniformly recognized that, acting in good faith, a debtor might thus prefer one or more creditors.[102]

Along with the emphasis on distinguishing between preferences and fraudulent transfers, the Court also analyzed the good faith affirmative defense, the precursor to the modern § 548(c).[103] Under the Bankruptcy Act, a transfer "to purchasers in good faith and for a present fair consideration" could not be voided even if "they have been made by the bankrupt with the intent on his part to hinder, delay, or defraud his creditors."[104] Further, "[t]he question as to whether a transfer is made with intent to hinder, delay, or defraud depends upon whether the act done is a bona fide [good faith] transaction."[105] The Court's rationale suggests that even though "intent"

Id. at 239–40. Section 67(e), the precursor to § 548(a)(1)(A), states:

> That all conveyances, transfers, assignments, or encumbrances of his property, or any part thereof, made or given by a person adjudged a bankrupt under the provisions of this act . . . *with the intent and purpose on his part to hinder, delay, or defraud his creditors, or any of them*, shall be null and void as against the creditors of such debtor, *except as to purchasers in good faith and for a present fair consideration*; and all property of the debtor conveyed, transferred, assigned, or encumbered as aforesaid shall, if he be adjudged a bankrupt, and the same is not exempt from execution and liability for debts by the law of his domicil, be and remain a part of the assets and estate of the bankrupt, and shall pass to his said trustee, whose duty it shall be to recover and reclaim the same by legal proceedings or otherwise for the benefit of the creditors.

Id. at 240 (emphasis added).

100. *Id.* at 241.

101. *Id.*

102. *Id.* at 242.

103. *See* note 193 and accompanying text.

104. *Coder*, 213 U.S. at 241–42.

105. *Id.* at 244.

relates only to the debtor and "good faith" relates only to the transferee, a nexus exists between the two.[106]

In summary, in *Coder*, the Court established the principle that a preference is distinct from a fraudulent transfer. A fraudulent transfer is not avoidable merely because it prefers one creditor over another. In addition, a transfer made in good faith for fair consideration is not avoidable even if the debtor had actual intent to defraud creditors.

b. *Van Iderstine v. National Discount Co.*

Four years after *Coder*, the Court revisited the fraudulent transfer issue in *Van Iderstine v. National Discount Co.*[107] The insolvent debtor borrowed money from a bank, using his business accounts as collateral.[108] The bank made two loans to the debtor even though it knew that the debtor was insolvent and was purportedly using the loan proceeds to pay creditors who were overdue.[109] When petition for bankruptcy was filed, the bankruptcy trustee sought both to have the transfer of the business accounts set aside and to have the collections that the bank had made on those accounts returned to the estate.[110] The district judge instructed the jury that a preference was just as voidable as if the debtor "had concealed the money from his creditors."[111] The jury found in favor of the trustee.[112] The appeals court reversed and the Supreme Court affirmed.[113] The Court rejected the trustee's argument that using company assets, specifically the accounts, to gain loans to pay existing debt should be treated as a fraudulent transfer.[114] Instead, the Court delivered a densely packed statement of fraudulent transfer principles.

> *Conveyances may be fraudulent because the debtor intends to put the property and its proceeds beyond the reach of his creditors; or because he intends to hinder and delay them as a class; or by preferring one who is favored above the others.* There is no

106. The relationship between the debtor's intent and transferee's good faith is analyzed *infra* at Part III.C.2.

107. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575 (1913).

108. *Id.* at 580.

109. *Id.*

110. *Id.*

111. *Id.* at 580–81.

112. *Id.*

113. *Id.*

114. *Id.*

> necessary connection between the intent to defraud and that to prefer, but in asmuch as one of the common incidents of a fraudulent conveyance is the purpose on the part of the grantor to apply the proceeds in such manner as to prefer his family or business connections, the existence of such intent to prefer is an important matter to be considered in determining whether there was also one to defraud. *But the two purposes are not of the same quality, either in conscience or in law*, and one may exist without the other. *The statute recognizes the difference between the intent to defraud and the intent to prefer, and also the difference between a fraudulent and a preferential conveyance. One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute. One is* malum per se *and the other* malum prohibitum,*-and then only to the extent that it is forbidden.* A fraudulent conveyance is void regardless of its date; a preference is valid unless made within the prohibited period. It is therefore not in itself unlawful to prefer, nor fraudulent for one, though insolvent, to borrow in order to use the money in making a preference.[115]

First, the Court gives three examples of transfers that may be fraudulent.[116] A transfer may be fraudulent when the intent of the debtor is to put property out of the reach of *creditors*. This act can only be accomplished if the transfer is to a *non-creditor*. Similarly, a transfer may be fraudulent when the property is made less accessible to creditors *as a class*. Again, the transfer must be to a *non-creditor*. The last example is a transfer to a creditor who is preferred because he is a *family or business connection*. These examples are relevant to an analysis of fraudulent transfers because they highlight the relationship between the debtor's intent and the transferee's status as a creditor. The receipt by a creditor of a legitimate amount owed cannot be a fraudulent transfer unless there is a special favored relationship between the debtor and the transferee.[117]

Second, the Court again emphasizes that preferences and fraudulent transfers are "not of the same quality, either in conscience or in law."[118] The

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115. *Id.* at 582 (emphasis added).

116. These three categories roughly match the three paradigms put forth by Judge Breyer in *Boston Trading Group*, discussed *infra* at Part II.B.4.

117. The important implications of this principle in the context of Ponzi schemes are discussed *infra* in Part III.A.

118. *Van Iderstine*, 227 U.S. at 582.

Court expands on its *Coder* holding, which found preferences were related to "policy,"[119] and reasons that a preference is merely *malum prohibitum*—not wrong in and of itself but only wrong to the extent that it is forbidden by statute. In contrast, a fraudulent transfer is *malum in se*—wrong because it is wrong. The Court noted that the transfer to the bank could be set aside only if the bank had known that the debtor intended both to pay some of its creditors and to actually defraud others.[120] This knowledge would have made the bank complicit in fraud, a *malum in se* act. Without such knowledge, the transfer was not avoidable even though the debtor misused the funds and the creditors were harmed.[121]

c. *Dean v. Davis*

The Court reaffirmed its position a few years later in *Dean v. Davis*.[122] In that case, an insolvent debtor implored his brother-in-law, Dean, to loan him money to pay creditors.[123] Dean loaned the money in exchange for a demand note secured by a mortgage on all the property the debtor owned.[124] Dean immediately foreclosed on the note.[125] The Court affirmed the lower court's findings that Dean had actual knowledge of the debtor's plan to place all of his assets outside the reach of creditors by transferring them to a relative.[126] The Court supported a subjective standard for good faith by noting that a mortgage by an insolvent debtor used to pay pre-existing debt would not be fraudulent if made with the expectation that the "debtor will extricate himself from a particular difficulty and be enabled to promote the interest of all other creditors by continuing his business."[127] In

119. Coder v. Arts, 213 U.S. 223, 241 (1909) ("In a preferential transfer the fraud is constructive or technical, consisting in the infraction of that rule of equal distribution among all creditors which it is the policy of the law to enforce when all cannot be fully paid.").

120. *Van Iderstine*, 227 U.S. at 583.

121. Compare this to the very similar facts given by Professor Glenn. *See infra* notes 163–68 and accompanying text. In Glenn's scenario, the loan is avoidable because the lender knew the proceeds from the loan would be ill-used and the estate consequently diminished.

122. Dean v. Davis, 242 U.S. 438 (1917).

123. *Id.* at 442.

124. *Id.*

125. *Id.* The demand note was executed September 10. It was recorded on September 11. September 12 was a Sunday. Dean foreclosed on the note on September 13, destroying any chance that other creditors could be paid. *Id.*

126. *Id.* at 445.

127. *Id.* at 444. "The lender who makes an advance for that purpose with full knowledge of the facts may be acting in perfect 'good faith.'" *Id.*

contrast, the debtor in *Dean* must have known that mortgaging all of his property to his brother-in-law for a demand note that had already matured would result in the collapse of his business and bankruptcy.[128] Dean's immediate foreclosure of the note was sufficient to find complicity in the fraud and deny Dean the good faith defense—even though Dean had given "fair value" for the transfer.[129]

The Court's holdings in *Van Iderstine* and *Dean* support a subjective, actual knowledge standard for good faith. To lose the good faith defense, the transferee must know of the debtor's intent to hinder, delay, or defraud creditors before the transaction, creating a virtual participation in the fraud. The favored relationship between the debtor and the transferee is important. The debtor's creation of more debt to pay off some creditors, even while knowingly insolvent, is not sufficient in itself to trigger the fraudulent transfer statute.[130]

d. *Cunningham v. Brown*

Although the parties in *Cunningham v. Brown*[131] might be unfamiliar to most people, the debtor in the case has become a household word: Ponzi. In December 1919, Charles Ponzi convinced people to lend him money, backed by unsecured notes, so that he could purchase international postal coupons and sell them at a profit.[132] Ponzi promised to pay a 50% return on the loan within ninety days.[133] Ponzi's consistent ability to make payments of amounts owed induced others to invest with him. Six months later, Ponzi's scheme was bringing in about $1 million a week.[134] On August 2, a newspaper published a report that Ponzi's selling of notes was being investigated.[135] The news led to a "wild scramble" by Ponzi's investors seeking to cash in their notes.[136] Ponzi shifted money from his accounts in

128. *Id.* at 445.

129. *Id.*

130. The failure of some modern courts to follow the Court's rationale in *Coder, Van Iderstine,* and *Dean* is discussed *infra* at Parts III.A and C.

131. Cunningham v. Brown, 265 U.S. 1 (1924). Henry Cunningham was appointed trustee after all the other trustees had died pending litigation. *Id.* at 7. Benjamin Brown, a minor at the time of the fraud, was one of five named defendants in the case. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* at 8.

135. *Id.*

136. *Id.*

other banks to one in Boston to cover the redemptions, but, by August 9, Ponzi's bank account was empty.[137]

The Ponzi case dealt exclusively with preferences.[138] Under the Bankruptcy Act, a preference was voidable if made during the preference period and if the transferee knew that his payment would be a preference[139]—"that is, that the effect of the payment will be to enable him to obtain a greater percentage of his debt than others of the creditors of the insolvent of the same class."[140] The Court noted that, on August 2, there began a "scramble and a race" by a crowd of people who "struggled" for eight days to get their money.[141] "Thus they came into the teeth of the Bankruptcy Act, and their preferences in payment are avoided by it."[142] The Court reasoned that all investors who had received payments within the prescribed preference period were subject to the preference statute.[143] The Court concluded that the case called "strongly for the principle that equality is equity, and this is the spirit of the bankrupt law. Those who were successful in the race of diligence violated not only its spirit, but its letter, and secured an unlawful preference."[144]

The Court's holding in the first Ponzi case is now largely apposite to litigation that surrounds modern Ponzi schemes. The trustee in *Cunningham* was seeking to avoid only preferences. The trustee's avoidance strategy was proper because each investor victim was a creditor of Ponzi

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137. *Id.*

138. The specific question was whether investors who had redeemed when they learned of an investigation of Ponzi were seeking a preference. *Id.* at 9. The trial court ruled and the appeals court affirmed that those who scrambled to withdraw their money between August 2 and the collapse had rescinded the transaction and were thereby a separate class of creditors. The Supreme Court reversed, concluding that there was no evidence that the investors had rescinded for fraud rather than merely cashing in the investment early. *Id.* Under the current Bankruptcy Code, all payments within the preference period are avoidable regardless of the transferee's knowledge of a preference. *See infra* note 174. Significantly, the trustee sought avoidance of no fraudulent transfers.

139. *Cunningham*, 265 U.S. at 10. The preference period under the Bankruptcy Act was four months, while the preference period under the Bankruptcy Code is ninety days. *See infra* note 174. Under the Bankruptcy Act, a preference was avoidable only if the transferee had knowledge of the preference. That requirement was removed from the Bankruptcy Code. *Id.*

140. *Cunningham*, 265 U.S. at 10.

141. *Id.* at 10–11.

142. *Id.* at 11.

143. *Id.*

144. *Id.* at 13.

and had received a transfer during the preference period. In contrast, the litigation today centers around a trustee's attempt to avoid transfers under the fraudulent transfer doctrine. As the *Coder* Court noted, preferences and fraudulent transfers are separate doctrines that should not be confused.[145] Preference doctrine does indeed have as its spirit equality of distribution. Notwithstanding the tendency of courts to apply *Cunningham* to fraudulent transfers, *Cunningham* applies to preferences only.

2. The Glenn Treatise

In 1940, two years after the Chandler Act "modernized" the Bankruptcy Act,[146] Garrard Glenn published his classic treatise, *Fraudulent Conveyances and Preferences.*[147] Modern courts still quote Glenn's scholarly work.[148] Analysis of fraudulent transfers and preferences under the Bankruptcy Act is relevant because the Bankruptcy Code is founded on the Act and the Supreme Court has emphasized that lower courts should interpret the Code in a manner consistent with the Act unless Congress has expressly indicated otherwise.[149] Glenn notes that a transferee who gives equivalent value to the debtor in exchange for the property transferred is immune from a fraudulent transfer claim because the creditors, "hav[ing] no trust interest in any particular asset," are not in any worse position than if the transfer had not been made.[150] Of singular importance is the effect the transfer has on the estate. "Where a transfer ... is put forward as a fraudulent conveyance, the test is whether, as a result of the transaction, the debtor's estate was unfairly diminished ... [A]n essential feature of the fraudulent conveyance is depletion of the debtor's estate."[151] An estate is not diminished if the debtor receives "fair consideration" for the transfer, which

145. Coder v. Arts, 213 U.S. 223, 241 (1909).

146. NORTON, *supra* note 44, § 2:1.

147. GLENN, *supra* note 83.

148. *See, e.g.*, Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 44 (1989) (quoting Glenn as "scholarly authority"); *In re* Abatement Envtl. Res., Inc., 102 F. App'x 272, 279 (4th Cir. 2004) ("In analyzing fraudulent conveyances, Professor Glenn wrote of whether a transfer was for value that 'the test is whether, as a result of the transaction, the debtor's estate was unfairly diminished.'" (quoting GLENN, *supra* note 83, § 275)).

149. *See In re* Teleservices Grp., Inc., 444 B.R. 767, 806 (Bankr. W.D. Mich. 2011) (noting that the United States Supreme Court "instructs the lower courts again and again to interpret the current Code in a manner that is consistent with prior bankruptcy practice unless Congress has expressly indicated a different intent") (collecting cases).

150. GLENN, *supra* note 83, § 235.

151. *Id.* § 275.

may be an exchange of property or satisfaction of an antecedent debt.[152] Put succinctly, "So long as the transfer does not diminish the estate, the motives of debtor and grantee are immaterial."[153]

The transferee who fails to give fully equivalent value is still protected from a fraudulent transfer claim if the transferee has "given value" in "good faith."[154] "Good faith" means the transferee "had no knowledge or notice of the debtor's intent" to defraud creditors—a subjective standard.[155] The test for good faith is closely linked with the value given because inadequacy of consideration would tend to show that the transferee knew that "he was not trading normally" and the debtor's purpose might be to defraud creditors.[156] If the transferee failed to pay equivalent value and had "knowledge of the debtor's purpose, or if what he did know was enough to put him on his inquiry," then he may be liable for the transfer.[157] In summary, a transferee's "good faith is tested by the extent to which he was implicated in the debtor's plan, first to get the money and then to put it beyond the reach of creditors."[158]

Glenn discussed a fraudulent type of scheme that has similarities to modern Ponzi schemes. He outlined a scenario whereby a debtor obtains a loan for which substantially all of his property is collateral.[159] The debtor uses the loan proceeds to pay off outstanding credit accounts, thereby creating a false impression of solvency, with the purpose of inducing others to supply even more goods on credit.[160] The new goods are sold, usually at a discount, and the debtor "makes away with the money."[161] The creditors then discover that all of the debtor's property is tied up as collateral for the loan and therefore unavailable to satisfy the debts.[162] The lender, who is not

152. *Id.* § 293.

153. *Id.* § 300. For a discussion of how modern courts have deviated from this clear principle, see *infra* Part II.C.

154. *Id.* § 294.

155. *Id.*

156. *Id.* § 295 ("The question is solely whether the grantee knew, or should have known, that he was not trading normally, that on the contrary, the purpose of the trade, so far as the debtor was concerned, was the defrauding of his creditors.").

157. *Id.* § 300.

158. *Id.* § 259. The deviation in some modern courts from this subjective definition of good faith is discussed *infra* at Part III.C.

159. *Id.* § 303.

160. *Id.*

161. *Id.*

162. *Id.* This is the scenario presented in *Dean v. Davis* discussed *infra* at Part II.B.1.

a creditor himself, forfeits the collateral if he makes the loan knowing that the debtor intends to defraud creditors.[163] "The extension of credit is induced by deceitful practices which the grantee's loan makes possible; and the grantee who cooperates in such a purpose must give up his collateral, inasmuch as the loan was a direct cause of creditors being defrauded."[164]

The complicit transferee must return the collateral, even if he gave the debtor "fair value" in the form of the loan, because he knew the debtor would "make away with" both the loan money and the money from the sale of the goods bought on credit. As a result, the estate is diminished. Having failed the "good faith" exception, the transferee will lose both the money transferred to the debtor and the collateral received from the debtor. Significantly, this forfeiture applies only when the transferee either actually knows of the intended fraud, and thereby participates in the scheme, or he "chooses to remain ignorant," "conscious[ly] turning away from" knowledge of the fraud at the time of the transfer.[165] "There must, indeed, be more than negligence."[166] A transferee who is negligent in inquiring into potential fraud of the debtor is still protected, but a willfully ignorant transferee is not.[167]

3. The Interplay Between Various Code Provisions

Congress placed the statutes dealing with fraudulent and preferential transfers in Chapter 5, subchapter III of the Code, which is entitled "The Estate."[168] The position of the statutes indicates a legal rather than equitable question: whether the property at issue is part of the bankruptcy estate. Section 541[169] is the first section under subchapter III and lists property that

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163. GLENN, *supra* note 83, § 303.

164. *Id.*

165. *Id.* § 304. A key argument for the presumption that all transfers in the context of a Ponzi scheme are fraudulent, discussed in depth *infra* at Part III.A, is that the payments from the perpetrator to some Ponzi investors makes it possible to induce new victims to sign on. Bankruptcy trustees use this similarity to justify taking back money paid by Ponzi debtors to victims. Further, trustees can often use a "Ponzi presumption" to avoid having to prove complicity on the part of the transferee. *See infra* Part III.B.

166. GLENN, *supra* note 83, § 304.

167. The distinction between negligence and willful ignorance should be taken into account when analyzing "inquiry notice" and "good faith." These issues are discussed *infra* at Part III.C.

168. The Bankruptcy Act is codified as Title 11 of the United States Code. Chapter 5 covers "Creditors, the Debtor and the Estate."

169. Section 541 says in relevant part:

is part of the estate and property that is not.[170] Included in the estate is "any interest in property that the trustee recovers under section . . . 550 . . . of this title."[171] Section 550[172] authorizes the bankruptcy trustee to "recover, for the benefit of the estate, the property transferred" if the trustee successfully avoids the transfer under § 547 or § 548.[173] In summary, a bankruptcy trustee may seek to avoid a transfer under § 547 or § 548 and then claw back the transferred property using § 550 for the estate created under § 541. Although the trustee can recover the transferred property for the estate, nothing in the statute requires the estate to return to the transferee the value of the property received by the debtor in the exchange.

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.
>
> . . . .
>
> (3) Any interest in property that the trustee recovers under section . . . 550 . . . of this title. . . .

11 U.S.C. § 541 (2006).

170. *Id.*

171. *Id.*

172. Section 550 says in relevant part:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.
>
> (b) The trustee may not recover under section (a)(2) of this section from—
>
> (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
>
> (2) any immediate or mediate good faith transferee of such transferee.

11 U.S.C. § 550 (2006).

173. § 550(a). Sections 544, 545, 549, 553(b), and 724(a) deal with liens and transfers outside the scope of this Comment. This Comment focuses on sections 547 and 548 only. The relevant text of sections 547 and 548 are printed *infra* at notes 174 and 183, respectively.

a. Preferences

Section 547,[174] entitled "Preferences," grants the trustee power to avoid preferential transfers.[175] In order to qualify as a preferential transfer, the transfer must be of "an interest of the debtor in property," to a creditor for a debt already owed, made while the debtor was insolvent, and made "on or within 90 days before the date of the filing of the [bankruptcy] petition . . . ."[176] Thus, preferences are payments by the debtor for debts he legitimately owes. Significantly, the window of voidability is very short—only ninety days.[177]

"Preferential transfer law has as its chief concern *distributional equality*."[178] Section 547 has no good faith defense. It has no fraud

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174. Section 547 says in relevant part:

> **(b)** Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
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> **(1)** to or for the benefit of a creditor;
>
> **(2)** for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> **(3)** made while the debtor was insolvent;
>
> **(4)** made—
>
> **(A)** on or within 90 days before the date of the filing of the petition; or
>
> **(B)** between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider
>
> . . . .

11 U.S.C. § 547 (2006).

175. *Id.*

176. *Id.* Subsection 547(c) bars the trustee from avoiding certain transfers, including a transfer that was either "(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms." § 547(c)(2). Some courts have dismissed the defense in the context of Ponzi schemes, holding that no payment in a Ponzi scheme can be considered in the ordinary course of business because businesses do not ordinarily defraud clients. *See, e.g.*, *Matter of* Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 819 F.2d 214, 216 (9th Cir. 1987) (rejecting the transferee's defense and holding that transfers pursuant to a Ponzi scheme are not in the ordinary course of business of the debtor). Nevertheless, the plain text suggests that if a transfer was ordinary in the relationship between the debtor and transferee, as consistent payments from the debtor to Ponzi scheme victims would be, then such a transfer would not be avoidable as a preference. The transfer would still be subject to avoidance as a fraudulent transfer under section 548. Discussion of this line of defense is outside the scope of this Comment.

177. § 547(b)(4)(A).

178. *In re* Carrozzella & Richardson (Daly v. Parete), 270 B.R. 92, 99 (Bankr. D. Conn. 2001).

requirement.[179] Except for a few defenses,[180] § 547 allows avoidance of all transfers made within the preference period. Preferences are *malum prohibitum*—"innocent and valid, except when made in violation of the express provisions of a statute."[181] Section 547 expressly allows the trustee to claw back "innocent and valid" payments by the debtor of debts already owed to the creditors.[182] The statute harms some innocent creditors to benefit other similarly situated creditors—distributional equality. But Congress limited the infliction of avoidance on innocent creditors to a ninety-day window.

b. Fraudulent transfers

In contrast to avoidance of antecedent debt payments under § 547, the bankruptcy trustee may avoid transfers under § 548[183] only if the transfers

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179. *In re* Teleservices Grp., Inc., 444 B.R. 767, 802 (W.D. Mich. 2011) ("[T]he debtor's intent is completely irrelevant to whether a transfer is avoided under Section 547(b) as a preference.").

180. *See* § 547(c) (barring the trustee from avoiding certain transfers, including a transfer that was either "(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (B) made according to ordinary business terms").

181. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913).

182. As an example, suppose, as is likely, that Debtor was insolvent during the ninety days preceding the filing for bankruptcy and that Debtor paid his credit card bill, his lease payments, and his supply expenses. The bankruptcy trustee may avoid all of those payments under section 547 and require the credit card company, landlord, and supply company to return the payments received to the debtor's estate pursuant to section 550, unless a 547(c) defense applies.

183. Section 548(a) says, in relevant part:

> (a)(1) The trustee 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, 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)** 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*;

were "fraudulent."[184] In contrast to the short ninety-day window for preferences, fraudulent transfers may be avoided if they are made up to two years before the filing of bankruptcy.[185] Fraudulent transfers may be "actually" or "constructively" fraudulent.[186] Actual fraud requires that the debtor made the transfer with "actual intent to hinder, delay, or defraud any entity to which the debtor was ... indebted."[187] Actual intent requires a subjective standard of proof, which may be hard to meet.[188] Subsection 548(a)(1)(B) provides an objective basis for avoiding fraudulent transfers.[189] Under subsection (B), a transfer is constructively fraudulent if the debtor "received less than a reasonably equivalent value in exchange" for the transfer and was either insolvent, had unreasonably small capital, could not pay debts as they became due, or transferred the property to an insider.[190]

Actual fraud requires intent, but constructive fraud does not. If the debtor had actual intent to hinder, delay, or defraud a creditor, then the entire transfer is voidable by the trustee.[191] In contrast, a constructively

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> **(III)** intended to incur, or believed that the debtor would incur, debts that would be *beyond the debtor's ability to pay as such debts matured;* or
> **(IV)** made such transfer to or for the benefit of an *insider,* or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548 (2006) (emphasis added).

184. *Id.*

185. § 548(a)(1).

186. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1509 (1st Cir. 1987).

187. § 548(a)(1)(A).

188. "Badges of fraud" developed as indicators from which actual fraud could be inferred. Historically, the primary badge of fraud was a relationship between the debtor and the transferee "more than a business acquaintanceship and further than friendship." GLENN, *supra* note 83, § 307.

189. A constructive fraud subsection was first added to the Bankruptcy Act in 1938 as part of the Chandler Act. *See supra* notes 82–88 and accompanying text. The constructive fraud subsection became § 548(a)(1)(B) in the modern code. *See supra* note 183.

190. § 548(a)(1)(B).

191. § 548(a)(1)(A). For example, suppose that two years before filing for bankruptcy, Debtor purchased a truck from Transferee for $4000, but the truck had a fair market value of only $2000. If Debtor's intent was to, delay, or defraud creditors from being paid, then the bankruptcy trustee may avoid the transfer under section 548(a)(1)(A). Typical methods of hindering, delaying, or defrauding creditors include transfer of the title only with the debtor retaining possession; the debtor giving exceptional deals to friends and family; and the debtor shifting money from liquid to illiquid assets. *See* discussion *infra* Part II.B.4.c. Once

fraudulent transfer may be avoided only if the debtor did not receive reasonably equivalent value, regardless of intent.[192]

c. Good faith defense

In either actually or constructively fraudulent transfers, the potential for innocent transferees to suffer loss is significant. If a transfer is otherwise avoidable under § 548, a transferee's best, and possibly only, defense is § 548(c).[193] A transferee who "takes for value and in good faith . . . may retain any interest transferred" to the extent of the value given.[194] The Bankruptcy Act had contained two good faith defenses, one for those who paid "present fair equivalent value" and one for those who, although acting in good faith, paid less than fair value.[195] The Bankruptcy Code combined both provisions into § 548(c).[196] In doing so, Congress replaced the terms

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avoided, the trustee may claw back $4000 from Transferee under section 550, even if Transferee gave Debtor the truck, had no knowledge of Debtor's intent to defraud creditors, and had already spent the money two years ago. If Debtor still has the truck, it will be liquidated to pay creditors; Transferee does not receive it back.

On the other hand, suppose Debtor purchased the $4000 truck but had no intent to hinder, delay, or defraud creditors. For example, Debtor may have merely been mistaken as to the fair market value of the truck. The bankruptcy trustee cannot avoid the transfer under the actual fraud subsection and must rely on the constructive fraud provision. If the court finds that $4000 was not a "reasonably equivalent value" for the truck, the trustee has passed the first prong of the constructive fraud test. *See* 11 U.S.C. § 548(a)(1)(B)(i). The trustee must still satisfy the second prong by proving that, at the time of the transfer, either Debtor was insolvent, Debtor's business was undercapitalized, Debtor was not able to make payments to creditors as they became due, or Transferee was "an insider." 11 U.S.C. § 548 (a)(1)(B)(ii). If the bankruptcy trustee proves both prongs of the test, he may then use section 550 to claw back $4000 for the estate.

192. § 548(a)(1)(B).

193. Section 548(c) says in relevant part:

> (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.

11 U.S.C. § 548 (emphasis added). Section 550(b) provides an additional defense for *subsequent* transferees. *See* discussion *infra* Part III.C.2.b.

194. In the example *supra* note 191, even if the bankruptcy trustee successfully avoids the $4000 payment, the trustee will only be able to recover $2000 ($4000 less the value of the truck) under section 550, but only *if* Transferee is found to have acted in "good faith."

195. *In re* Teleservices Grp., Inc., 444 B.R. 767, 804 (Bankr. W.D. Mich. 2011).

196. *Id.* at 806.

"bona fide" and "without actual fraudulent intent" with the single term "good faith."[197] It is reasonable to assume, then, that Congress considered the terms synonymous.

In the UFCA, badges of fraud were intended to be objective, but the standard for good faith was subjective.[198] The Bankruptcy Act provided that transfers could be avoided if made with the intent and purpose to hinder, delay, or defraud creditors except as to purchasers in good faith and for a present fair consideration.[199] An analysis of the good-faith-for-value defense considered value as an indicator of good faith; where full value was paid, good faith was presumed.[200] Prior to implementation of the Bankruptcy Code, a landmark Washington State case, *Tacoma Association of Credit Men v. Lester*,[201] elevated good faith beyond its narrow function by requiring a three-part test.[202] Although the test was subjective, it shifted the fraudulent transfer inquiry from whether the transaction was "normal" to the subjective mental workings of the transferee.[203]

d. Special issues in Ponzi scheme cases

Ponzi scheme cases create difficulties for courts seeking to analyze fraudulent transfer doctrine. Although the expectations of Ponzi investors are the same as any other investor—a return on principal commensurate with the risk of investment—in hindsight the investment often does not exist. Therefore, there is no chance of a legitimate return on investment.[204] All payments made to the investor victim are funds taken from other

197. *Id.*

198. Sinclair, *supra* note 28, at 16.

199. Coder v. Arts, 213 U.S. 223, 240 (1909) (quoting section 67(e) of the Bankruptcy Act, "That all conveyances, transfers, assignments, or encumbrances of his property, or any part thereof, made or given by a person adjudged a bankrupt under the provisions of this act . . . with the intent and purpose on his part to hinder, delay, or defraud his creditors, or any of them, shall be null and void as against the creditors of such debtor, except as to purchasers in good faith and for a present fair consideration.").

200. *See* GLENN, *supra* note 83, § 300.

201. Tacoma Ass'n of Credit Men v. Lester, 72 Wash.2d 453, 433 P.2d 901 (1967).

202. Sinclair, *supra* note 28, at 16. The court defined good faith as "(1) an honest belief in the propriety of the activities in question, (2) no intent to take unconscionable advantage of others and (3) no intent or knowledge that the activities in question will hinder, delay or defraud others." *Id.*

203. *Id.*

204. Alex S. Weiner, Comment, *Net Equity Only Comes with Net Equality: An Exploration of an Alternative Remedy for Victims of Ponzi Schemes*, 84 TEMP. L. REV. 523, 526–27 (Winter 2012).

investor victims.[205] In addition, because there are no assets that the bankruptcy trustee can attach, the trustee increases the value of the estate and also earns his own fees, primarily by recovering money paid out to those who have been victimized.[206]

The trustee may seek to avoid transfers under both the actual fraud theory and the constructive fraud theory. Under the actual fraud theory, the entire amount paid to the transferee is avoidable, including "return of principal."[207] Most courts use an avoidability presumption that all transfers made in a Ponzi scheme fall within the actually fraudulent provision.[208] Section 548(c), however, permits an investor who can prove good faith to keep the property received, up to the amount invested.[209] The standard for good faith becomes critical to the question of whether a Ponzi victim will have to disgorge the return-of-principal payments.[210]

Under the constructive fraud theory, the trustee must prove both that the estate did not receive equivalent value for the transfer and that the transferee did not act in good faith.[211] Courts have suggested that investors give no value by investing their money in the scheme because the "investment" underlying the Ponzi scheme is fictitious and payments merely serve to induce new victims.[212] Nevertheless, courts have recognized a tort claim for fraud for investors in fraudulent schemes, entitling them to rescission of the transaction.[213] The debtor owes the investor her money back. The rescission claim constitutes antecedent debt.[214] Each payment from the debtor to the transferee gives "reasonably equivalent value" because it decreases the debtor's obligation to pay.[215] "Payments up to the amount of the initial investment are considered to be exchanged for 'reasonably equivalent value,' and thus not fraudulent, because they proportionally reduce the investors' rights to restitution."[216] Once the

205. *Id.* at 523.

206. *Id.* at 523–24.

207. Donell v. Kowell, 533 F.3d 762, 771 (9th Cir. 2008).

208. *Id.* at 770.

209. *Id.* at 771.

210. *See* discussion *infra* Part III.C.

211. *See* discussion *supra* notes 185–88 and accompanying text.

212. *Kowell*, 533 F.3d at 770.

213. *Id.* at 772.

214. *Id.*

215. *Id.* (quoting *In re* United Energy Corp., 944 F.2d 589, 595 (9th Cir. 1991)).

216. *Id.* (quoting *In re* United Energy Corp., 944 F.2d 589, 595 (9th Cir. 1991)).

investor has received back an amount equivalent to her investment, she no longer has a claim of rescission and she gives nothing of value in return for the payment.[217] A "net-winner," one who has received back all her principal,[218] is liable for return of fictitious profits.[219] A "net-loser," one who has not received back all her principal,[220] can defeat a constructive fraud claim.[221] As a result, the trustee may only avoid "profits" above the amount invested—unless the trustee can prove a lack of good faith.[222] In that case, the trustee can avoid and recover the entire amount paid to the transferee.[223] Under the actual fraud theory, the victim must prove her good faith; under the constructive fraud theory, the trustee must show the victim's lack of good faith.[224] Either way, the amount clawed back from the victim rests on the definition of good faith.

4. *Boston Trading Group*—A Modern Exposition on Fraudulent Transfer

Undoubtedly, *Boston Trading Group, Inc. v. Burnazos, Inc.*[225] is one of the most instructive expositions on modern fraudulent transfer law. While *Coder, Van Iderstine,* and *Dean*[226] were adjudicated under the Bankruptcy Act, *Boston Trading Group* was adjudicated under the modern Massachusetts fraudulent transfer statute.[227] Judge Stephen Breyer's[228]

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217. *Id.*

218. *In re* Rothstein Rosenfeldt Adler, P.A., 464 B.R. 465, 467 n.6 (Bankr. S.D. Fla. 2012).

219. *Kowell,* 533 F.3d at 770.

220. *Rothstein,* 464 B.R. at 467 n.7.

221. *Kowell,* 533 F.3d at 771. In a long-term fraud, especially consisting of purported investments in securities, investors may make dozens or hundreds of transfers with the debtor. To simplify determination of whether an investor is liable to return funds, some courts use a "netting rule." *Id.* Amounts received by the investor are "netted against the initial amounts invested by that individual." *Id.* If the net is positive, the investor is a "net-winner" and must return the fictitious profits. If the net is negative, the investor is a "net-loser." A "net-loser" is not safe, however, because the trustee can still seek to claw back what the net-loser has received under the actual fraud statute. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504 (1st Cir. 1987).

226. *See* discussion *supra* Part II.B.1.

227. The suit against the transferee was initiated by a court-appointed receiver prior to filing of bankruptcy. *Boston Trading Grp.*, 835 F.2d at 1506. Therefore, the Bankruptcy Code statutes could not be used. Fraudulent transfer cases often involve both state and Code statutes, especially where a trustee finds advantage in using the state statute. *See, e.g., In re*

reasoning shows that the common law roots and traditional analysis of fraudulent transfer principles remain valid today.[229]

a. The facts

Robert Burnazos bought for $200,000 Boston Trading Group, a company that managed pools of money for commodities transactions.[230] Two years later, Burnazos sold Boston Trading Group to Richard Shaw for $1.6 million.[231] Burnazos had previously worked for the same company as Shaw and was aware that customers complained that Shaw was dishonest.[232] The prior year, Shaw had founded his own investment company for the purpose of defrauding customers.[233] In connection with the purchase of Boston Trading Group, Shaw gave Burnazos, as a down payment, $400,000 from the funds dishonestly acquired from defrauded customers and gave Burnazos a promissory note for the balance.[234] Shortly thereafter, Shaw's investment company closed, after its customers lost $3 million, and Shaw siphoned money from Boston Trading Group customer accounts to make the payments to Burnazos.[235] Burnazos sued Shaw, claiming that he was

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Agric. Research and Tech. Grp. Inc., 916 F.2d 528, 534 (9th Cir. 1990) (using state statute's longer avoidance period). Analysis of the requirements and terms under uniform state statutes is applicable to the same provisions and terms in the Code. *Id.* ("Although the Uniform Act and the common law thus provide the substantive law in this case, cases construing the Bankruptcy Code counterparts are persuasive authority due to the similarity of the laws in this area."); *In re* Pajaro Dunes Rental Agency, Inc., 174 B.R. 557, 572 (Bankr. N.D. Cal.1994) ("Unless otherwise specified, common-law authorities and case-law dealing with the UFCA, UFTA, Bankruptcy Act of 1898 or the Bankruptcy Code may be cross-referenced whatever the statutory basis of the action at bar.").

228. Judge Breyer was sitting on the First Circuit Court of Appeals when he wrote this decision. He became a United States Supreme Court justice in 1994. *Biographies of Current Justices of the Supreme Court*, http://www.supremecourt.gov/about/biographies.aspx (last visited Aug. 12, 2013).

229. Judge Breyer refers to the statutes of Elizabeth as the common law basis for the Massachusetts fraudulent statute. *Boston Trading Grp.*, 835 F.2d at 1505–06. He also cites Gerrard Glenn's treatise on fraudulent transfers (*see supra* note 83) fifteen times. *Id.* at 1506, 1508, 1509, 1511, 1512, 1513, 1515.

230. *Id.* at 1506.

231. *Id.* Shaw had a partner, Theodore Kepreos. *Id.*

232. *Id.*

233. *Id.* Shaw and Kepreos cheated their customers by making and charging commissions for unnecessary trades, called "churning." *Id.*

234. *Id.*

235. *Id.*

destroying both businesses, which were Burnazos's only security for repayment of the note.[236] At this point, Burnazos knew that payments made to him were from funds defrauded from Shaw's investment clients.[237] Burnazos and Shaw settled the suit, and Shaw paid Burnazos $400,000 with certified checks drawn from Boston Trading Group customer accounts.[238] At the time of the payment, Burnazos knew the funds he received were from defrauded clients.[239] The following month, a federal district court appointed a receiver, who subsequently sought to avoid the transfers and recover the money for the estate.[240] A jury found, by special verdict, that Burnazos had given fair consideration in good faith for the down payment of $400,000 but not for the subsequent payments.[241] The verdict was appealed.[242]

b. Fraudulent transfer, unlike restitution, is not an equitable remedy

Judge Breyer begins his analysis with the distinction between equitable and legal remedies. He notes that a person might think that the laws of restitution fit just such a case as *Boston Trading Group*, but the person would be wrong.[243] An investment advisor's wrongful taking of client money is embezzlement, and a transferee who receives such funds, *knowing* the funds have been embezzled, will be required to return the money to the original owners.[244] Likewise, if a person, *knowing* money has been stolen, takes that money from the thief, the person must return the money to the victim even though the person has no fiduciary duty to the victim—and therefore the victim has no legal claim against the transferee.[245] These are "well-established principles of restitution."[246]

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236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.* The receiver was requested by the Commodity Futures Trading Commission, and the court gave the receiver power to prosecute all claims of equity on behalf of both Boston Trading Group and Shaw's company. *Id.*

241. *Id.* at 1507.

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.* at 1508.

246. *Id.*

In contrast, the fraudulent transfer doctrine flows from *law*, not equity, and is designed for a different purpose than restitution.[247] Fraudulent transfer law establishes a legal, not equitable, remedy whereby a creditor may recover money disposed of by a debtor and held by a third party.[248] This is accomplished by declaring the transfer void as a matter of law.

c. Fraudulent transfer paradigms

Judge Breyer notes that an extensive review of cases and commentators indicates that fraudulent transfers fall into "three basic paradigm examples."[249] Judge Breyer's paradigm examples generally reflect the examples given by the *Van Iderstine* Court.[250] The first, and most important, paradigm is a debtor who transfers property to a transferee but expects to retain the benefit of the property.[251]

> In such a case, the debtor in effect lies to his creditors, pretending he has no property left, when he really has some (in the hands of his friend). The law calls this untruthful kind of conveyance "fraudulent" and permits the creditor to void the transfer and attach the property in order to satisfy his debt.[252]

This type of transfer was seen in *Dean v. Davis*, where the debtor gave all his property as security for a note held by his brother-in-law.[253] As in *Dean*, the transferee in this paradigm is a *non-creditor*.

The second paradigm involves a transfer by the debtor to a non-creditor transferee in a "special relationship," like a friend or family member.[254] Although the debtor does not expect to retain a benefit from the property, "he simply prefers that the property go to a friend rather than to an enemy or to a stranger."[255] The creditor may recover from the transferee because

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247. *Id.*

248. *Id.*

249. *Id.*

250. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913). See *supra* text accompanying notes 110–12.

251. *Boston Trading Grp.*, 835 F.2d at 1508. This might happen when a debtor transfers to a friend the title to property but retains possession. *Id.* Similarly, the debtor may give money to a friend to hold for the debtor with the secret agreement that the friend will return the money when the creditors give up. *Id.*

252. *Id.*

253. Dean v. Davis, 242 U.S. 438, 442 (1917). *See* discussion *supra* Part II.B.1.c.

254. *Boston Trading Grp.*, 835 F.2d at 1508.

255. *Id.*

the transfer violated the principle "be just before you are generous."[256] This paradigm resembles the second example, "preferring one who is favored above the others," given by the *Van Iderstine* Court.[257]

Third, a debtor may exchange liquid assets, such as cash, for assets a creditor will have difficulty in seizing, like a homestead.[258] This paradigm resembles the third example given by the *Van Iderstine* Court.[259] "Even though the conveyance is open, truthful, and not to a friend, it hinders creditors in their efforts to satisfy their debts," and the creditor will be able to void the transfer.[260]

In *Boston Trading Group*,[261] Shaw transferred to Burnazos funds, likely acquired through fraud or embezzlement, in payment of a contractual business obligation. Nevertheless, the facts do not match any of the three paradigms.[262] The transaction was open, not hidden. Burnazos had no *special relationship* with Shaw. The exchange of cash was for payment of an antecedent debt, a situation very different from an illiquid asset like a homestead.[263] While the paradigms are not "rules" and are not exclusive, "it [is] significant . . . that this [case] does not resemble any of them."[264]

Of even more significance, Judge Breyer notes, "The cases and the commentators also state that fraudulent conveyance law does *not* seek to void transfers in a fourth circumstance known as a 'preference.'"[265]

> Suppose a debtor owes A $10,000 and B $20,000. He has only $8000, which he uses to satisfy his debt to A. This conveyance may be unfair to B, but it is not a 'fraudulent conveyance'

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256. *Id.*

257. *Van Iderstine*, 227 U.S. at 582.

258. *Boston Trading Grp.*, 835 F.2d at 1508.

259. *Van Iderstine*, 227 U.S. at 582.

260. *Boston Trading Grp.*, 835 F.2d at 1508.

261. The facts of *Boston Trading Group* are recounted *supra* at Part II.B.4.a.

262. *Boston Trading Grp.*, 835 F.2d at 1510–11.

263. *Id.* at 1511.

264. *Id.* Similarly, in a typical Ponzi case, the debtor, like Shaw, through fraud or embezzlement, uses investor money to make payments to other investors. As in *Boston Trading Group*, the transferees have no "special relationship" with the debtor, but are arm's length clients. The debtor retains no control over the payments made to transferees. The transfers are payments for contractual obligations. Significantly, payments made by a debtor to Ponzi scheme victims do not match Judge Breyer's three paradigms. *See infra* Part III.A.3.c.

265. *Boston Trading Grp.*, 835 F.2d at 1508 (emphasis in original).

> because it satisfies a debt owed to a person who is, at least, a legitimate creditor.[266]

Judge Breyer's interpretation of the fraudulent conveyance statutes matches the Court's earlier analysis under *Coder*[267] and *Van Iderstine*.[268] The purpose of fraudulent transfer statute is not to provide equal distribution to creditors. That is the function of preference statutes and only for transfers made during the short preference period. "The basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them."[269]

d. The distinction between actual and constructive fraud

Judge Breyer noted the distinction between actual and constructive fraud. Actual fraud requires that the debtor has "an actual intent to defraud as exemplified by the three paradigms" presented *supra*.[270] Although the paradigms indicate the need for closer scrutiny when a transfer is to a relative or associate, not every such transfer is fraudulent. Common law courts "sometimes found it difficult to decide whether a debtor's conveyance, say to a relative or associate, in fact amounted to a device to 'hinder, delay or defraud' creditors while reserving some benefit for the debtor."[271] In the absence of a confession by the debtor, the court had to infer actual intent by considering the surrounding circumstances. Circumstances such as insolvency and inadequate consideration became known as "badges of fraud," which supported an inference of fraudulent transfer in otherwise close cases.[272] Some of these badges of fraud were codified in the constructive fraud provision.[273]

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266. *Id.*

267. *See* discussion *supra* Part II.B.1.a.

268. *See* discussion *supra* Part II.B.1.b.

269. *Boston Trading Grp.*, 835 F.2d at 1509 (emphasis in original). The court handling some of the Madoff cases distinguished *Boston Trading Group*, noting that ratable distributions for victims-defendants under SIPA is governed by different statutes and priorities than the typical bankruptcy code sections. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Madoff Sec.), 476 B.R. 715, 727 (S.D.N.Y. 2012).

270. *Boston Trading Grp.*, 835 F.2d at 1509.

271. *Id.*

272. *Id.*

273. Judge Breyer noted the inclusion of badges of fraud in the constructive fraud section of the Uniform State Law of Massachusetts and the Uniform Fraudulent Transfer Act. *Id.* at 1509. The badges of fraud included in the Code's constructive fraud subsection are: receiving less than a reasonably equivalent value, being insolvent, having unreasonably small capital,

The trial court in *Boston Trading Group* found there was not enough evidence of the debtor's actual intent to defraud creditors to allow the question to go to the jury. The receiver appealed.[274] The receiver argued that every transfer made with actual intent to "hinder, delay, or defraud" creditors is a fraudulent transfer.[275] Since Shaw defrauded his clients of funds with which to pay Burnazos and Burnazos knew of the fraud, the transfers should be avoidable.[276] The First Circuit declared that it had "found no modern case (nor any reference in any modern case, treatise, or article to any case in the past 400 years) that has found a fraudulent conveyance in such circumstances."[277] The circumstances, as analyzed by Judge Breyer, were that Shaw used fraud to obtain the funds transferred to Burnazos and that Burnazos "[knew] *but did not participate in* [the initial fraud]."[278]

Judge Breyer reasoned that fraud used to obtain the funds is not ordinarily relevant to the transfer itself. "Fraudulent conveyance law is basically concerned with *transfers* that 'hinder, delay or defraud' creditors; it is not ordinarily concerned with how such debts were created."[279] Judge Breyer further noted that the facts in *Boston Trading Group* do not match any of the three actual fraud paradigms.[280] Consequently, the receiver could only recover the money under a fraudulent transfer claim by proving the two prongs of the constructive fraud provision: failure to give equivalent value and insolvency.[281] The trial court refused to give the requested jury instruction that the jury must find Shaw insolvent for the receiver to win on the constructive fraud claim.[282] Burnazos was therefore entitled to a new trial.[283]

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having no ability to pay debts as they become due, and transferring to an insider. *See supra* note 183.

274. *Boston Trading Grp.*, 835 F.2d at 1509.

275. *Id.*

276. *Id.*

277. *Id.*

278. *Id.*

279. *Id.* (emphasis in the original).

280. *See supra* Part II.B.4.c.

281. *Boston Trading Grp.*, 835 F.2d at 1510.

282. *Id.*

283. *Id.*

e. The subjective standard for good faith

Affirming the lower court's dismissal of the actual fraud count, Judge Breyer addressed "a second, independent reason" why the jury verdict in favor of the receiver on the constructive fraud count could not stand.[284] The lower court's instruction to the jury on good faith was inadequate. The trial court "refused to instruct the jury that a transfer that simply constituted a 'preference' did not, by itself, constitute fraud or show lack of 'good faith.'"[285] When Burnazos tried to argue this point to the jury, the trial court stated, "that is not the law."[286] Judge Breyer points out that even if Burnazos knew the money he received had been gotten from Shaw's clients through fraud and Burnzos was paid preferentially over other creditors, "that fact in and of itself, is not sufficient to show lack of 'good faith.'"[287]

Acknowledging that good faith is difficult for courts to define, Judge Breyer nevertheless reasoned:

> Whatever "good faith" may mean, however, we believe it does not ordinarily refer to the transferee's knowledge of the *source* of the debtor's monies which the debtor obtained at the expense of other creditors. To find a lack of "good faith" where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a kind of 'preference'- concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless. [288]

Judge Breyer further noted that with all the motives fully known, the lower court had already found, and the First Circuit Court affirmed, that there was no basis for a claim under the *actual* fraud provision.[289] "[W]hat reason could there be for *presuming* fraudulent intent in such circumstances?"[290]

The *Boston Trading Group* standard for good faith required more than just knowledge of the fraud. The *Boston Trading Group* court reasoned that a court could find a lack of good faith "where the transferee participates in

284. *Id.* at 1511.

285. *Id.*

286. *Id.*

287. *Id.* at 1512.

288. *Id.* (emphasis in original).

289. *Id.*

290. *Id.*

the original dishonesty . . . ."[291] Significantly, Burnazos did not know of Shaw's dishonest misappropriation of funds when they entered into the sale of Boston Trading Group. Therefore, Burnazos could not be charged with the kind of subjective knowledge that would make him a participant in the fraud. In this way, Judge Breyer's analysis matches that of *Van Iderstine* and *Dean*.[292] The First Circuit acknowledged that other courts have supported a more expansive definition for good faith but noted that in each case the transfer resembled the classic fraudulent transfer paradigms. In contrast, the transfer in *Boston Trading Group* concerned only "the *source* of the funds transferred, the transferee bore no special relationship to the transferor, and the transferee did not participate in the fraud."[293]

f. Other courts accept *Boston*'s reasoning

Quoting *Boston Trading*, the Second Circuit Court of Appeals in *HBE Leasing*[294] agreed with the First Circuit's reasoning regarding what constituted good faith. The court noted that some New York cases had "broadly construed the reference to 'good faith'" in the New York fraudulent transfer statutes but that "other authorities have cautioned against an expansive reading."[295] The court embraced the more conservative *Boston Trading* approach.[296] The court held that where "a transferee has given equivalent value in exchange for the debtor's property, the statutory requirement of 'good faith' is satisfied if the transferee acted *without either actual or constructive knowledge of any fraudulent scheme.*"[297] The court clarified that the "requirement of 'good faith' refers solely to 'whether the grantee knew, or should have known, that he was not trading *normally*, but that . . . *the purpose of the trade, so far as the debtor was concerned, was the defrauding of his creditors.*'"[298] The determining factor, then, for good faith

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291. *Id.* The First Circuit subsequently affirmed just such a lack of good faith in a 1991 case where the transferee "had long had an intimate financial relationship" with the debtor and the transfer was "a sham." Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1253, 1255–56, 1256 n.13 (1st Cir. R.I. 1991).

292. *See* discussion *supra* Part II.B.1.

293. *Boston Trading Grp.*, 835 F.2d at 1513.

294. HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. N.Y. 1995).

295. *Id.* at 636 (citing *Boston Trading Grp.*, 835 F.2d at 1512–13).

296. *Id.*

297. *Id.* (emphasis added). The court's wording left open the door for an expansive definition of constructive knowledge to include "inquiry notice" that a deal was too good to be true. *See infra* Part III.C.3.

298. *HBE Leasing*, 48 F.3d at 636. (emphasis added) (citations omitted).

is whether the transferee participated in the fraud by accepting a transfer that the transferee knew was made solely for the purpose of defrauding other creditors. The court agreed with Judge Breyer that fraudulent transfer avoidance is a legal rather than equitable doctrine.[299] The court reasoned that the state fraudulent transfer statute "makes clear, even the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors."[300]

The Second Circuit Court followed similar reasoning in *Sharp Int'l Corp. v. State Street Bank & Trust Co.*[301] The directors of Sharp falsified nonpublic financial records, especially accounts receivable, in order to facilitate borrowing increasingly large sums of money from various lenders.[302] The directors then looted more than $44 million from Sharp and diverted it to their other entities.[303] State Street Bank, one of Sharp's lenders, became increasingly suspicious of Sharp's activities.[304] State Street Bank, by then aware that Sharp was defrauding its investors, demanded repayment of the loan from the proceeds of new loans from unsuspecting lenders.[305] Sharp obtained $25 million in new loans from innocent investors and used half to pay off the State Street loan.[306] Soon after, the fraudulent scheme was discovered and Sharp was forced into bankruptcy.[307] The bankruptcy trustee attempted to avoid the payment to State Street on the theory that State Street lacked good faith.[308]

The bankruptcy court dismissed the claim and the district court affirmed the decision, concluding that "although Sharp had adequately alleged State Street's *actual knowledge* of the [entire fraudulent] scheme, Sharp had not alleged that State Street '*participated in*' or '*induced*'" the fraud.[309] The court found that Sharp had no fiduciary duty to other creditors, and therefore its silence about the fraud was not bad faith even though it knew that the

299. *Id.* at 634.

300. *Id.*

301. Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.), 403 F.3d 43, 54–55, (2d Cir. N.Y. 2005).

302. *Id.* at 46.

303. *Id.* at 46–47.

304. *Id.* at 47.

305. *Id.*

306. *Id.* at 48.

307. *Id.*

308. *Id.*

309. *Id.* at 49 (emphasis added).

source of the funds for its payments was defrauding investors.[310] The court concluded:

> The decisive principle in this case is that a mere preference between creditors does not constitute bad faith: "Even the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors ...." Nor does it matter that the preferred creditor knows that the debtor is insolvent.[311]

Even though the transactions in Sharp and Boston Trading Group involved loans instead of other forms of investments more often encountered in Ponzi schemes, the principles distilled by the courts in applying the fraudulent transfer statutes should still apply. It would mock the concept of "uniform laws on the subject of Bankruptcies"[312] if the definition of fraudulent transfer and good faith depends on whether the transferee lent money or invested in stocks. The principles established over decades and embraced in *Boston Trading Group*, *HBE*, and *Sharp* are that preferences are not avoidable as fraudulent transfers and that a finding of bad faith requires knowledge of and participation in the debtor's fraud.

C. *The Shifting Jurisprudence*

Boston Trading expounded the principles of fraudulent transfer law that had remained consistent for almost a hundred years. In summary, fraudulent transfers are designed to set aside transfers made with the intent, whether actual or inferred, to transfer debtor property out of the easy reach of creditors.[313] Additionally, fraudulent transfers usually follow one of three paradigms: (1) a transfer in name but not substance; (2) a transfer to one with a favored relationship; or (3) a transfer that makes the property illiquid.[314] Specifically, a mere preference among creditors is not a fraudulent transfer.[315] Furthermore, even if a transfer is fraudulent, a transferee that takes for value and in good faith is allowed to keep the

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310. *Id.*

311. *Id.* at 54 (quoting HBE Leasing Corp. v. Frank, 48 F.3d 623, 634 (2d Cir. N.Y. 1995)).

312. U.S. CONST., art. I, § 8, cl. 4.

313. *See* discussion *supra* Part II.B.3.b.

314. *See* discussion *supra* Part II.B.4.c.

315. *See id.*

transfer up to the amount of the value given.[316] A transferee who knew before the transfer that the debtor intended to defraud, and thus is deemed to have participated in the fraud, lacks good faith and may not claim the defense.[317]

Some modern courts have deviated from these well-established principles. Much of the deviation can be traced to the seminal Ninth Circuit Court of Appeals decision in *Agricultural Research*.[318] Other courts have followed the Ninth Circuit's lead. This section provides an overview of *Agricultural Research* and its impact on modern jurisprudence. Part III[319] *infra* discusses problems with the Ninth Circuit's reasoning and the resulting improper and inconsistent application of fraudulent transfer doctrine.

1. *Agricultural Research*

a. The facts

Agricultural Research involved a Hawaiian firm, Agretech, that solicited investors to give Agretech seeds and a cash advance for Agretech's cultivation of the seeds.[320] Agretech entered into a contract with Grant to cultivate seeds.[321] Pursuant to the agreement, Agretech received the seeds Grant had purchased and a payment to cover Agretech's anticipated cultivation expenses.[322] In exchange, Agretech promised to purchase the resulting seedlings from Grant for $229,000 fourteen months later.[323] In

316. *See* discussion *supra* Part II.B.4.e.

317. *See* discussion *supra* Part II.B.1.c.

318. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528 (9th Cir. 1990).

319. *See infra* Part III.

320. *Agric. Research*, 916 F.2d at 532.

321. Brief for Appellants at 2, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 532 (9th Cir. 1990) (No. 89-15416), 1989 WL 1129295. The limited partnership that contracted with Agretech was Palm Seedling Partners-A. Grant-Buskett Management Corporation was the general partner of Palm Seedling Partners-A. Robert Grant, personally, was a limited partner in Palm Seedlings-A. This Comment will refer to the Appellants collectively as "Grant" as did the Appellants in their brief. *Id.* at *1. Pursuant to the contract, Grant purchased palm seeds from a California seed broker unaffiliated with either Grant or Agretech. *Id.* at *2.

322. *Agric. Research*, 916 F.2d at 532.

323. *Id.* Grant agreed that if the germination rate fell below 65%, then he would acquire additional seeds. *Id.* This would not be a problem since Grant had an express guarantee from the seed broker of a 65% germination rate. Brief for Appellants, *supra* note 321, at 2. The seed broker shipped only half the seeds and notified Grant that the shipped seeds were

spite of poor germination rates with the first set of seeds, but with the replacement seeds on their way, Agretech paid Grant half the promised payment with a promise to pay the remaining half in six months, after the new batch of seeds had begun to sprout.[324] Agretech paid the second half of the promised payment a month late, claiming it was experiencing temporary cash flow problems.[325]

The bankruptcy trustee filed suit against Grant two and a half years later claiming that Agretech was a Ponzi scheme that paid Grant by using funds of new investors rather than from business profits.[326] Grant argued that Agretech had in fact sold the Grant seedlings to an unrelated party for $263,000, and thus received full value; the bankruptcy trustee contested the fact.[327] Grant claimed Agretech did receive value.[328] The trustee countered that the $229,500 in payments by Agretech to Grant were part of a Ponzi scheme and Agretech did not receive value because few of the seeds actually germinated.[329] Grant maintained through a sworn affidavit that Grant acted in good faith at all times and in all respects.[330] The trustee argued that the

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possibly damaged—the seed broker had already filled out the insurance forms just in case. *Id.* at 3. Grant transferred his account balance, and his guarantee rights, with the seed broker to Agretech so it could obtain the required seeds elsewhere, but Agretech was unable to do so. *Id.* at 4. Ultimately, the seeds were obtained nearly a year later from the original seed broker. *Agric. Research*, 916 F.2d at 532. While the court simply references this as a "second shipment," the appellant brief notes that the seed broker sent an entirely new shipment, including replacement seeds for those that had been damaged or had not germinated in the first shipment. Brief for Appellants, *supra* note 321, at 4.

324. Brief for Appellants, *supra* note 321, at 4.

325. *Agric. Research*, 916 F.2d at 533.

326. *Id.* at 531.

327. Reply Brief for the Appellants at 1, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528 (9th Cir. 1990) (No. 89-15416), 1989 WL 1129297. Grant based the argument on an affidavit by the purchaser of the seedlings and the bankruptcy trustee's sworn testimony in court that he was unaware of the checks that documented the purchase. *Id.* The trustee acknowledged that a buyer had paid Agretech $263,000 for seedlings, but contested that the seedlings were from Grant's specific seeds. Answering Brief of Appellee at 30, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 532 (9th Cir. 1990) (No. 89-15416), 1989 WL 1129296.

328. Brief for Appellant, *supra* note 321, at 13. The value included $56,000 worth of seeds, a $40,000 payment to Agretech for their cultivation services, assignment of all contract rights and credits with the seed broker, including the seed broker's express guarantee that the seeds would germinate at a rate of 65%, a $40,000 bond and $100,000 insurance policy with an Agretech subsidiary as named beneficiary. *Id.*

329. Answering Brief of Appellee, *supra* note 327, at 10–11.

330. Brief for Appellants, *supra* note 321, at 14.

test for good faith is objective, not subjective, and Grant lacked good faith because a reasonably prudent man would have been put on inquiry notice by cash flow problems and overpayment for seedlings.[331] The Ninth Circuit Court affirmed the lower court's grant of summary judgment for the bankruptcy trustee.[332]

b. The Ninth Circuit Court's reasoning

The Ninth Circuit first addressed the actual fraud theory of fraudulent transfer. The court began its analysis of actual intent by noting that "the mere existence of a Ponzi scheme ... has been found to fulfill the requirement of actual intent on the part of the debtor."[333] The court found that the trustee argued "convincingly" that the first payment to Grant could not have come from profits from the seeds Grant purchased and therefore must have come from other investors.[334] The court then noted, "Distributing funds to earlier investors from the receipt of monies from later investors is the hallmark of Ponzi schemes."[335] Thus, in the first paragraph of actual intent analysis, the court disregarded Grant's proffered evidence of a legitimate business transaction and embraced a broad definition of Ponzi scheme and then used the inference of a Ponzi scheme to presume actual intent.[336] Having presumed that the transfers to Grant were made by Agretech with actual intent to hinder, delay, or defraud its creditors, the court chose not to address the constructive fraud claim.[337]

The court then addressed Grant's good faith defense. Although the court acknowledged that summary judgment was usually not appropriate for an issue of good faith, the court noted that "appellants carry the burden of demonstrating their *objective* good faith at trial."[338] The court declared that "courts look to what the transferee objectively 'knew or should have known' in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint."[339] The court reasoned that

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331. Answering Brief of Appellee, *supra* note 327, at 21.

332. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 542 (9th Cir. 1990).

333. *Id.* at 536. *See* discussion *infra* Part III.A.

334. *Agric. Research*, 916 F.2d at 536.

335. *Id.*

336. *Id.* The court also reasoned that operating a business to the detriment of creditors was sufficient to show actual intent to hinder, delay, or defraud creditors. *Id.*

337. *Id.* at 538–39.

338. *Id.* at 539.

339. *Id.* at 535–36.

Grant's "subjective assertions of good faith," including a sworn affidavit, were irrelevant.[340] Although the court proceeded to analyze Grant's subjective good faith as the basis for the ruling,[341] later courts adopted the Ninth Circuit Court's objective standard.[342]

2. Other Courts Follow *Agricultural Research*

Five years after *Agricultural Research*, the Eighth Circuit Court of Appeals became the first circuit to adopt the Ninth Circuit's objective standard. *In re Sherman*[343] involved an alleged fraudulent transfer of rental properties between family members.[344] The case did not involve a Ponzi scheme. After noting that the Bankruptcy Code does not define good faith, the Eighth Circuit Court declared, "To determine whether a transferee acts in good faith, courts look to what the transferee objectively 'knew or should have known' instead of examining the transferee's actual knowledge from a

340. *Id.* at 536.

341. *Id.* at 539–40. The court weighed the evidence presented by the trustee and by Grant and found that Grant's statement to Agretech that a prompt payment of money due would induce other investments supported the existence of a Ponzi scheme. *Id.* at 539. The court reasoned that Grant's procurement of guarantees that the seeds would germinate and the later shipment of replacement seeds was not sufficient to show that Grant was not complicit in the fraud. *Id.* The court reasoned that Grant's research of Agretech before investing was not probative because Grant was unaware that Agretech was paying more to investors than it was taking in. *Id.* at 539–40. On the one hand, the court reasoned that Grant's statement that more investments would be made if Agretech timely paid what was owed, was "a strong indication that Grant not only knew of the fraud, but was an active participant in it as well." *Id.* at 539. On the other hand, the court reasoned that Grant should have realized there was a fraudulent scheme because Agretech stated that funds had not come in as quickly as expected. *Id.* at 540. Finally, the court found the "gross disparity" between the value of the seeds and the first payment of "over $100,000" to be "very damaging" to Grant's case. *Id.* at 537.

342. *In re* Teleservices Grp., Inc., 444 B.R. 767, 798–99 (Bankr. W.D. Mich. 2012) (observing that adoption by modern courts of the objective standard reflects "only the inertial of a seminal case—*In re Agricultural Research*—that has been cited again and again without the benefit of reflection"). Two of the most prominent purveyors of the objective approach are *In re* M & L Bus. Mach. Co., Inc., 84 F.3d 1330 (10th Cir.1996) and *In re* Sherman, 67 F.3d 1348 (8th Cir.1995), both of which refer to *Agricultural Research. Id.* at 799.

343. *In re Sherman*, 67 F.3d 1348 (8th Cir. 1995).

344. *Id.* at 1355.

subjective standpoint."[345] The court cited *Agricultural Research*.[346] The court then applied the standard to the facts without additional analysis.[347]

The following year, the Tenth Circuit Court of Appeals adopted the objective standard in *M & L Business Machine*.[348] After noting that the Bankruptcy Code does not define good faith, the court observed that the Eighth Circuit had recently adopted a standard requiring inquiry notice of the debtor's possible insolvency.[349] The court then cited *Agricultural Research* and said that "the Ninth Circuit relied on several Supreme Court decisions construing 'good faith' in other contexts to conclude that 'courts look to what the transferee objectively knew or should have known in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint.'"[350] The court observed that "the majority of bankruptcy courts ... have followed the Eighth and Ninth Circuits."[351] The Fifth Circuit adopted the objective standard, citing *Agricultural Research*.[352]

III. ANALYSIS

The Ninth Circuit Court's analysis of the "Actual Intent" section in *Agricultural Research* begins with the statement, "As previously noted, the mere existence of a Ponzi scheme, which could be established by circumstantial evidence, has been found to fulfill the requirement of actual intent on the part of the debtor."[353] In the next sentence, the court found that the trustee had "convincingly argue[d]" that one payment received by the transferee likely came from new investor money just deposited rather

345. *Id.* (internal quotation marks omitted). The court also noted that good faith is indicated when the transaction carries the earmarks of an arm's-length transaction and when the transferee does not have sufficient knowledge to suspect the debtor is insolvent. *Id.*

346. *Id.* Although the court declares an objective standard, the emphasis on trading normally and knowledge before the transfer takes place, match the practical aspects of the subjective standard. *See* discussion *infra* Part III.C.

347. *Sherman*, 67 F.3d at 1355.

348. *In re* M & L Bus. Mach. Co., Inc., 84 F.3d 1330 (10th Cir. 1996).

349. *Id.* at 1335–36.

350. *Id.* at 1336 (internal citations omitted). The problem with the court's reliance on *Agricultural Research* is that the "Supreme Court decisions" do not support *Agricultural Research's* holding. *See* discussion *supra* Part III.C.

351. M & L Bus. Mach. Co., 84 F.3d at 1336.

352. *Id.* at 1338.

353. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 536 (9th Cir. 1990).

than actual profits traceable to the transferee's investment.[354] In the third sentence, the court concluded, "Distributing funds to earlier investors from the receipt of monies from later investors is the hallmark of Ponzi schemes."[355] Thus in the first paragraph of analysis, the court presumed a Ponzi scheme, based on the purported use of funds from a later investor to pay the transferee, and then used that presumption to find, *as a matter of law,* actual intent sufficient to avoid all transfers. The presumption is a windfall for the trustee who does not have to prove actual intent, because it is presumed, and who can enjoy a claw back period of up to six years.[356] Where actual fraud is presumed, trustees do not have to rely on a constructive fraud theory. Significantly, under the constructive fraud theory, a transferee who gives equivalent value has a complete defense against avoidance *regardless of any fraud or fraudulent intent on the part of the debtor or the transferee.* This result follows because when the debtor receives equivalent value the estate is not diminished and, therefore, the transfer is not a fraudulent transfer at all.[357] Nevertheless, where courts presume the avoidability of all transfers, they deprive investor victims of their first line of defense—the chance to argue that the transfer was not avoidable as a fraudulent transfer.

The Ninth Circuit Court acknowledged that the fraudulent transfer provision "provides for an 'out' to certain transferees who . . . received the transfer in good faith and gave reasonably equivalent value."[358] The court also acknowledged that "questions of good faith may generally be difficult to establish on summary judgment" but emphasized that the transferees "carry the burden of demonstrating their *objective* good faith at trial."[359] The court further acknowledged that neither party had briefed "what exactly constitutes 'good faith.'"[360] Nevertheless, the court applied an objective

354. *Id.*

355. *Id.*

356. Sinclair, *supra* note 28, at 78 ("For the investors with Bernie Madoff, or the several other Ponzi cases now emerging in 2008's cataclysmic market reversal, a broad and expansive reading of good faith can make the return of $125 million to the investors in *Bayou* look like pocket change. This is even more troublesome because *Bayou*, Madoff and other cases are in New York, which has a six-year statute of limitations for fraudulent transfers.").

357. *See* discussion *infra* Part III.A.3.d.

358. *Agric. Research*, 916 F.2d at 535.

359. *Id.* at 539.

360. *Id.* at 535.

standard to good faith and affirmed summary judgment for the trustee.[361] Where courts presume that all transfers are actually fraudulent, victims must resort to the good faith defense under § 548(c) as their last hope, only to discover that courts disregard their proof of good faith as completely irrelevant.[362] Where courts apply an objective standard to good faith, they deprive investor victims of the second line of defense—a chance to prove that they are not culpable.[363]

Other courts have followed the Ninth Circuit's lead in presuming avoidability and in applying an objective standard of good faith. Presumptions are tempting shortcuts because they require minimal analysis. Likewise, an objective standard promises to ease the burden on the trustee and the court by allowing the court to step into the "reasonable, prudent investor's" shoes and determine good faith. Although easier for the courts, these two doctrines strip investor victims of any defense against an aggressive trustee. For that reason, the doctrines deserve analysis. The analysis will show that neither doctrine should be adopted.

A. *An Avoidability Presumption Lacks Sufficient Legal Basis*

The Ninth Circuit Court embraced a presumption that all transfers in a Ponzi scheme are avoidable as fraudulent transfers. Many courts are willing to follow the Ninth Circuit's lead and first presume that a Ponzi scheme exists and then presume that a Ponzi scheme "is sufficient to establish actual intent to hinder, delay, or defraud creditors so as to permit avoidance as a fraudulent transfer under § 548(a)(1)(A)."[364] Once courts use these presumption shortcuts, still other courts follow the practice.[365] Courts

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361. *Id.* at 536.

362. See *id.* ("subjective assertions [are] of no moment").

363. *See* discussion *infra* Part III.C.

364. *In re* Whitley, 463 B.R. 775, 781 (M.D.N.C. 2012). *See also In re* IFS Fin. Corp. 417 B.R. 419, 439 (2009) ("The Fifth Circuit and other circuits have repeatedly held that the existence of a fraudulent scheme itself is sufficient to find that a transfer made in furtherance of that scheme was made with fraudulent intent.").

365. *See, e.g.*, *Whitley*, 463 B.R. at 781–82 (Bankr. M.D.N.C. 2012) (relying primarily on a quote from *Agricultural Research* when it considered the matter as an issue of first impression); *see also In re* Dreier LLP, 452 B.R. 391, 435 (Bankr. S.D.N.Y. 2011) (denying a motion to dismiss after "[a]pplying the Ponzi scheme presumption"). For a further example of the willingness of courts to accept presumptions without analysis, consider the following. The court in *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528 (9th Cir. 1990), cited Conroy v. Shott, 363 F.2d 90, 92 (6th Cir. 1966), for its statement that "the debtor's actual intent to hinder, delay or defraud its creditors may be inferred from the mere existence of a

justify the presumption by reasoning that each transfer to one investor creditor was intended to "hinder, delay, or defraud" another investor creditor. Indeed, the reasoning goes, the whole purpose of paying out returns is to lure in more investors creditors, which indicates intent on the part of the debtor to defraud all the investor creditors. Nevertheless, the presumption ignores well-established fraudulent transfer doctrine, and usurps Congress's careful balancing of public policy goals.

1. The Term "Ponzi Scheme" Lacks a Consistent Definition

The presumption that "the mere existence of a Ponzi scheme" makes all transfers avoidable rests on the finding of a Ponzi scheme. Black's Law Dictionary provides a typical definition of a "Ponzi scheme":

> A fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, without any operation or revenue-producing activity other than the continual raising of new funds.[366]

The definition leaves unclear whether a Ponzi scheme should be found where the rate of return was not "artificially high,"[367] where something other than the original investor's "example attract[ed]" the new investors,[368] or

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Ponzi scheme." *Agricultural Research*, 916 F.2d at 535. But the *Conroy v. Shott* citation is a long quote from the district judge with no citations or legal analysis by the district court judge except an observation that the debtor's scheme was "the essence of simplicity, not to say of stupidity." *Conroy*, 363 F.2d at 92. Following the long excerpt, the Sixth Circuit Court provides no legal analysis. *Id.* at 93. The court did, however, vacate and remand the case for a new determination of damages. *Id.* In spite of the lack of legal analysis *Conroy v. Shott* was cited by *Agricultural Research*. A Westlaw search indicates that *Agricultural Research* has been cited by more than twenty other courts in at least four different circuits for the proposition that "the mere existence of a Ponzi scheme" is sufficient to find all transfers avoidable under section 548(a)(1).

366. BLACK'S LAW DICTIONARY 1198 (8th ed. 2004).

367. *See, e.g.*, Breeden v. Thomas (*In re* Bennett Funding Grp., Inc.), No. 98-61376, 1999 Bankr. LEXIS 1843 at *5 (Bankr. N.D.N.Y. Apr. 29, 1999) (finding a Ponzi scheme although "[a]t all times, the effective rate of interest paid to Defendant ranged from six to eight percent, a rate of return considered non-usurious under the laws of both New York and Vermont"). *See also* Kurzawa, *supra* note 29 at 463 (discussing *Bennett Funding Group*).

368. *See, e.g.*, Barasch, *supra* note 32, at 924 (finding a Ponzi scheme although victims purchased fictitious certificates of deposit).

where the debtor had some "operation or revenue-producing activity" from which at least some of the dividends might have been paid.[369]

The defendants in *Bayou*[370] argued that the presumption should not be applied because the debtor's business lacked signs of a "*true* Ponzi scheme (promise of high returns, no legitimate underlying business activity and the certainty that later investors cannot possibly be repaid)."[371] The court rejected the "restricted definition" for a broader one.[372] A Ponzi scheme is "any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud."[373] Significantly, the *Bayou* court eliminated from the definition the characteristics that would be a sign to would-be investors that the deal was "too good to be true"—artificially high rates of return and no legitimate underlying business.

Given the enormous advantage that accrues to the trustee when a court presumes a Ponzi scheme, a broad definition is troubling. *Agricultural Research* exemplifies the danger. The Ninth Circuit Court rejected the transferee's argument that an undisputed $263,000 purchase by a customer of the debtor within the same month as the transfer to the transferee was evidence against a Ponzi scheme.[374] Instead, the court micro-analyzed the financial transactions and found that the payment by the customer could not have been from profit generated by the transferee's investment.[375] The source of the funds, therefore, must have been another investor.[376] Further, the court rejected the transferee's evidence that the business was legitimate at the time he invested.[377] The court's analysis that early investors were paid

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369. *See, e.g.*, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 536 (9th Cir. 1990) (finding a Ponzi scheme although it was undisputed that a customer had paid $263,000 near the time of the disputed transfer for seedlings grown by the debtor—the only question being whether the seedlings were from the transferee's seeds).

370. *In re* Bayou Grp., LLC, 362 B.R. 624 (Bankr. S.D.N.Y. 2007).

371. *Id.* at 633.

372. *Id.*

373. *Id.*

374. *Agric. Research*, 916 F.2d at 536.

375. *Id.*

376. *Id.*

377. *Id.* at 542. The court rejected these arguments even though the appeal concerned a motion for summary judgment. *Id.* The trial court's grant of summary judgment and the Ninth Circuit Court's affirmation removed the transferee's opportunity to present evidence that would have argued against a Ponzi scheme.

with the funds of later investors rested primarily on one transaction. Nevertheless, the court found a Ponzi scheme.

2. The Avoidability Presumption Ignores That Congress Distinguishes Between Preferences and Fraudulent Transfers

Some courts have read the plain text of § 548(a)(1)(A) and reasoned that if the debtor's intent was to defraud any creditor, then the nature of the transfer is irrelevant. The transfer is avoidable as a fraudulent transfer. Although the analysis appears reasonable on its face, such an interpretation contradicts Congress's intent. The Supreme Court has cautioned that "[t]he plain meaning of words should be conclusive, except in cases where the literal interpretation produces a result demonstrably at odds with the intention of the drafters."[378] A literal interpretation of § 548(a)(1)(A) produces a result demonstrably at odds with the intention of Congress.

a. "Hinder, delay, or defraud"

Congress intended the phrase "hinder, delay, or defraud" to be interpreted in keeping with its common law meaning, not as a disjunctive string of words. The phrase "hinder, delay, or defraud" appeared in the Statutes of Elizabeth, which were promulgated in 1570.[379] The phrase was in common use when Congress enacted the Bankruptcy Act more than 300 years later.[380] In 1909, the United States Supreme Court noted that the phrase "is familiar to the law of fraudulent conveyances."[381] Further, the Court held that "Congress, in enacting [the fraudulent transfer section of the Bankruptcy Act], and using the terms 'to hinder, delay, or defraud creditors,' intended to adopt them in their well-known meaning."[382] In addition, the Court emphasized that "there can be no doubt that Congress intended the words employed should have the same construction and effect as have for a long period of time been attributed to those words."[383]

Having concluded that Congress intended the well-established meaning for "hinder, delay, or defraud," the Court distinguished fraudulent transfers from preferences. A fraudulent transfer must have actual intent to hinder,

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378. Sinclair, *supra* note 28, at 80 (citing *United States v. Ron Pair Ent. Inc.*, 489 U.S. 235 (1989)).

379. *In re* Miami Gen. Hosp., Inc., 124 B.R. 383, 390–91 (Bankr. S.D. Fla. 1991).

380. Coder v. Arts, 213 U.S. 223, 242 (1909).

381. *Id.*

382. *Id.*

383. *Id.* at 243.

delay, or defraud *creditors*.[384] On the contrary, "[t]he mere fact that one creditor was preferred over another" does not qualify as a fraudulent transfer.[385]

Some courts have failed to recognize the context of the phrase. Courts use the term "hinder, delay or defraud" as a disjunctive string of words.[386] Isolation of the word "defraud" tends to focus the attention on the fraud perpetrated by the debtor instead of the nature of the transfer. Faced with blatant fraud, courts fail to distinguish between fraudulent transfers that "hinder, delay, or defraud" creditors and preferences that merely prefer one investor creditor over another. The Supreme Court's warning still holds true: "In construing the bankruptcy act this distinction [between preferences and fraudulent conveyances] must be kept constantly in mind."[387]

b. Two separate code sections for two separate tools

Significantly, Congress distinguished between preferences and fraudulent transfers by creating two separate sections of the Code. Section 547 contains the avoidance statute for preferences.[388] Preferences may be avoided under § 547 regardless of the intent of the debtor, regardless of the good faith of the transferee, and regardless of value given.[389] Preferences are *malum prohibitum*—wrong because the Code says so, but only to the extent specified by statute.[390] The preference statute does not differentiate, but rather casts its net over all transfers made during the preference period so that an equitable distribution may be made. Congress balanced the harsh result with a very short window of avoidability—only ninety days.[391] "[B]y definition all transfers in furtherance of a Ponzi scheme are preferential, yet

384. *Id.* (emphasis added).

385. *Id.* at 242.

386. *See, e.g.*, *In re* Hunter, 06-60694, 2008 WL 2076750 at *2 (Bankr. N.D. Ohio May 15, 2008) ("The operative clause is disjunctive.").

387. *Coder*, 213 U.S. at 241.

388. *See* 11 U.S.C. § 547; *see also* discussion *supra* Part II.B.3.

389. *See* 11 U.S.C. § 547.

390. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582–83 (1913). *See* discussion *supra* Part II.B.3.a.

391. 11 U.S.C. § 547(b).

under the Code the trustee may recover only those transfers made within ninety days before bankruptcy."[392]

Section 548 and fraudulent transfer avoidance, on the other hand, claw back those transfers that diminish the estate.[393] This provides a bigger pool of property from which to pay creditors, but Congress limited avoidance to those transfers that took money out of the reach of creditors. "[F]raudulent transfer law is not concerned with equality *among* creditors. Instead, its goal is *distributional enhancement* for a diligent creditor or, in the context of bankruptcy, for *all* creditors [as a group]."[394] Payment of existing creditors does not diminish the estate as a whole because the decreased cash also results in a decreased liability. [395] Other creditors have no legal interest in specific property of the debtor.[396] "The basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them."[397] The Code's recognition of antecedent debt as value shows that fraudulent transfer avoidance is not designed for distributional equality. Section 548(d)(2)[398] defines "value" as including antecedent debt.[399] The Code sanctions the payment by the debtor of one creditor over another, so long as some creditor is paid. Section 548, therefore, is not a tool to redistribute debtor property from one creditor to another. Congress enacted § 548 to empower the trustee to claw back from *non*-creditors property that had been fraudulently removed from the estate. Sadly, when Congress combined the Bankruptcy Act's actual and constructive fraud sections into one section in the Code, the wording became less clear and suggests that a transfer may be avoided from a *creditor* merely if the transferor had actual

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392. *In re* Indep. Clearing House Co., 77 B.R. 843, 887–88 (D. Utah 1987). The court in *Independent Clearing House* suggested that all payments in a Ponzi scheme should be avoidable—back to the very first payment. *Id.* Nevertheless, the court conceded that the Code does not allow a trustee to do so. *Id.* at 888.

393. GLENN, *supra* note 83, § 275 ("[A]n essential feature of the fraudulent conveyance is[] depletion of the debtor's estate.").

394. *In re* Carrozzella & Richardson, 270 B.R. 92, 99 (Bankr. D. Conn. 2001) (quoting *Unified Commercial Capital*, 260 B.R. 343, 352 n.10 (W.D.N.Y. 2001)).

395. GLENN, *supra* note 83, § 293.

396. *Id.* § 235.

397. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1509 (1st Cir. Mass. 1987).

398. Section 548(d)(2)(A) ("'[V]alue' means property, or satisfaction or securing of 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.").

399. *Id.*

intent to defraud. Such an interpretation, however, ignores Congress's purpose in distinguishing preferences from fraudulent transfers. Section 547 seeks equality *among creditors*, judging creditor against creditor. Section 548 judges a *non*-creditor against the estate.

Congress created two different tools for the bankruptcy trustee. Congress listed the two avoidance powers in different statutes, gave different avoidance criteria, and established different avoidance periods. Congress mitigated the harsh results of the preference statute by limiting the avoidance period to only ninety days. Where courts employ a Ponzi presumption of avoidability, they ignore Congress's distinction and create the harsh results of the preference statute stretched over a period of years.

3. The Avoidability Presumption Ignores Court Precedent That Distinguishes Between Preferences and Fraudulent Transfers

As early as 1909, the United States Supreme Court observed that fraudulent transfers and preferences "are sometimes spoken of in such a way as to confuse the one with the other."[400] Nevertheless, the Court emphatically declared, "An attempt to prefer is not to be confounded with an attempt to defraud, nor a preferential transfer with a fraudulent one."[401] It further warned, "In construing the bankruptcy act this distinction must be kept constantly in mind."[402] Courts adopting the Ponzi presumption of avoidability have neglected the Court's warning.[403]

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400. Coder v. Arts, 213 U.S. 223, 241 (1909).

401. *Id.*

402. *Id.*

403. One court, relying on *Agricultural Research*, reasoned that "[b]ecause a Ponzi scheme is, by definition, unable to repay *all* its creditors, *any transfer* from the scheme to *a creditor* is necessarily made with the intent to hinder the rights of some other creditor." Wing *ex rel.* 4NExchange, L.L.C. v. Yager, 103CV54DAK, 2003 WL 23354487 (D. Utah Nov. 7, 2003) (emphasis added) (quoting *Missal v. Washington*, 1998 U.S. Dist. LEXIS 6016, *7 (D.D.C.1998) (quoting *In re* Agricultural Research & Technology Grp., Inc., 916 F.2d 528, 535 (9th Cir.1990))). Another court reasoned that "a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them." *In re* Indep. Clearing House Co., 77 B.R. 843, 860 (D. Utah 1987). Both of these courts confused preferences, which is the paying of one creditor over another, with fraudulent transfer, which a payment to a non-creditor to the detriment of the estate. The presumption of avoidability seeks to avoid the transfers merely because one investor creditor was paid and another was not. Payment of one creditor over another is a preference. The fraudulent transfer provision provides no support for avoidance of preferences.

a. A fraudulent transfer is not avoidable just because it is a preference

The Supreme Court has steadfastly held that merely preferring one creditor over another is not a fraudulent transfer. In *Coder*, the Court noted that the phrase "hinder, delay, or defraud" "was used at common law, and in the statute of Elizabeth."[404] In common law, "[t]he mere fact that one creditor was preferred over another, or that the conveyance might have the effect to secure one creditor and deprive others of the means of obtaining payment, was not sufficient to avoid a conveyance."[405] The Court reasoned that Congress in "using the terms 'to hinder, delay, or defraud creditors,' intended to adopt them in their well-known meaning as being aimed at conveyances intended to defraud."[406] One might be tempted to argue that since Ponzi schemes *defraud* investor creditors, all transfers are avoidable. But the Court specifically held that a "mere preferential transfer, as distinguished from a fraudulent one," was not avoidable under the fraudulent transfer provision.[407] Therefore, a court must determine whether the transfer was merely a preference before allowing fraudulent transfer avoidance.

In *Van Iderstine*, the Court analyzed the connection between fraudulent transfers and preferences. The Court reasoned that there is "no necessary connection between the intent to defraud and that to prefer."[408] The Court noted a difference of quality between the two in both law and conscience.[409] In *Coder*, the Court reasoned that whether a transfer was fraudulent had to be measured by the "bona fides of the transfer."[410] The *Van Iderstine* Court, likewise, focused on whether the transferee was a legitimate creditor. The Court found that transfer of a mortgage on the debtor's property, which moved the property out of the reach of creditors, was a legitimate transaction even though the transaction meant that other creditors would not be paid. The resulting preference to the transferee over other creditors

404. *Coder*, 213 U.S. at 242. *See* discussion *supra* Parts II.A.2, III.A.2.a.

405. *Coder*, 213 U.S. at 242.

406. *Id.*

407. *Id.* at 243.

408. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913). *See* discussion *supra* Part II.B.1.a.

409. *Van Iderstine*, 227 U.S. at 582. Fraudulent transfers are *malum in se*—"inherently and always vicious;" preferences are *malum prohibitum*—"*innocent and valid, except when made in violation of the express provisions of a statute.*" *Id.* at 582.

410. *Coder*, 213 U.S. at 243.

was not avoidable.[411] This holding aligns with *Coder*: "For it is the *well-settled law* that a conveyance made in good faith, *whether for an antecedent or present consideration*, is not forbidden by such statutes, *notwithstanding the effect may be that it hinders or delays creditors by removing from their reach assets of the debtor.*"[412] If the investor victim of a Ponzi scheme is a legitimate creditor and received a payment on a legitimate debt owed by the debtor, then the transfer cannot be avoided under the fraudulent transfer statute.

b. A fraudulent transfer is not avoidable just because the debtor is defrauding creditors

The *Boston Trading Group* court observed that preferences are not avoidable under fraudulent transfer statutes, even when a debtor is involved in illegal activity.[413] The court declared that it had "found no modern case (nor any reference in any modern case, treatise, or article to any case in the past 400 years) that has found a fraudulent conveyance in such circumstances."[414] The circumstances included a defendant who had actual knowledge of the transferor's fraud and knew that the funds used to pay the defendant were acquired by defrauding others.[415] Nevertheless, the payment was not avoidable as a fraudulent transfer. The result was "concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless."[416]

Likewise, the *Sharp* court reasoned that a "conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another."[417] This was true even though the transferee knew that the debtor would defraud new investors to pay the debt.[418] If transferees who had

411. *Van Iderstine*, 227 U.S. at 583.

412. *Coder*, 213 U.S. at 243 (emphasis added).

413. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. Mass. 1987) ("The cases and the commentators also state that fraudulent conveyance law does *not* seek to void transfers in a fourth circumstance known as a 'preference.'").

414. *Id.* at 1510.

415. *Id.* at 1506.

416. *Id.* at 1512 (emphasis in original).

417. Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.), 403 F.3d 43, 54 (2d Cir. N.Y. 2005) (citation omitted).

418. *Id.*

actual knowledge of the debtor's fraud and the fraudulent source of the funds in *Boston Trading Group* and *Sharp* benefitted from the distinction between preferences and fraudulent transfers, then *a fortiori* a Ponzi scheme victim with no knowledge of the fraud should enjoy the same benefit.[419]

c. A fraudulent transfer is usually not avoidable unless it resembles well-established paradigms

The *Van Iderstine* Court noted that transfers could be "fraudulent [1] because the debtor intends to put the property and its proceeds beyond the reach of his creditors; or [2] because he intends to hinder and delay them as a class; or [3] by preferring one who is favored above the others."[420] The Court went on to clarify that "favored" ones referred to a debtor's "family or business connections."[421] Similarly, Judge Breyer gave three basic paradigms for fraudulent transfers.[422] A debtor may seek to place property out of reach of creditors by exchanging liquid assets, like cash, for illiquid ones, like a homestead.[423] A debtor may transfer the property to one in a "special relationship," like a friend or family member.[424] A debtor may transfer property but retain the benefit.[425] Though penned nearly eighty years apart, the observations of the two courts are very similar. In each of the

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419. *See* Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 491 (D. Conn. 2002) ("Regardless of the Debtor's business, legitimate or otherwise, so long as the Debtor received 'reasonably equivalent value' in exchange for its transfer of property, there has been no diminution in the Debtor's estate and the remaining creditors have not been damaged by the transfer."). Admittedly, *Boston Trading Group* and *Sharp* transfers appear to be distinguishable from a typical Ponzi payment because the transfers were on account of unsecured notes. Many Ponzi schemes have no legitimate underlying business transactions. The payments to Ponzi investors, however, are not for the fictitious business deal. The transfers are for the non-fictitious antecedent debt based on a claim of rescission of the fraudulent contract. *See* discussion *supra* Part II.B.4.d. Therefore, like *Boston Trading Group* and *Sharp*, the investor receives transfers as a legitimate creditor.

420. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913).

421. *Id.* An intent to prefer family or business connections is not *per se* a fraudulent transfer, but "is an important matter to be considered in determining whether there was also [an intent] to defraud." *Id.* By implication, if an intent to prefer a family or business connection merely presents the possibility of a fraudulent transfer, then "preferring" one arm's-length creditor over another should provide little basis for a fraudulent transfer claim.

422. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. Mass. 1987). *See* discussion *supra* Part II.B.4.c.

423. *Boston Trading Grp.*, 835 F.2d at 1508.

424. *Id.*

425. *Id.*

paradigms, the debtor is using the particular transaction to gain something particular for himself at the expense of the estate—something more than a generalized desire to defraud creditors and abscond with estate funds.

Judge Breyer found it significant that the transfer in *Boston Trading Group* did not match any of the paradigms. Similarly, it is significant that payments in a typical Ponzi scheme do not match any of the paradigms either. Investor victims typically have no special relationship with the debtor. The debtor retains no benefit, like use of the money, from the transfer. Payments to a particular investor victim does not put the property out of the reach of creditors—the transfer puts property into the hands of a particular creditor. Where a court adopts an avoidability presumption, the court fails to evaluate the lack of similarity with the paradigms.

Courts justify the presumption by reasoning that the debtor gains a generalized benefit because it can prolong the fraud by which later creditors are defrauded. A similar scenario was presented by Glenn in *Fraudulent Conveyances and Preferences.*[426] A debtor mortgages all its property and uses the loan proceeds to pay off existing credit accounts with the sole intention of inducing more credit. The debtor buys as much as possible on credit, sells the goods, and absconds with the funds. When the fraud is exposed, creditors find that all the property within reach has already been transferred to others.[427] The scenario resembles a Ponzi scheme where some creditors are paid by the debtor solely to induce others to invest. When the scheme implodes, victims find that all property has already been paid out to other investors. Glenn, however, finds a fraudulent transfer in this situation only if the transferee is complicit in the fraud. This analysis matches the Court's reasoning in *Van Iderstine* and *Dean.*[428]

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426. GLENN, *supra* note 83, § *303.*

427. *Id.*

428. *See* discussion *supra* Part II.B.1. In *Van Iderstine* the debtor placed most of the estate property out of the reach of creditors by using its accounts receivable as collateral for several loans. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 580 (1913). The day after receiving the last loan, and without paying any creditors with the proceeds, the debtor filed for bankruptcy. *Id.* The court found no fraudulent transfer, even though all property from which other creditors could have been paid had already been transferred to the defendant. *Id.* at 583. A key factor in the Court's decision was the fact that the defendant "had no relation with the persons to whom the money was paid [the debtor]." *Id.* As in *Van Iderstine,* the debtor in *Dean* placed all of his property out of the reach of creditors by using it as collateral for a loan. Dean v. Davis, 242 U.S. 438, 442 (1917). But in contrast to *Van Iderstine,* the *Dean* court found that the transfer was avoidable as a fraudulent transfer because the defendant had to have known that he was helping the debtor defraud the creditors. In *Dean,* the defendant was the debtor's brother-in-law. *Id.* The two cases were distinguished by the

Courts, possibly overwhelmed by the scope of the fraud, can see that many transfers in a Ponzi context do not match the traditional paradigms. Rather than find that the transfers, consequently, are not fraudulent transfers, they add Ponzi scheme transfers as a new paradigm. Such a large departure from Congress's careful balancing of equities between preferences and fraudulent transfers should be done by Congress, not the courts.

d. A fraudulent transfer is not avoidable unless it diminishes the estate

According to the *Coder* Court's analysis, avoidance of a transfer as actually fraudulent requires more than the intent on the part of the debtor to "hinder, delay, or defraud" creditors; the transfer must also diminish the estate.[429] A transfer that diminishes the estate is a fraudulent transfer, and conversely, a transfer that does not diminish the estate—even if it represents a preference—is not a fraudulent transfer.[430] The Court's reasoning in *Coder* and *Van Iderstine* is augmented by scholarly authority.[431] "[T]he test of whether a transfer can be avoided under the fraudulent transfer statute is whether, as a result of the transaction, the debtor's estate was unfairly diminished ... [A]n essential feature of the fraudulent conveyance is depletion of the debtor's estate."[432] Of singular importance to the question of fraudulent transfer is the effect the transfer has upon the estate. Put succinctly, "So long as the transfer does not diminish the estate, *the motives of debtor and grantee are immaterial.*"[433] Regardless of the debtor's motive in making a transfer, if an antecedent debt is paid, the estate is not diminished and the transfer cannot be avoided.

An estate is not diminished if the debtor receives equivalent value for the transfer, which may be an exchange of property or satisfaction of an

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relationship between the debtor and the transferee. Where there was no special relationship, there was no fraudulent transfer.

429. Coder v. Arts, 213 U.S. 223, 242–43 (1909) (holding that Congress intended "hinder, delay, or defraud" to have its common law meaning and that under that meaning a payment on account of antecedent debt is not a fraudulent transfer even when it prefers one creditor over another).

430. *See Van Iderstine*, 227 U.S. at 583 (finding that a transfer that depleted the estate and deprived creditors of the opportunity to be paid was nevertheless not a fraudulent transfer because the transferee was itself a legitimate creditor).

431. Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 44 (1989) (quoting Glenn as "scholarly authority").

432. GLENN, *supra* note 83, § 275

433. *Id.* § 300.

antecedent debt.[434] Courts have uniformly recognized that return of principle in the context of a Ponzi scheme constitutes a dollar-for-dollar equivalent "value."[435] Courts that apply a presumption that all transactions are actually fraudulent relegate the giving of equivalent value to the good faith defense under 548(c); this is incorrect. A transfer that does not diminish the estate is not voidable as a fraudulent transfer at all because the creditors as a group have not been hindered, delayed, or defrauded. The issue of a good faith defense need never be reached.

A presumption that all transfers in a purported Ponzi scheme are fraudulent transfers ignores the distinction between preferences and fraudulent transfers and denies the investor victim the opportunity to show that the transfer was merely a preference. "[F]raudulent conveyance remedies are designed to 'right' the singular 'wrong' of a *windfall* received at the expense of the debtor's estate, not to police the legality of transactions otherwise fair to the debtor."[436] Victims of a fraudulent scheme are tort creditors with a claim of rescission for the fraudulent transaction. "[A] preference by definition is made on account of an antecedent debt."[437] At least to the extent that a creditor victim has not received back his invested principal, transfers to that transferee merely prefer one creditor victim over another. Such preferences are not avoidable under the fraudulent transfer provision regardless of the debtor's actual intent to hinder, delay, or defraud creditors because the transferee has not received a windfall at the expense of the debtor's estate. Instead, the creditor victim has received back a portion of what was rightfully owed on account of the rescission claim. A correct analysis of avoidability requires the court to determine if the transferee is a legitimate tort creditor. Courts that employ a Ponzi presumption of fraudulent transfer rob creditor victims of a key defense to the trustee's claw backs.[438]

Significantly, payments on account of antecedent debt are avoidable under § 547, the preference statute, but not under § 548, the fraudulent

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434. *Id.* § 293.

435. *See* discussion *supra* Part II.B.3.d.

436. Daly v. Parete (*In re* Carrozzella & Richardson), 270 B.R. 92, 97 (Bankr. D. Conn. 2001).

437. *In re* Teleservices Grp., Inc., 469 B.R. 713, 757 (Bankr. W.D. Mich. 2012).

438. In fact, it is even more than a "defense" because the burden of proof is on the trustee to prove that the transfer is avoidable. The trustee must show that the estate did *not* receive equivalent value in the transfer. This the trustee cannot do where creditor victims have an unpaid rescission claim, and "net-loser" victims are thereby protected from the trustee's attempt to claw back funds.

transfer statute. A payment on account of a legitimate antecedent debt does not diminish the estate because the debtor receives equivalent value in the form of reduced obligation for the transfer given. When the debtor uses its limited funds to pay some legitimate creditor, even if the debtor's intent is to defraud other creditors, no fraudulent transfer has occurred.[439] The source of the funds used to pay the debt does not turn a preference into a fraudulent transfer.[440]

B. *An Avoidability Presumption Turns Fraudulent Transfer Avoidance into a "Super Preference"*

Some courts have tried to "forc[e] the square peg facts of a 'Ponzi' scheme into the round holes of the fraudulent conveyance statutes in order to accomplish a further reallocation and redistribution to implement a policy of equality of distribution in the name of equity."[441] The avoidability presumption allows the trustee to "utilize the fraudulent conveyance statutes as 'super preference' statutes."[442] The "super preference" applies equitable reasoning to a legal remedy and allows courts to impermissibly override Congress's careful balancing of policy objectives.

1. A "Super Preference" Impermissibly Seeks "Equity" by Conflating Preferences and Fraudulent Transfers

Fraudulent transfer avoidance is a legal, not equitable, remedy.[443] But a growing number of courts find the legal remedies of the Code unjust and inapplicable to Ponzi schemes.[444] "[C]ourts have long held that [it] is more equitable to attempt to distribute all recoverable assets among the

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439. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1512 (1st Cir. 1987) ("'[I]f all that has occurred is a preference, there is no fraudulent conveyance, regardless of the debtor's evil thoughts, and the grantee's knowledge upon that subject.'" (quoting GLENN, *supra* note 83, §298a)).

440. *Id.* at 1513 (finding that the transferee's knowledge that the transferred funds were obtained by defrauding investors was insufficient to find a fraudulent transfer).

441. *In re* Unified Commercial Capital, Inc., 260 B.R. 343, 350 (Bankr. W.D.N.Y. 2001) *aff'd sub nom. In re* Unified Commercial Capital, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

442. *In re* Carrozzella & Richardson, 286 B.R. 480, 489 (D. Conn. 2002).

443. *Boston Trading Grp.*, 835 F.2d at 1508.

444. *See, e.g.*, *In re* Indep. Clearing House Co., 77 B.R. 843, 887 (D. Utah 1987) (lamenting that it was "[u]nable to do perfect justice," that the Code is premised on presumptions inapplicable to Ponzi schemes, and that it was constrained by the short and restricted avoidance provisions in the Code).

defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fell."[445] One court went so far as to designate victims of the fraud as co-perpetrators because the fraud could not have continued without the investment of new investors.[446] Faced with hundreds or thousands of financially devastated victims, courts and trustees look to what is often the only source of recoverable assets—the payments made to earlier investors.[447] The use of the fraudulent transfer section as a "super-preference" tool allows courts to promote "equity," but does so by conflating preferences and fraudulent transfers as equally "equitable" remedies.

a. Seeking "equity"

Preference statutes seek "*distributional equality*"[448] by avoiding transfers as a blanket action—all transfers made within ninety days of bankruptcy are presumed avoidable unless an exception is shown.[449] In contrast, the purpose of fraudulent transfer avoidance is to "'right' the 'wrong' of a single transaction received at the expense of the debtor's estate."[450] The presumption underlying fraudulent transfer doctrine is that the transferee holding the property is entitled to keep the property unless the trustee can show why the estate, and therefore the creditors, has a stronger claim on the property. Nevertheless, courts have increasingly used the avoidability presumption to sweep as many transfers as possible into the pool so that the court can reallocate the money in the way it deems "equitable." The *Independent Clearing House* court lamented that the preference period in § 547(b) was only ninety days and suggested that Congress change the rule to allow avoidance of all preferences transferred.[451] What *Independent Clearing House* suggested, other courts have done by fiat.

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445. Donell v. Kowell, 533 F.3d 762, 776 (9th Cir. 2008).

446. *In re* Taubman, 160 B.R. 964, 981 (Bankr. S.D. Ohio 1993) ("An investor in a ponzi scheme is not only a victim but at the same time is a perpetrator, for without the continual influx of new funds the scheme quickly collapses and the Debtor is unable to perpetuate the scheme and create harm to new creditors.").

447. Mallory A. Sullivan, Note, *When the Bezzle Bursts: Restitutionary Distributions of Assets After Ponzi Schemes Enter Bankruptcy*, 68 WASH. & LEE L. REV. 1589, 1609 (2011).

448. Daly v. Parete (*In re* Carrozzella & Richardson), 270 B.R. 92, 99 (Bankr. D. Conn. 2001).

449. *See* discussion *supra* Part II.B.3.a.

450. *In re* Carrozzella & Richardson, 286 B.R. 480, 489 n.19 (D. Conn. 2002).

451. *In re* Indep. Clearing House Co., 77 B.R. 843, 871 (D. Utah 1987).

The case of Robert Kowell and his mother Edna[452] exemplifies the use of a super-preference to turn a legal remedy into an "equitable" one. The Ninth Circuit Court of Appeals acknowledged that "it may seem 'only fair'" that Kowell be allowed to keep the profit earned on his money.[453] The court acknowledged "[t]hat would be true as between" Kowell and the Ponzi scheme operator, but "not true as between him and either the creditors of or other investors in the corporations."[454] The court's rationale clearly expresses its intention to effect an equitable redistribution among creditors. This redistribution between creditors is allowed only under the preference statute. The fraudulent transfer statute allows a weighing of equities only between the transferee and the estate. The court admitted that as between Kowell and the estate, Kowell would be allowed to keep his money. The court, however, used the fraudulent transfer tool to create a "super-preference" that reached back two years instead of ninety days. Ignoring the Supreme Court's distinction between the *malum prohibitum* preference and the *malum en se* fraudulent transfer, the court claimed that Ponzi scheme "winners" should be subject to fraudulent transfer avoidance "even if innocent of any fraud themselves."[455] The court acknowledged the "significant hardship when an innocent investor such as Kowell is informed that he must disgorge profits he earned innocently."[456] Nevertheless, the court concluded, "We see nothing inequitable in the effort to mitigate the losses suffered by other innocent investors."[457] The court erred because fraudulent transfer is a legal, not equitable, remedy. Congress set a narrow window on avoidance of preferences, designed to redistribute equally among creditors. The narrow window prevents just such a hardship as the court imposed on Kowell in the name of equity.

b. "Equality is equity"

Perhaps no phrase in fraudulent transfer analysis is so often taken out of context as "equality is equity."[458] The phrase originated in the Supreme

452. Donell v. Kowell, 533 F.3d 762, 767 (9th Cir. 2008). *See also supra* Part I (giving the facts of the case).

453. *Kowell*, 533 F.3d at 770.

454. *Id.* (citation omitted).

455. *Id.*

456. *Id.* at 776.

457. *Id.*

458. Cunningham v. Brown, 265 U.S. 1, 13 (1924). *See* discussion *supra* Part II.B.1.d.

Court's opinion in *Cunningham v. Brown*, the original Ponzi case,[459] and is often quoted to justify clawing back all transfers in order to redistribute them among the victims. For example, the Ninth Circuit Court in *Kowell* observed,

> Addressing the victims of the original Ponzi scheme, the Supreme Court commented that "[i]t is a case the circumstances of which call strongly for the principle that equality is equity." In this case, then, equity compels that Kowell share some of the hardship equally with those who lost their initial investment.[460]

Ignoring the distinction between law and equity,[461] the court used preference reasoning to convert the legal remedy of fraudulent transfer into a tool to spread hardship and suffering among victims.[462] *Cunningham* is inapposite to analysis of fraudulent transfer because the case dealt exclusively with *preferences*.[463] Preference avoidance does indeed seek equality of distribution. Fraudulent transfer avoidance, however, does not. The Court warned courts to keep the distinction in mind.[464]

Preference doctrine provides that transfers made during the ninety-day preference period be avoided so that all similarly situated creditors can be treated equitably.[465] Some courts reason that all Ponzi scheme investors "are of the same class" because all gave their money to the perpetrator expecting to invest in an enterprise that was fictitious.[466] On the contrary, the bankruptcy trustee seeks claw backs specifically because investors are *not* similarly situated. Some have received all their principal back, with profit.

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459. *Cunningham*, 265 U.S. at 13.

460. *Kowell*, 533 F.3d at 779–80 (quoting *Cunningham*, 265 U.S. at 13).

461. *See* Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. Mass. 1987) (distinguishing between fraudulent transfer doctrine, which flows from law, and restitution, which flows from equity).

462. *But see* Daly v. Parete (*In re* Carrozzella & Richardson), 270 B.R. 92, 98 (Bankr. D. Conn. 2001) (rejecting the trustee's reliance on the "equality is equity" argument).

463. *Id.* at 98–99. ("It is also important to note that *Cunningham's* 'equality is equity' pronouncement was made in the context of a preferential transfer case."); *see* discussion *supra* Part II.B.3.

464. Coder v. Arts, 213 U.S. 223, 241 (1909) ("In construing the bankruptcy act this distinction [between preferences and fraudulent conveyances] must be kept constantly in mind.").

465. *In re* Indep. Clearing House Co., 77 B.R. 843, 871 (D. Utah 1987).

466. *Id.* ("All investors in a Ponzi scheme are creditors of the same class, so in theory all should be treated equally.").

Some have received back a portion of their investment. Some have received back nothing at all. Preference doctrine should not be applied to fraudulent transfers. The use of preference reasoning to justify avoidance of fraudulent transfers ignores the different purposes of the two doctrines.

2. "Super Preferences" Impermissibly Usurp Congress's Policy-Making Role

As the *Kowell* court admitted, avoidance of Ponzi scheme transfers causes hardship to innocent victims.[467] The extent to which some creditor victims are made to suffer to benefit others is a policy question for Congress to decide. Currently, Congress has enacted no "Ponzi exception" to the well-established principles of transfer avoidance. Until it does so, courts should not create an exception by use of the "super preference."

Not all courts believe that a Ponzi scheme is fundamentally different from other bankruptcies. The court in *In re Unified Commercial Capital*,[468] for example, criticized courts that ignore universally accepted business practices, such as enforcing contracts, just because the company involved is perpetrating a Ponzi scheme.[469] The court suggested that Ponzi schemes are not that "different from the many other fraudulent schemes seen in bankruptcy cases."[470] "[H]opelessly insolvent consumer debtors with negative monthly disposable income who borrow money they will never repay so that they can do things such as go on vacation" resemble Ponzi scheme operators who never intend to pay their creditors.[471] "[H]opelessly unprofitable businesses . . . are diminished by paying interest on funds borrowed when they had negative disposable income or were unprofitable," just like Ponzi schemes are hopelessly insolvent and are diminished by each

467. *Kowell*, 533 F.3d at 779–80.

468. *In re* Unified Commercial Capital, Inc., 260 B.R. 343 (Bankr. W.D.N.Y. 2001).

469. *Id.* at 351 ("I do not understand why courts have found them to be so different from the many other fraudulent schemes seen in bankruptcy cases where innocent individuals lose money, that they are willing, in the name of public policy, to do what I consider to be such an injustice to the fraudulent conveyance statutes by ignoring the universally accepted fundamental commercial principal that, when you loan an entity money for a period of time in good faith, you have given value and are entitled to a reasonable return.").

470. *Id.*

471. *Id.* at 352.

payment to investor victims.[472] Other courts have agreed with this reasoning.[473]

The effect of the preference statute is "to move the determination date of the estate backwards in time to effect a *redistribution* among creditors."[474] Redistribution necessarily creates loss from some innocent and diligent creditors in order to benefit other creditors. Such an infliction of harm on innocent creditors requires careful consideration and balancing of policy objectives. As noted by the *Cunningham* Court, Congress established a policy of "equality is equity" for preferences,[475] but Congress chose to limit the painful consequences of equal distribution to the very narrow preferential period of ninety days.[476] Congress established a second bright-line for *fraudulent* transfers by allowing avoidability only if made within two years of the bankruptcy filing.[477] Congress protected creditors from harsh results by restricting avoidability to those transfers either that were intended to actually "hinder, delay, or defraud" creditors, which as noted *supra*[478] are distinct from preferences, or that depleted the estate through unequal exchange of consideration. The Code does not suggest that Congress intended for the pain of redistribution of funds from one innocent creditor to another be extended from ninety days to two years. Fraudulent transfer avoidance is a legal, not equitable, remedy.[479]

Congress codified the fraudulent transfer statute within the section of the Code entitled "The Estate."[480] Congress intended fraudulent transfer to be a legal question: whether the transferred property was legally part of the

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472. *Id.*

473. *See, e.g.*, Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 491 (D. Conn. 2002) (holding that payment of reasonable interest to innocent Ponzi scheme victims was not avoidable as a fraudulent transfer).

474. Daly v. Parete (*In re* Carrozzella & Richardson), 270 B.R. 92, 99 (D. Conn. 2002).

475. Cunningham v. Brown, 265 U.S. 1, 13 (1924). *See* discussion *supra* Part II.B.1.d.

476. 11 U.S.C. § 547(b) ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . on or within 90 days before the date of the filing of the petition . . . ."). *See* discussion *supra* Part II.B.3.a.

477. 11 U.S.C. § 548(a)(1) ("The trustee may avoid any transfer . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition . . . ."). *See* discussion *supra* Part III.B.3.b.

478. *See, e.g., supra* Parts II.B.1.a; II.B.2; II.B.3; II.B.4.c; III.A.2.

479. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. 1987). *See* discussion *supra* Part II.B.4.b.

480. The Bankruptcy Code is codified as Title 11 of the U.S.C. Chapter 5 covers "Creditors, the Debtor, and the Estate." Subchapter III is entitled "The Estate."

bankruptcy estate. Congress crafted boundaries on the avoidability of transfers. These boundaries carefully balanced policy objectives concerning creditors, debtors, the needs of interstate commerce, and the needs of society in general. Bankruptcy trustees sometimes "articulate[] sound reasons why it might be wise to allow an exception . . . where the trustee's efforts stand to benefit hundreds of innocent investors."[481] The Tenth Circuit Court of Appeals rejected the argument. "However, to paraphrase the Supreme Court, the issue is not whether such an exception would make good policy, but whether the exception can be found in the Bankruptcy Code."[482] The plain language of the Code lacks an "illegality exception" for transfers made in the course of a Ponzi scheme.[483] If Congress wishes for Ponzi scheme bankruptcies to be adjudicated with different rules than other bankruptcies, then Congress can amend the Code. Courts should not utilize the fraudulent transfer statute as a "super preference" to circumvent the Congress's Code provisions.

3. "Super Preferences" Impermissibly Destroy the Protection of the Constructive Fraud Provison

Historically, the test for actually fraudulent transfers focused on whether the parties were "trading normally."[484] Merely preferring one creditor over another does not constitute a fraudulent transfer. By definition, a preference is a transfer on account of antecedent debt.[485] Also, by definition, payment of antecedent debt is "value."[486] Where the debtor receives equivalent value, the estate is not diminished and no fraudulent transfer has occurred.[487] Consequently, the only time a preference may be properly avoided as a fraudulent transfer is where the transfer was not "trading normally," as in

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481. *In re* Hedged-Investments Assocs., Inc., 84 F.3d 1281, 1285 (10th Cir. 1996).

482. *Id.* at 1285–86.

483. Daly v. Deptula (*In re* Carrozzella & Richardson), 286 B.R. 480, 491 (D. Conn. 2002) ("Regardless of the Debtor's business, legitimate or otherwise, so long as the Debtor received 'reasonably equivalent value' in exchange for its transfer of property, there has been no diminution in the Debtor's estate and the remaining creditors have not been damaged by the transfer.").

484. GLENN, *supra* note 83, § 295 ("The question is solely whether the grantee knew, or should have known, that he was not trading normally, but that on the contrary, the purpose of the trade, so far as the debtor was concerned, was the defrauding of his creditors.").

485. 11 U.S.C. § 547(b)(2).

486. 11 U.S.C. § 548(d)(2).

487. *Deptula*, 286 B.R. at 491.

the paradigms given by Judge Breyer[488] and the *Van Iderstine* Court,[489] or where the transferee did not give equivalent value for the transfer. The first situation falls under the actual fraud provision and the second situation falls under the constructive fraud provision.

The addition of a constructive fraud provision[490] expanded the bankruptcy trustee's avoidance powers to cover transfers that diminished the estate, notwithstanding the lack of intent to conceal estate property from creditors. If a trustee cannot meet—what was intended to be—the high burden of showing that a particular transfer was an actually fraudulent transfer, the trustee can still recover for the estate those funds transferred with constructive fraud. For constructive fraud, the trustee needs show only that the debtor did not receive equivalent value and that the debtor was insolvent at the time of the transfer.[491] The Code still protects parties who traded normally, at least to the extent of the value exchanged. Section 548(d)(2)(A) defines equivalent value to include antecedent debt.[492] An investor victim has a claim for rescission that constitutes antecedent debt. Repayment of that debt constitutes value.[493] "This is so, notwithstanding negligence or inquiry notice on the part of the investor."[494] Under a constructive fraud theory, even "net-winners" are liable only for fictitious profits.

By accepting a presumption that all transfers are avoidable under the actually fraudulent provision, courts shift the focus from whether the trade appeared normal at the time of investment to whether, with perfect hindsight, the deal was bogus. This shift destroys the balance of equities established by Congress and deprives investor victims, both "winners" and "losers," of the chance to argue that the fraudulent transfer was merely constructively, not actually, fraudulent.

The distinction between actual and constructive fraud matters. Under the actual fraud provision, the whole amount received by the investor

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488. Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. Mass. 1987). *See* discussion *supra* Part III.A.3.c.

489. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575,582 (1913). *See* discussion *supra* Part III.A.3.c.

490. 11 U.S.C. § 548(a)(1)(B). *See* discussion *supra* Part II.B.3.b.

491. 11 U.S.C. § 548(a)(1)(B).

492. Section 548(d)(2)(A) states that "'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." 11 U.S.C. § 548(d)(2)(A).

493. Sinclair, *supra* note 28, at 78.

494. *Id.*

victim must be returned, including the principal. The investor victim then bears the burden to prove good faith under § 548(c).[495] The innocence of the investor victim "[is] of no moment."[496] Rather, the investor victim must prove that a prudent investor would not have been suspicious of the debtor's intent. Whether the investor acted in objective good faith is a question of fact, generally requiring a trial. The defense, therefore, requires the victim to expend substantial funds to defend the transfers already received, and often spent.

On the other hand, under the constructive fraud theory, the transfer can be avoided only if it is *both* not for equivalent value and not in good faith. Therefore, the burden is on the trustee to prove both elements. Transfers of "net-losers" are not avoidable because the debtor received value for each transfer because the transfer paid down an antecedent debt.[497]

In summary, an avoidability presumption that all transfers were made with actual intent to hinder, delay, or defraud deprives investor victims of the safeguards that Congress built into the Bankruptcy Code. If the transfer is merely a preference of one creditor over another, then it is not avoidable as a fraudulent transfer at all. Nevertheless, a presumption allows it to be avoided. Avoidance under the actual fraud theory requires the trustee to show that the transfer was made to hinder, delay, or defraud creditors, by diminishing the estate or moving property out of the reach of creditors. Even so, a presumption allows the trustee to bypass his burden of proof. Where a transfer is a preference, the trustee must prove that the debtor did not receive equivalent value under the constructive fraud theory. Nevertheless, a presumption allows the transfer to be avoided without such proof. An avoidability presumption of actual intent should not be used.

4. "Super Preferences" Impermissibly Shift the Balance of Equities from One Victim to Another

The Ninth Circuit Court of Appeals declared, "[C]ourts have long held that [it] is more equitable to attempt to distribute all recoverable assets among the defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fell."[498] In an attempt to be "more equitable," courts use the "super preference" to

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495. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 535 (9th Cir. 1990). *See* discussion *infra* Part III.C.2.

496. *Id.* at 536.

497. *See* discussion *supra* Part II.B.2.d.

498. Donell v. Kowell, 533 F.3d 762, 776 (9th Cir. 2008).

redistribute gains and losses among investor victims. What may appear "just" in the eyes of the court, however, may not appear equitable to the victims.

a. "Super preferences" punish prudent investors

Super-preference distributions lack equity because they punish good faith, prudent investors. Investors, especially those with short-term investments, have often spent the money they received "on retirement expenses, college funds or other daily living expenses."[499] Adding insult to injury, "because of the fraudulent activity of the bankrupt corporation, the good faith investor has to defend himself in court and face having to return the payments received to the estate."[500] The claw back of such funds creates a tremendous hardship on investors. Irving Picard, the bankruptcy trustee in the Madoff litigation, acknowledged this hardship when he allowed victims to petition not to be sued.[501] But even this action is inequitable because it punishes those who have managed their money well and have assets from which the trustee can recover. Prudent investors are targeted simply because they managed their finances and investments better than others. The use of a "super preference" to bring all transfers under the avoidance power of a trustee allows the trustee to pick and choose which victims to target.

Rothstein provides another example. Scott Rothstein orchestrated a Ponzi scheme through his law offices whereby investors could purchase discounted settlements in exchange for an immediate payment to the client.[502] The clients and settlements did not exist.[503] When the scheme collapsed, the bankruptcy trustee sued investor victims, including "net-losers."[504] The "net-losers" filed a motion to abate the proceedings against them, arguing that because of their rescission claims[505] the trustee could not

499. Kurzawa, *supra* note 29, at 463 (describing the Bennet Ponzi scheme where 3,000 good faith investors were sued by the bankruptcy trustee).

500. *In re* Carrozzella & Richardson, 286 B.R. 480, 491 n.21 (D. Conn. 2002).

501. Sullivan, *supra* note 447, at 1625. Hardship factors include foreclosure, bankruptcy, living and medical expenses, and care of dependents. *Id.*

502. *In re* Rothstein Rosenfeldt Adler, P.A., 464 B.R. 465, 467 (Bankr. S.D. Fla. 2012).

503. *Id.*

504. *Id.* "Net-losers" are investors who received from the debtor less than they invested. *Id.* n.7. "Net-winners" are investors who received from the debtor more than they invested. *Id.* n.6.

505. *See* discussion *supra* Part II.B.2.d.

recover from them and was wasting estate resources.[506] The court denied the motion, reasoning that "[i]n the end, it is the Trustee who makes the determination whether to pursue claims."[507]

b. "Super preferences" generate a windfall of litigation for the trustee

In theory, courts use the "super preference" to allow the trustee to claw back funds from a wide pool of investor victims so that the funds can be equitably redistributed. The reality, however, is that much of the money confiscated from targeted victims will never be distributed to other victims. The money swept into the pool is used first to pay the trustee, the trustee's attorney or attorneys, those hired by the trustee (including accounting firms), real estate brokers, investigators, etc., as well as court costs. For example, in less than six months, the *Rothstein* trustee generated over $1.5 million in fees and expenses paid to the trustee's own law firm and over $600,000 paid to the accountant working for the trustee.[508] Similarly, the Lancer Management Group scheme, in Connecticut, "generated upwards of $40 million in professional fees and costs" for the trustee's firm and others.[509] The trustee's attorney was the "second top earner in a Daily Business Review survey" in 2010, "making a top wage of $735 an hour."[510] Admittedly, these fees are not considered excessive based on the size and scope of the fraud. Trustees and their attorneys must untangle a complicated web of transactions and pursue hundreds or thousands of lawsuits—often against investor victims. Nevertheless, millions of dollars of funds clawed back from investor victims go to pay the trustee, his attorneys and those working for the trustee rather than being "equitably" distributed to victims.

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506. *Rothstein*, 464 B.R. at 468.

507. *Id.*

508. John Paceti, *Feds Seek to Take over Receivership*, DAILY BUS. REV. (July 17, 2010), http://www.dailybusinessreview.com/PubArticleFriendlyDBR.jsp?id=1202469879654#.

509. *Id.*

510. *Id.* Some have suggested leaving the search for and distribution of Ponzi assets to a government agency, like the Federal Bureau of Investigation. The FBI usually investigates on a parallel track with bankruptcy attorneys but are paid a fixed salary instead of by the hour. *Id.*

c. "Super preferences" result in inconsistent treatment

Fraudulent transfer doctrines are legal, not equitable, doctrines. Legal doctrines have predictable consequences, but when courts use fraudulent transfer avoidance as an equitable tool, inconsistency and inequity result.

(1) *Choosing whom to sue*

Courts that use presumptions of avoidance to claw back funds justify the action by reasoning that each transfer to a Ponzi investor merely prolongs the scheme and allows the perpetrator to induce more victims. The *Unified Commercial Capital* court rhetorically asks how those payments advance the fraud any more than do payments to trade creditors, like the landlord, utility company, or telephone service provider.[511] In addition, allowing the enforcement of contracts entered into by a "Ponzi" perpetrator results in as much of a diminution of the estate as paying earlier investors because the payments for those goods and services could only come from the funds of investors.[512] Yet bankruptcy trustees who sue earlier investor victims rarely pursue the debtor's trade creditors. One could argue that the payments for telephone, electricity, and rent represent tangible benefits provided to the debtor. Moreover, those very benefits promote and advance the fraudulent scheme. The appearance of legitimacy—an office address, a telephone number, and a fax machine—allows a person to perpetrate the fraud. Courts and trustees pick and choose which creditors to target. "Again, if it is simply a question of reallocating the risks and redistributing losses among those giving value and fair consideration to an entity engaged in a 'Ponzi' scheme, isn't that for Congress to do?"[513]

(2) *Interest for the trustee, but not for the victim*

Unified Commercial Capital involved loans by individuals to the company, which were paid back with reasonable market-rate interest.[514] The

511. *In re* Unified Commercial Capital, Inc., 260 B.R. 343, 352 (Bankr. W.D.N.Y. 2001) *aff'd sub nom. In re* Unified Commercial Capital, No. 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002) ("What did the innocent investor victims that received reasonable contractual interest payments do so wrong to diminish the estate of Unified Commercial that the trade creditors did not do? ... Furthermore, in this case, goods and services provided by trade creditors, such as telephone service, office space, and power to run computers, allowed Unified Commercial to appear to be a legitimate business and also furthered its fraudulent scheme.").

512. *Id.*

513. *Id.*

514. *Id.* at 351.

court held that payment of reasonable interest for the use of funds has always been considered "value" in the business context.[515] The court rejected the theory that the company's use of the funds to perpetrate a fraud somehow erases the "universally accepted fundamental commercial principal that, when you loan an entity money for a period of time in good faith, you have given value and you are entitled to a reasonable return."[516] Ponzi schemes operate on the debtor's use of investor funds. The investor believes the company is using the funds to buy stocks, securities, fund certificates of deposits, pay cultivation expenses or engage in other legitimate investment activities. Often the company is using the funds instead to promote the fraud. Nevertheless, use of money is a quintessential form of business. Arguably, an investor victim should be entitled to both return of their principal and a reasonable rate of interest. "[I]f Congress did not intend such a result when the debtor was involved in a Ponzi scheme, it should so specify in the Bankruptcy Code rather than leaving it to the courts to ignore what is clearly value and fair consideration under the fraudulent conveyance statutes."[517] Few courts have followed *Unified Commercial Capital's* lead.

The converse, however, has been widely accepted. Bankruptcy trustees regularly win pre-judgment interest from investor victims because the victims, albeit unknowingly, have been using the estate's money.[518] In spite of one court's statement to the contrary, it is hard not to see pre-judgment interest collected from an innocent victim as anything but a windfall for the trustee.[519] The time value of money, then, flows only one way—to the trustee.

(3) *The tracing requirement*

Similarly, the issue of tracing is applied inconsistently to Ponzi transfers. Courts presume that the funds received by an earlier investor came from a later investor and are not a return of the investor's own funds. Because the funds are money, usually deposited in a bank account, it is virtually

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515. *Id.*

516. *Id.*

517. *In re* Carrozzella & Richardson, 286 B.R. 480, 489 (D. Conn. 2002) (citing *Unified Commercial Capital*, 260 B.R. at 350).

518. Donell v. Kowell, 533 F.3d 762, 772 (9th Cir. 2008).

519. *Id.* (quoting *In re* P.A. Bergner & Co., 140 F.3d 1111, 1123 (7th Cir. 1998) ("[P]rejudgment interest should not be thought of as a windfall in any event; it is simply an ingredient of full compensation that corrects judgments for the time value of money.")).

impossible to prove whether the dollar bills received by the investor were the same dollar bills given. Courts have construed this difficulty exclusively in the trustee's favor. An investor cannot prove that his own dollars were returned. The trustee does not have to prove the dollars were different. An investor victim of a Ponzi scheme argued that the tracing requirements should be applied consistently.[520] The status quo should remain unless one party or the other can prove its assertion through tracing. The Ninth Circuit rejected the argument, noting that such a requirement on bankruptcy trustees would be "unmanageable in practice."[521] The court determined that trustees do not have to follow the same rules of tracing that transferees must follow to prove the transfer is *not* avoidable.[522] The court reasoned that this inconsistency was needed "in the typical Ponzi scheme case, where documentation of transfers is less than complete, payments are sporadic and not always in accordance with the documentation of the investment, and neither the investor nor the debtor can recall precisely what the parties intended."[523] Inconsistent application of business principles shifts Congress's carefully balanced policy decisions decidedly in favor of the trustee and to the detriment of investor victims.[524]

C. *The Shift to an Objective Standard of Good Faith Lacks Legal Foundation*

The avoidability presumption lacks a sufficient legal foundation and should not be adopted. Nevertheless, even with the avoidability presumption, a Ponzi scheme victim would enjoy some protection with the good faith defense that Congress provided in § 548(c). Sadly, most federal courts have ignored the well-established subjective standard for good faith and replaced it with an objective standard that lacks sufficient legal support. Like the avoidability presumption, the objective good faith standard can be traced back to the Ninth Circuit Court's decision in *Agricultural Research.* After the Ninth Circuit Court presumed avoidability of the transfers, the

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520. *Id.* at 773–74.

521. *Id.* at 774.

522. *Id.*

523. *Id.*

524. See *also* Sullivan, *supra* note 447, at 1595–96, 1595 n.27 (noting the court's rewriting of the terms of SIPC insurance from replacement of stocks to the "net investment method" because the extraordinary facts of the Madoff case made the method appropriate even though, in many instances, it would not be and even though such a change violated contractual expectations of the parties and left victims with huge uninsured losses).

court acknowledged that the good faith defense of 548(c) provided an "out" for investor victims.[525] The court disregarded the defendant's attempts to prove a lack of culpability, observing that subjective intent was irrelevant.[526] Since then, the doctrine has become widely accepted in spite of its faulty foundation. The *Teleservices* court is one of the few to criticize acceptance of *Agricultural Research's* objective standard because it lacks "any critical analysis."[527] An analysis of the historical doctrine of good faith and a critical look at *Agricultural Research's* rationale suggests the *Teleservices* court was correct.

1. The Ninth Circuit's Shift to an Objective Standard Lacked a Sufficient Legal Basis

The Ninth Circuit Court rejected the traditional subjective standard of good faith and created an objective one in its place. The court quoted dicta from *In re Independent Clearing House*[528] to support the proposition that "a lack of good faith is demonstrated by a transferee who knows that a debtor is operating a Ponzi scheme."[529] Then, citing only the two cases asserted by the trustee's Appellee brief, the court declared,

> These pronouncements indicate that courts look to what the transferee objectively "knew or should have known" in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint. Therefore, appellants' reference to the subjective assertions of good faith in the Grant affidavit are of no moment.[530]

The dicta and two cases, therefore, deserve a closer look.

a. *Independent Clearing House* dicta

The Ninth Circuit Court misstated the *Independent Clearing House* dicta. The court stated, "One court has remarked that a lack of good faith is demonstrated by a transferee who knows that a debtor is operating a Ponzi scheme."[531] *Independent Clearing House* actually said: "Certainly, *if* a

525. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 535 (9th Cir. 1990).

526. *Id.* at 536.

527. *In re* Teleservices Grp., Inc., 444 B.R. 767, 798–99 (Bankr. W.D. Mich. 2011).

528. *In re* Indep. Clearing House Co., 77 B.R. 843 (D. Utah 1987).

529. *Agric. Research*, 916 F.2d at 535.

530. *Id.* at 535–36.

531. *Id.* at 535 (citing *In re* Indep. Clearing House Co., 77 B.R. 843, 861 (D. Utah 1987)).

defendant knew that the debtor was running a Ponzi scheme when he advanced money to the debtor or knew of the debtor's insolvency at the time of the allegedly fraudulent transfer, that knowledge *might* indicate a lack of good faith."[532] Significantly, the *Independent Clearing House* standard was *subjective* and considered that an actual knowledge of a Ponzi scheme prior to the investment *might* constitute bad faith. The *Independent Clearing House* court declared, "The test is whether the transaction in question bears the earmarks of an arm's length bargain."[533] The court reasoned that the promise of "exorbitant returns on a defendant's investment, however, does not, without more, mean that the defendant lacked good faith. . . . Moreover, because the debtors paid the promised returns, at least initially, a defendant may have had no reason to suspect that the debtors were insolvent."[534] The court concluded that the trial court erred in granting summary judgment because it failed to take evidence "*on the subjective question of whether the defendants took in good faith.*"[535] *Independent Clearing House* does not support the Ninth Circuit's affirmation of summary judgment. On the contrary, the *Agricultural Resources* defendant proffered evidence that the debtor had paid the promised returns, at least initially, and evidence that the transaction bore the earmarks of an arm's-length bargain.[536] If the Ninth Circuit Court had followed the rationale of *Independent Clearing House*, it would have reversed the trial court's grant of summary judgment for the trustee.

b. *Harrell v. Beall*'s inquiry notice

The Ninth Circuit's legal rationale for an objective standard rests on *Harrell v. Beall*[537] and *Shauer v. Alterton*.[538] Both cases predate the Bankruptcy Act, predecessor of the current Code, and the Uniform Fraudulent Conveyances Act.[539] Thus, at the time these cases were decided,

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532. *Indep. Clearing House*, 77 B.R. at 861–62 (emphasis added).

533. *Id.* at 862.

534. *Id.*

535. *Id.* (emphasis added).

536. *See* discussion *supra* Part II.C.1.

537. Harrell v. Beall, 84 U.S. 590 (1873).

538. Shauer v. Alterton 151 U.S. 607 (1894).

539. The Bankruptcy Act was enacted in 1898. NORTON, *supra* note 44, § 1:15. The Uniform Fraudulent Conveyance Act was proposed twenty years later. Fraudulent Transfer Act Summary, UNIFORM LAW COMMISSION: THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS,

there was no bankruptcy statute directly addressing procedures for fraudulent transfers. Notwithstanding these shortcomings, the cases *still* fail to support the court's legal rationale.

The Ninth Circuit cited *Harrell*, without elaboration, and apparently accepted the assertion in the trustee's appellee brief that *Harrell* stands for the proposition that a "transferee cannot point to its avowed subjective ignorance as a defense."[540] *Harrell* does not support that conclusion.

In *Harrell v. Beall*, Harrell claimed he was an innocent purchaser for value.[541] The court noted that the question presented was "wholly one of the weight of evidence, involving no controverted proposition of law."[542] The Court affirmed the lower court's ruling that seventy-one pages of documents helped prove that Harrell's knowledge of the fraud could be inferred.[543] In a three paragraph decision, the Court affirmed the lower court's finding that the debtor was involved in a "barefaced fraud" and that if the transferee did not know it, it was because he "intentionally shut his eyes to the truth, and that he had such notice and information as made it his duty to inquire further, and that the slightest effort by him in that direction would have discovered the whole fraud."[544] The Court's emphasis in *Harrell* comports with its later holdings in *Van Iderstine* and *Dean*,[545] which were decided under the Bankruptcy Act.

The Supreme Court's reasoning is consistent in *Harrell*, *Van Iderstine*, and *Dean*. A transferee lacks good faith only when the transferee participated in the fraud, either through actual knowledge of the fraud or by consciously ignoring, *at the time the transaction was entered into*, clear signs that the transfer was designed to defraud creditors.

> As such, it is difficult to characterize *Harrell* as having established a standard where the transferee's good faith is to be

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http://uniformlaws.org/ActSummary.aspx?title=Fraudulent%20Transfer%20Act (last visited Dec. 21, 2012). *See* discussion *supra* notes 75–79 and accompanying text.

540. Answering Brief of Appellee, *supra* note 330, at 25 ("In this case, as in Harrell v. Beall, 84 U.S. 590 (1873), the transferee cannot point to its avowed subjective ignorance as a defense.").

541. *Harrell*, 84 U.S. at 590. The subject property was sold "for a merely nominal sum, one out of all proportion to its real value" to an intermediary, who was in collusion with the debtor. The intermediary then sold to Harrell "for a sum far below the value of the property purchased." *Id.*

542. *Id.* at 591.

543. *Id.* at 590–91.

544. *Id.* at 591.

545. *See supra* note 431.

> tested by the inquiries of a reasonably prudent man as opposed to the transferee's own honesty and integrity. To the contrary, *Harrell* seems to be more a harbinger of what is now known as "willful blindness"—i.e., inexcusable avoidance of the obvious.[546]

c. *Shauer v. Alton*'s definition of good faith ignored

The second "early case cited by the trustee" on which the Ninth Circuit Court based its "prudent man"[547] objective standard was *Shauer v. Alton.* The court based its application of *Shauer* on a single quote and no discussion:

> [K]nowledge or actual notice of circumstances sufficient to put him, as a prudent man, upon inquiry as to whether his brother intended to delay or defraud his creditors . . . should be deemed to have notice . . . as would invalidate the sale as to him.[548]

The court then concluded that *Shauer* stood for the proposition that "courts look to what the transferee objectively 'knew or should have known' in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint."[549] A closer look at *Shauer* shows that it, like *Harrell,* does not support an objective "prudent man" standard for good faith.

Shauer involved the sale of Louis Shauer's inventory and store to his brother Gustave in full payment of a debt Louis owed Gustave.[550] The issue was whether Gustave knew that Louis owed many debts, and this scheme was merely a way to move the store and inventory assets out of the reach of creditors.[551] The jury instruction stated:

> [I]f the facts brought to the attention of Gustave G. Shauer were such as to awaken suspicion, and lead a man of ordinary prudence to make inquiry, and he fails to make such inquiry, then he is chargeable with notice of fraudulent intent and *with*

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546. *In re* Teleservices Grp., Inc., 444 B.R. 767, 800 (Bankr. W.D. Mich. 2011) (footnote omitted).

547. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 535 (9th Cir. 1990).

548. *Id.* (quoting Shauer v. Alterton, 151 U.S. 607, 621 (1894)) (ellipses added by the *Agric. Research* court).

549. *Id.* at 535–36.

550. Shauer v. Alterton 151 U.S. 607, 619 (1894).

551. *Id.*

> *participation in the fraud*, and it will be your duty to find for the defendant.[552]

Thus the question in *Shauer* was whether Gustave had participated in a fraud against Louis's creditors or had acted in good faith. The United States Supreme Court quoted with approval the definition of good faith found in the Dakota statute:

> [T]o express it exactly, good faith consists in an honest intention to abstain from taking any unconscientious advantage of another, even through the forms or technicalities of law, together with an absence of all information or belief of facts which would render the transaction unconscientious; and notice [of creditor claims] is either actual or constructive.[553]

In the context of the Court's other holdings, taking advantage of another creditor must be more than merely receiving a preference. It must include *malum in se* conduct. It must be wrong.[554]

Contrary to the Ninth Circuit Court's citation of *Shauer* to support an objective standard, the Supreme Court used a standard of "honest intention" and "unconscientious advantage of another" to determine good faith—a decidedly subjective and morally based approach not founded merely on "inquiry notice." Even though the Court quoted an explicit definition of "good faith," the Ninth Circuit Court failed to use the Court's definition and instead exchanged the Court's subjective standard for its own objective one.

The Ninth Circuit Court cited *Shauer* and *Harrell* and then stated,

> These pronouncements indicate that courts look to what the transferee objectively "knew or should have known" in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint. Therefore, appellants' reference to the subjective assertions of good faith in the [transferee's] affidavit are of no moment.[555]

If the Ninth Circuit Court had actually applied the standards from those cases, the outcome would have been different. Both *Harrell* and *Shauer* were concerned with the transferee's knowledge of fraud at the time the

552. *Id.* at 620–21 (emphasis added) (internal quotation marks omitted).

553. *Id.* at 622 (internal quotation marks omitted).

554. *See* discussion *supra* Part II.B.1.

555. *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 535–36 (9th Cir. 1990).

transferee entered the transaction. This is important because it emphasizes the Court's focus on whether the transferee, in effect, *participated* in the fraud by knowing beforehand what the debtor was doing. The transferee in *Agricultural Research* proffered evidence that he was ignorant of the scheme.[556] The trustee offered no evidence to dispute the transferee's subjective good faith. Instead, the trustee argued, and the court accepted, that the transferee could not point to his avowed ignorance as a defense. In both *Harrell* and *Shauer*, the transferee was found, by trial jury, to be actually aware of the debtor's fraudulent scheme to defraud creditors. In contrast, the Ninth Circuit Court denied the transferee a trial because it found actual knowledge to be irrelevant to an objective standard.

2. A Shift to an Objective Standard Ignores Congress's Intent and the Plain Meaning of Good Faith

Courts analyzing the issue of good faith uniformly note that the Code does not define good faith, in spite of the critical position of good faith in fraudulent transfer doctrine. Further, courts have been reluctant to enunciate a firm definition. Apart from the Court's quotation of the Dakota good faith standard in *Shauer*,[557] the Supreme Court has not defined good faith in the context of fraudulent transfers. Nevertheless, the Supreme Court gives guidance on defining an undefined term. First, "Congress says in a statute what it means and means in a statute what is [sic] says there."[558] Congress could have chosen the objective phrase "knew or should have known." Congress could have chosen the phrase "inquiry notice." "Instead,

556. *See* Brief for the Appellants, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 532 (9th Cir. 1990) (No. 89-15416), 1989 WL 1129295 at *6–7, 16. First, the transferee "carefully researched and monitored [the debtor's] actions" before investing. *Id.* at *6. He reviewed the debtor's unaudited financial statements, which had been prepared by a reputable third-party accounting firm. *Id.* He was aware that a company dealing in foliage grown by the debtor was voluntarily undergoing scrutiny by the Securities and Exchange Commission as part of its registration process to make a public offering. *Id.* That company had been featured in the March 1984 edition of Money magazine. *Id.* The transferee knew that the debtor had been started by two well-respected state legislators and that the company had a track record of timely making payouts to investors for two years prior to the transferee's investment. *Id.* at *7. The transferee's contract with the debtor also involved third parties including a seed distributor in another state and an insurance company. *Id.* The transferee visited the debtor's place of business to confirm the contract was being performed. *Id.* The transferee reinvested money in subsequent projects. *Id.* at *16.

557. *See Shauer*, 151 U.S. at 622.

558. Sinclair, *supra* note 28, at 80 (quoting Hartford Underwriters Ins. Co. v. Union Planters Bank, 530 U.S. 1 (2000)).

it used the words 'good faith,' which have nothing other than a subjective meaning."[559]

Second, "[t]he plain meaning of words should be conclusive, except in cases where the literal interpretation produces a result demonstrably at odds with the intention of the drafters."[560] Since Congress did not define "good faith" in the Code, one must assume that Congress intended good faith to have the meaning commonly in use when the Code was enacted. Congress was undoubtedly aware of the definition of good faith used in the Uniform Commercial Code—"honesty in fact."[561] The promulgation of the Uniform Commercial Code had highlighted the need for a reformed, uniform bankruptcy system and Congress responded with the Bankruptcy Code.[562] Since the primary purpose for the Bankruptcy Clause is to create a unified national economy,[563] one can reasonably assume that Congress intended terms undefined in the Code to have their standard business meaning. The use of standard business meanings for other terms undefined in the Code support this assumption.[564]

In spite of these indications that Congress intended a subjective definition of good faith aligned with the UCC's "honesty in fact" or the *Shauer* Court's "honest intent," the push to substitute a new, objective definition has infected the courts. To its credit, the *Bayou* bankruptcy court attempted to explain why the definition used by the court is "somewhat different from the traditional notion of good faith as the term is customarily

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559. *Id.*

560. *Id.* (citing United States v. Ron Pair Enter., 489 U.S. 235 (1989)).

561. Craig T. Lutterbein, Note, *"Fraud and Deceit Abound" but Do the Bankruptcy Courts Really Believe Everyone Is Crooked: The Bayou Decision and the Narrowing of "Good Faith,"* 18 AM. BANR. INST. L. REV. 405, 446 (2010). Although an objective component was proposed, it was rejected in the early definition. *Id.* The definition of good faith in the UCC as passed in 1978, roughly the same time that Congress enacted the Bankruptcy Code, was purely subjective. *Id.* at 444 n.305 (citing Robert Braucher, *The Legislative History of the Uniform Commercial Code,* 58 COLUM. L. REV. 798, 812–14 (1958)). The objective prong was added in the early 1990's. *Id.* The current UCC Definition is "honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 1-201(20) (2012).

562. NORTON, *supra* note 44, § 2:1.

563. *See* discussion *supra* Part II.A.1.

564. *See, e.g., In re* Price, 562 F.3d 618, 624 (4th Cir. 2009) (looking to the Uniform Commercial Code to define "purchase money security interest"); *In re* Waner Corp., 146 B.R. 973, 979 (Bankr. N.D. Ill. 1992) (using Article 9 of the UCC to determine claim priority on unperfected security interests); *In re* Fursman Ranch, 38 B.R. 907, 911 (Bankr. W.D. Mo. 1984) (noting that the term "feasible" is not defined in the code and looking to the business concepts of earning capacity, dividend requirements, and capital structure).

used by laymen."[565] The court acknowledged that "[i]n common parlance," good faith means "a conformity with accepted standards of integrity, trust and *good* conduct and the absence of any of the usual indicia of *bad faith* such as dishonesty, deceit, intent to harm or complicity in some form of wrongdoing."[566] The court cautioned that "the narrow, layman's definition is not the meaning ascribed to Section 548(c) 'good faith' by the case law."[567] Rather, the court adopted the "broader meaning expressed in Black's Law Dictionary."[568] Black's Law Dictionary quoted the Court's subjective definition of "honest intent" as well as "freedom from knowledge."[569] Nevertheless, the bankruptcy court construed the definition to mean that an investor who redeems his investment because he suspects the debtor might be financially unstable cannot claim the good faith defense even if the investor had no "bad faith."

> [A]ny rational investor or financial advisor, on inquiry notice of a warning signal respecting an investment, would be entirely justified in requesting or recommending redemption and could not be criticized for doing so. Indeed, it would be quite reasonable for an investor to decide to redeem solely on the basis of the red flag without making any inquiry, since the investor has no obligation to any third party to make any inquiry. But if he does so, the courts have held that he cannot invoke the good faith defense under Section 548(c).[570]

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565. *In re* Bayou Grp., LLC, 396 B.R. 810, 847 (Bankr. S.D.N.Y. 2008*) aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

566. *Id.* at 847 (footnote omitted).

567. *Id.* at 847–48. By "case law," the court was probably referring to its lengthy quotation of the Plaintiffs' [Trustees'] Omnibus Memorandum of Law, which stated that "federal courts have reached a consensus that 'good faith' as used in section 548(c) must be determined according to an 'objective' or 'reasonable person' standard, and not on the subjective knowledge or belief of the transferee." *Id.* at 844.

568. *Id.* at 847–48, 848 n.8 (noting that the definition of "good faith" in Black's Law Dictionary (1990) is broader and includes "'freedom from knowledge of circumstances which ought to put the holder upon inquiry' and 'an honest intention to abstain from taking any unconscientious advantage of another, even through technicalities of law, together with absence of all information, notice, or benefit or belief of facts which render transaction unconscientious.'"). The latter definition is from Shauer v. Alterton, 151 U.S. 607, 622 (1894).

569. *See supra* text accompanying note 567.

570. Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (*In re* Bayou Grp., LLC), 396 B.R. 810, 851 (Bankr. S.D.N.Y. 2008).

The bankruptcy court's reasoning no doubt contributed to the district court's reversal of the good faith standard used by the bankruptcy court.[571] Nevertheless, the court laudably explained its reasoning in departing from the traditional subjective meaning. Most courts do not bother with analysis but simply state that the consensus is an objective standard.

Third, the current Code is to be interpreted in "a manner that is consistent with prior bankruptcy practice unless Congress has expressly indicated a different intent."[572] Because the Bankruptcy Act, like the Code, did not define the term "good faith," it is reasonable to assume that Congress intended for good faith to have the meaning in use at the time.

a. The good faith standard has historically been subjective

Common law fraudulent transfer doctrine can be traced back to the statutes of Elizabeth, which were created to combat the problem of fraudulent transfers.[573] The primary fraud at that time was the "selling" of assets to third parties but the retaining of use of the property by the debtor.[574] In these earliest scenarios, the purported transferee had to know the transaction was not normal because the debtor retained the purportedly transferred item. In contrast, both the statutes of Elizabeth and the American application of the statutes dictated that a transfer was not voidable if the transferee paid equivalent value without knowledge of the fraud.[575] Forty years before the Bankruptcy Act, the "settled American

571. *In re* Bayou Grp., LLC, 439 B.R. 284, 322–23 (S.D.N.Y. 2010).

572. *In re* Teleservices Grp., Inc., 444 B.R. 767, 806 (Bankr. W.D. Mich. 2011) (collecting cases); *see* Hamilton v. Lanning, 130 S. Ct. 2464, 2473 (2010) ("[W]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." (internal quotation marks omitted)).

573. Clayborn v. Hill, 1 Va. 177, 183 (1793) ("This inconvenience produced the Statutes of *Elizabeth* respecting fraudulent conveyances. The preamble recites the mischief which resulted from the possession remaining in one person, whilst the property was transferred to another, whereby creditors, and purchasers, were defrauded; and the Judges stretched as far as they well could, to carry this Statute into full effect."). *See* cases cited *supra* notes 69–71 and accompanying text.

574. *Id.* Judge Breyer recognized this as lying to creditors—the debtor "pretending he has no property left, when he really has some (in the hands of his friend)." Boston Trading Grp., Inc. v. Burnazos, 835 F.2d 1504, 1508 (1st Cir. Mass. 1987).

575. Grumbles v. Sneed, 22 Tex. 565, 577 (1858) (noting "the settled American doctrine" that "a *bona fide* purchaser, for a valuable consideration, is protected under the statutes of 13 and 27 Elizabeth, as adopted in this country, whether he purchases from a fraudulent grantor, or a fraudulent grantee").

doctrine" was that a good faith purchaser for value was protected from avoidance of the transfer.[576]

Historically, analysis of good faith focused on fair consideration. If the debtor receives fair consideration for the transfer, then there is no fraudulent transfer—regardless of whether the transferee exhibited good faith.[577] The good faith defense under the Bankruptcy Act was merely a parenthetical within the avoidance statute that prohibited the bankruptcy trustee from avoiding transfers to "purchasers in good faith and for a present fair consideration."[578] The *Coder* Court stated that "[t]he question as to whether a transfer is made with intent to hinder, delay, or defraud depends upon whether the act done is a bona fide [good faith] transaction."[579] The Court's analysis looked to the nature of the transaction to determine good faith, rather than looking to good faith to determine the nature of the transaction. "So long as the transfer does not diminish the estate, the motives of debtor and grantee are immaterial."[580]

Although Congress modified the fraudulent transfer provision when it enacted the Bankruptcy Code, it still did not define good faith. The Bankruptcy Act had contained two good faith defenses, one for those who paid "present fair equivalent value" and one for those who, although acting in good faith, paid less than fair value.[581] The Bankruptcy Code combined both provisions into § 548(c).[582] In doing so, Congress replaced the terms "bona fide" and "without actual fraudulent intent" with the single term "good faith."[583] One can reasonably assume, then, that Congress considered the terms synonymous. If Congress had intended to create a new standard for good faith, then it most certainly would have defined the term. By using the term "good faith" to replace "without actual fraudulent intent," Congress supports the notion that good faith is simply honest dealing.

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576. *Id.*

577. GLENN, *supra* note 83, § 300 ("So long as the transfer does not diminish the estate, the motives of debtor and grantee are immaterial.").

578. *In re* Teleservices Grp., Inc., 444 B.R. 767, 804 (Bankr. W.D. Mich. 2011) (quoting The Bankruptcy Act of 1898, § 67(e)).

579. Coder v. Arts, 213 U.S. 223, 244 (1909).

580. GLENN, *supra* note 83, § 300.

581. *In re* Teleservices Grp., Inc., 444 B.R. 767, 805–06 (Bankr. W.D. Mich. 2011).

582. *Id.* at 806.

583. *Id.*

b. Congress's use of the term "good faith" in a related section supports a subjective definition

In addition to Congress's reliance on the historically subjective meaning of good faith, Congress's use of the term "good faith" in a related Code section supports a subjective definition. The fraudulent transfer statute provides § 548(c) as a defense to *avoidance* of the transfer.[584] If the transferee took for value in good faith, then the trustee cannot recover the transfer. If the transferee does not fall within the protection of § 548(c), then the bankruptcy trustee uses § 550 to recover the property for the estate.[585] The § 548(c) defense protects the initial transferee.[586] Section 550 provides an additional defense to subsequent transferees.[587] In § 550(b)(1) the transfer may not be recovered from a subsequent transferee who gave value in good faith and without knowledge of the transfer.[588] Congress distinguished good faith from notice or knowledge by listing them as two separate elements of the defense. Additionally, Congress eliminated the knowledge requirement for immediate or mediate transferee's of the initial subsequent transferees.[589] In other words, the initial transferee may retain the transfer under § 548(c) if he takes for value in good faith. The initial subsequent transferee may keep the transfer if he takes for value, in good faith, and without knowledge of the voidability of the transfer. Later transferees may keep the transfer if they took in good faith. A definition of good faith that incorporated inquiry notice would be nonsensical in § 550(b)(2) where a transferee may have good faith even if he has actual knowledge of the voidability of the transfer. "To hinge the good faith analysis on notice, or even actual knowledge, would require that one definition be given to good faith when evaluating the first transfer and a

584. *See supra* note 193 and accompanying text.

585. *See* discussion *supra* Part II.B.3.

586. 11 U.S.C. § 548(c) ("[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." (emphasis added)).

587. 11 U.S.C. § 550(b) ("The trustee may not recover under section (a)(2) of this section from—(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee of such transferee.").

588. *Id.*

589. *Id.*

second definition given to good faith for the second transfer."[590] Thus, Congress could not have intended the term "good faith" in § 548 to have a different meaning than the same term in § 550, especially since it did not define the term.

3. A Shift to an Objective Standard Destroys the Good Faith Defense

Investor victims of the *Bayou* Ponzi scheme tried unsuccessfully to convince the bankruptcy court that the objective standard effectively destroys the good faith defense. The investor victims noted that "[i]t would be an almost impossible standard to meet."[591] The objective standard requires that an investor make a diligent inquiry if a reasonably prudent investor would have become suspicious, *and* that, as a result of the investigation, the investor "have no lingering concerns or suspicions regarding the transferor and the transfer."[592] If a defendant is relying on the § 548(c) good faith defense, then by definition the debtor was engaged in actual fraud.[593] Under the objective standard, a diligent inquiry that exposes the fraud will give the investor *actual* knowledge and bar receipt of future good faith transfers. Because, by definition, the transferor is involved in fraudulent activity, an inquiry that does not expose the fraud can always be said to have been insufficiently diligent. Only a "diligent" inquiry that results in a belief by the investor, with no lingering doubts, that there is no fraud will preserve the good faith defense.[594]

The *Bayou* bankruptcy court rejected these observations, stating that the investor victims "misstate[] the case law."[595] The court emphasized that § 548(c) is an affirmative defense and therefore each "redeeming investor must prove that he took the redemption payment 'in good faith.'"[596] According to the court, an investor had good faith only if he took "his investment out of the particular Bayou fund 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

590. Lutterbein, *supra* note 562, at 442.

591. Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (*In re* Bayou Grp., LLC), 396 B.R. 810, 851 (Bankr. S.D.N.Y. 2008).

592. *Id.*

593. *Id.*

594. *Id.*

595. *Id.*

596. *Id.*

and its remaining investors."[597] The court declared again that the "case law holds that the redeeming investor cannot sustain his burden to prove his good faith if the evidence shows that he was on objective notice of *some infirmity in the fund.*"[598]

The district court rejected the bankruptcy court's expansion of objective notice to include "[s]ome infirmity in the integrity of [the fund's] management," replacing it with notice of insolvency.[599] The court noted that the bankruptcy court's objective standard combined with its expanded inquiry notice requirements "render the good faith defense largely illusory whenever a transferor is actually engaged in fraud or is insolvent."[600] But the district court retained the requirement that once a reasonable man would be on notice, the investor must conduct a diligent inquiry to the point that his fears are allayed and he firmly believes there is no fraudulent activity.[601] Since the transferor is, in fact, conducting a fraudulent scheme, it is difficult to see how the objective standard affords any hope of a good faith defense. The bankruptcy court declared that it was "precisely the purpose and the effect of the objective approach adopted by all the courts in interpreting § 548(c) to virtually rescind the availability of the 'good faith' defense" in cases where a diligent inquiry leaves any lingering suspicions.[602]

While rejecting the investor-victim's argument that the requirement of a diligent inquiry that turns up nothing will destroy the good faith defense, the court acknowledges that inquiries will never reach that level of diligence.

> As a practical matter, few if any "inquiry notice" investigations will be carried on to the point of actually proving fraud. Once the investigation encounters evasion or stonewalling exacerbating the concerns caused by the original red flag, the sensible investor

597. *Id.*

598. *Id.* (emphasis added).

599. *In re* Bayou Grp., LLC, 439 B.R. 284, 314 (S.D.N.Y. 2010).

600. *Id.* at 316.

601. *Id.*

602. *Bayou Accredited Fund, LLC*, 396 B.R. 810 at 852 (internal quotation marks omitted). Although the district court reversed the court's definition of good faith, it merely moved the inquiry line from "any infirmity" to "insolvency or fraud." The outcome is the same if an investor suspects that the business is insolvent.

> will promptly redeem without spending more time and money on further inquiry.[603]

The objective standard requires of investors actions that are neither reasonable nor prudent. It is difficult, then, to see how such actions can be legally "objective"—what a reasonably prudent investor" would do.

In regard to one group of investor victims, the bankruptcy court noted that "[t]here is not a single element of 'bad faith' or misconduct of any sort on the part of [this defendant] or its clients. Quite the contrary, the ... decisions ... were in every respect proper and entirely reasonable in the circumstances."[604] The court, nevertheless, denied the good faith defense, reasoning that one can lack good faith but not necessarily have "bad faith." Traditional case precedent and doctrine hold that a fraudulent transfer must be *malum in se*—a bad act.[605] Nevertheless, the *Bayou* bankruptcy court declared that Congress did not intend the good faith requirement, or fraudulent transfer avoidance, to deter bad conduct.[606] "Like Section 547, which requires innocent creditors to refund payments of money owed to them within ninety days of a bankruptcy filing, Section 548 seeks to promote a limited degree of equality of treatment among creditors ...."[607] In its support of the objective standard, the court thereby ignored well-established Supreme Court precedent distinguishing between the purpose and nature of preferences and fraudulent transfers. Conflating the two, the court used the objective standard to create a "super preference"[608] that can claw back from investor-victims who exhibited no "bad faith." Although the district court reined in the bankruptcy court, the natural result of an objective standard is exactly what the *Bayou* investors feared and the district court acknowledged. "[T]he good faith defense [is rendered] largely illusory whenever a transferor is actually engaged in fraud or is insolvent."[609]

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603. *Id.* Although the bankruptcy court's standard was modified by the district court, the bankruptcy court's position is the natural evolution when embracing an objective standard. With hindsight, courts find it easier to reason that a reasonable investor would have seen indications of fraud.

604. *Id.* at 866.

605. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582 (1913).

606. *Bayou Accredited Fund, LLC*, 396 B.R. at 866.

607. *Id.*

608. *See* discussion *supra* Part III.B.

609. *In re* Bayou Grp., LLC, 439 B.R. 284, 316 (S.D.N.Y. 2010).

4. The Shift to an Objective Standard Applies "Equitable" Policies Inconsistently

Fraudulent transfer is a legal, not equitable remedy. While legal doctrines provide stability, equitable ones allow courts opportunity to fashion rules they believe fit the facts of the case. This judicial power is detrimental to business.

a. The policies impose an unreasonable expectation

An investor with a little money to invest might wonder how to protect herself against the claw back of her money if a company should turn out to be a Ponzi scheme. Under traditional principles of fraudulent transfer avoidance, a person who "traded normally" and exchanged equivalent value could be confident that a transfer would not be avoided as fraudulent. Traditionally, the concepts of good faith and equivalent value, along with arm's-length trading, were intertwined. Today, there is no such assurance. Courts that have adopted the objective standard for good faith create a mythical "reasonably prudent investor." Courts have determined that this prudent investor would spot red flags of insolvency or fraud. Courts, with the benefit of perfect hindsight, decide what a prudent investor would have noticed and attribute that knowledge to all investors under the "knew or should have known" standard. This is in spite of the fact that thousands of similarly situated investors, some of whom were sophisticated businessmen and experienced traders, failed to spot the signs of fraud.[610]

The Madoff scheme presents an even starker picture of the unrealistic expectation that the court can determine what a "reasonably prudent investor" "should have known." A reasonably prudent investor, realizing that he or she does not have the funds or ability to investigate a firm, relies on regulatory oversight. A cautiously prudent investor may also limit investments to those that are insured.[611] Bernard Madoff and his hedge fund

610. *See id.* Although the *Bayou* district court rolled back the most egregious extensions of the bankruptcy court's objective standard, it still found that investors who "should have known" of the company's insolvency because of red flags lacked good faith. Paul Sinclair & Brendan McPherson, *Red Flags of Fraud: Background for Due Diligence*, 30-4 AMER. BANK. INSTITUTE J. 34, 34 (2011).

611. Sullivan, *supra* note 447, at 1593–96. Many prudent Madoff victims had investments insured by the SIPC. *Id.* A prudent investor might rely heavily on the fact that SIPC-insured brokers are regulated by the SEC. *Id.* Prudent investors might also rely on the SIPC's express promise that insured securities would be replaced (even if the broker never bought them) if malfeasance by the broker is discovered. *Id.* These prudent investors, however, were left holding empty accounts when the court allowed the SIPC to change its guarantee. As a

were under the regulatory authority of the Securities and Exchange Commission.[612] The SEC investigated Madoff and his company at least five times over two decades, yet never discovered Madoff's massive fraud.[613] The appearance of legitimacy makes Ponzi schemes difficult to see.[614] "Red flags," that seem obvious in hindsight, were not obvious at the time. Every fraudulent schemer needs a plausible investment strategy to lure people in. Madoff developed a complex investment strategy that seemed plausible.[615] Although fraudulent schemes of the past may have targeted the ignorant or greedy,[616] modern schemes lure in the prudent. Madoff, for example, was able to lure in reasonably prudent investors because the investments were insured by the SIPC, regulated by the government, and recommended by investment professionals. Courts, using hindsight, determine which "red flags"—missed by experienced business people and government regulators—should have been seen by investor victims.

b. Case-by-case decisions

Rather than rule in a manner consistent with law and precedent, courts handling large Ponzi scheme cases struggle with finding an equitable solution. When defining terms or constructing tests, courts often are "influenced substantially by the equities of the particular fact situations before the courts."[617] This influence would be less troubling if the doctrine being applied was an equitable doctrine instead of a legal one. As courts become untethered from the well-established traditional interpretations of fraudulent transfer doctrine, decisions are "marked by a lack of clarity if not outright confusion."[618] An example of this lack of clarity is the use in the

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result, investor-victims who prudently invested in a federally insured and regulated security suffer the same losses as those who chose riskier investments. *Id.*

612. *Id.* at 1596.

613. *Id.* at 1622.

614. *Id.*

615. *Id.* at 1622–23.

616. In his blog, *Becker-Posner Blog*, Judge Richard Posner describes victims of classic schemes as "greedy dopes," "the least sophisticated," and "suckers." Posner, *supra* note 19. This view of Ponzi victims reflects the lack of sympathy for those who have been swindled and suggests why courts allow investor victims to be pursued by bankruptcy trustees.

617. *In re* Bayou Grp., LLC, 439 B.R. 284, 309–10 (S.D.N.Y. 2010) (internal citation omitted).

618. *Id.* at 309 ("As a result, courts have struggled in applying [inquiry notice], and the case law discussing Section 548(c)'s good faith affirmative defense is marked by a lack of clarity if not outright confusion.").

objective standard of the term "inquiry notice." Under traditional tests of good faith, the standard was a subjective one—honesty and lack of knowledge or participation in the fraud. In contrast, courts applying the objective standard "focus on the circumstances specific to the transfer at issue—that is, whether a transferee 'reasonably should have known . . . of the fraudulent intent underlying the transfer.'"[619] By focusing on factually specific determinants, the definition of inquiry notice becomes a moving target. An investor victim might be on inquiry notice and, therefore, lack good faith if he was on notice of "a debtor's fraudulent *purpose*[,]"[620] or if he was on notice of "the possibly fraudulent nature of the *transaction*[,]"[621] or if he was on notice of facts that would have alerted him to "the debtor's fraudulent purpose" if he had not "chosen to remain willfully ignorant of [the] facts,"[622] or if he was on inquiry notice "of any facts that would have caused a reasonable person to make further inquiry."[623] Some courts add another layer of analysis by rejecting a generic, reasonable person standard, for a modified, reasonable person standard based on the "standards, norms, practices, sophistication, and experience generally possessed by participants in the transferee's industry or class."[624] Courts thereby apply inconsistent "objective" standards and deprive investors of stability and predictability.

5. A Shift to the Objective Standard Harms Business

The purpose of the Bankruptcy Clause is to promote the orderly flow of interstate commerce.[625] Bankruptcy and business are intimately

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619. *Id.* at 311 (quoting Jobin v. McKay (*In re* M & L Bus. Mach. Co.), 84 F.3d 1330, 1336 (10th Cir. 1996)).

620. *Id.* at 311–12 (emphasis added) (quoting *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 536 (9th Cir. 1990)).

621. *Id.* (emphasis added) (quoting Boyer v. Crown Stock Distribution, Inc., No. 1:06–CV–409RM, 2009 WL 418275, at *14 (N.D. Ind. Feb. 17, 2009).

622. *Id.* (quoting Luzinski v. Gosman (*In re* Gosman), No. 01–30953–BKC–PGH, 2005 Bankr. LEXIS 3183, at *52 (Bankr. S.D. Fla. Mar. 1, 2005)).

623. *Id.* (quoting Development Specialists, Inc. v. Hamilton Bank, N.A. (*In re* Model Imperial, Inc.), 250 B.R. 776, 798 (Bankr. S.D. Fla. 2000)). The *Bayou* court went on to cite the varied objective tests from more than twenty other courts. *Id.* at 311–12, 310 n.23.

624. *Id.* at 313. The *Bayou* bankruptcy court thus phrased its issue as whether the information "would have put a *reasonably prudent institutional hedge fund investor* on inquiry notice" that the debtor was insolvent or had a fraudulent purpose. *Id.* (emphasis added).

625. NORTON, *supra* note 44, § 1:3. *See* discussion *supra* Part II.A.1.

intertwined.[626] At the heart of every Ponzi scheme transfer is a business transaction. Although hindsight may be nearly perfect, an investor evaluating the risk and reward of a business opportunity does not have the benefit of hindsight. Every investor must make his decision to invest based on the risk that he might not be repaid any or all of his principal, that the company might go bankrupt, that the company might be perpetrating a fraud, or that an executive or manager might embezzle the funds.[627] Each investor in an enterprise that turns out to be a Ponzi scheme made the decision based on the same risks and the same hope of reward.[628] Business must have a consistent and stable bankruptcy system in order to make risk/reward decisions.

Every investor knows that she may lose her investment because of a bad investment choice. Emphatically, that is *not* what fraudulent transfer avoidance is. Rather, avoidance means the clawing back of money already received on the investment, and possibly already spent. Although an investor knows she may lose her investment, she does not expect the funds in her own possession to be at risk. Under the current system, and with the proliferation of sophisticated and credible Ponzi schemes, an investor who redeems a certificate of deposit,[629] sells a security through a licensed broker,[630] or invests money in a business[631] is vulnerable to claw back for up to six years.[632] To fend off the trustee attacks requires attorney fees and

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626. Ry. Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 465–66 ("As James Madison observed, 'the power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce and will prevent so many frauds where the parties or their property may lie or be removed into the different states, that the expediency of it seems not likely to be drawn into question.'").

627. *See In re* Unified Commercial Capital Inc., 260 B.R. 343, 351 (Bankr. W.D.N.Y. 2001), *aff'd sub nom. In re* Unified Commercial Capital, 01-MBK-6004L, 2002 WL 32500567 (W.D.N.Y. June 21, 2002).

628. *See id.*

629. *See, e.g.*, Barasch, *supra* note 32, at 924 (discussing the Stanford Ponzi scheme where victims purchased fictitious certificates of deposit).

630. *See, e.g.*, Picard v. Katz, 462 B.R. 447, 451 (S.D.N.Y. 2011) (noting that Madoff Securities was a licensed and insured securities dealer), *motion to certify appeal denied*, 466 B.R. 208 (S.D.N.Y. 2012).

631. *See, e.g.*, *In re* Agric. Research & Tech. Grp., Inc., 916 F.2d 528, 532 (9th Cir. 1990) (finding a Ponzi scheme where investors invested in a foliage business).

632. Sinclair, *supra* note 28, at 78 ("For the investors with Bernie Madoff, or the several other Ponzi cases now emerging in 2008's cataclysmic market reversal, a broad and expansive reading of good faith can make the return of $125 million to the investors in *Bayou* look like pocket change. This is even more troublesome because *Bayou*, *Madoff* and

lengthy litigation. And to add insult to injury, a court may add pre-judgment interest to the avoided transfer.[633]

Uncertainty chills investment in business. An investor naturally tries to maximize return on investment while avoiding scams that seem too good to be true. Inconsistent rulings by courts assessing what is an "unreasonable" rate of return make the evaluation even more difficult—especially since a wrong choice can defeat a future claim of good faith.

> *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. 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. 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.[634]

Commerce requires predictability. Bankruptcy laws provide that predictability. Congress has balanced competing policy concerns like limitations periods, distributional enhancement, and distributional equality. When courts substitute equitable judgments for the legal remedy of fraudulent transfer, outcomes become unpredictable.[635]

> [T]he United States Supreme Court has emphasized that where, as here, the operative language of an applicable statute is plain and unqualified, courts should be loath to announce equitable exceptions thereto. The creation of such non-textual equitable exceptions is especially problematic in the context of fraudulent transfer law, which is itself equitable in nature—acting to upset

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other cases are in New York, which has a six-year statute of limitations for fraudulent transfers.").

633. *Agric. Research*, 916 F.2d at 541–42.

634. Jessica D. Gabel et al., *The Collapse of Financial Fraud: Measuring Bankruptcy Avoidance Actions*, 42 GOLDEN GATE U. L. REV. 587, 610 (2012) (internal citations omitted).

635. *See* George P. Roach, *Rescission in Texas: A Suspect Remedy*, 31 REV. LITIG. 493, 495 (2012) ("Sitting in equity, a trial judge has greater authority to issue more forceful orders to the litigants and greater discretion to deny particular equitable remedies than for remedies at law. The resulting unpredictability and risk to the final outcome is compounded by the fact that equitable remedies are not well understood by lawyers or the judiciary . . . .").

the pre-existing contractual rights and expectations between transferor and transferee.[636]

IV. PROPOSAL

As one court noted, the ideal outcome when a Ponzi scheme collapses would be for all victims to receive back their money from the perpetrator's assets.[637] The perpetrator, however, has already spent the received funds—either on personal expenses or on payments to earlier investors.[638] The court suggested that the next best thing would be to force all victims to share pro rata in the losses.[639] The court noted that attempts to claw back money involve expensive court litigation and would not be effective against transfers made prior to the avoidance window.[640] The court concluded that courts, "unable to do perfect justice," must assume that justice will be best served by simply applying the Code as promulgated by Congress.[641]

Congress has already drawn a line between redistribution and "allow[ing] the losses to rest where they fell."[642] Congress has already balanced the needs of debtors, creditors, and the business world by establishing two distinct avoidance sections—one for preferences and one for fraudulent transfers. Congress has already balanced justice and the need for repose by establishing specific time limitations on avoidance. If the balance is to be changed, Congress must change it.[643]

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636. *In re* Carrozzella & Richardson, 270 B.R. 92, 99 (Bankr. D. Conn. 2001).

637. *In re* Indep. Clearing House Co., 77 B.R. 843, 887 (D. Utah 1987).

638. *Id.*

639. *Id.*

640. *Id.*

641. *Id.*

642. Donell v. Kowell, 533 F.3d 762, 776 (9th Cir. 2008).

643. In 2010, a bi-partisan group of representatives introduced legislation that would have protected Ponzi scheme victims. *Perlmutter & Members of Congress Introduce Legislation to Improve Relief for Victims of Madoff & All Ponzi Scheme,* (April 15, 2010), http://perlmutter.house.gov/index.php?option=com_content&view=article&id=726. The bill was sponsored by U.S. Representatives Gary Ackerman (D-NY), Peter King (R-NY), Ron Klein (D-FL), Dan Maffei (D-NY), Ed Perlmutter (D-CO) and Jackie Speier (D-CA), all of whom were members of the House Financial Services Committee. *Id.* The bill would have prohibited "clawing-back any money from victims unless the bilked investor was proven to be complicit or negligent in their participation in the Ponzi scheme in bankruptcy court." *Id.* The bill was referred to committee where it died. H.R. 1987 (112*th*): Ponzi Scheme Investor Protection Act of 2011, http://www.govtrack.us/congress/bills/112/hr1987.

Nevertheless, because of the misapplication of these statutes in the Ponzi context, Congress should add a provision to the fraudulent transfer section of the Code to clarify the limits on avoidance in a Ponzi scheme situation. Congress could easily clarify the fraudulent transfer issue by adding a subsection to § 548.[644] In that section, after actual and constructive fraudulent transfers are described in § 548(a)(1),[645] Congress codified as § 548(a)(2)[646] an exception for transfers to charities.[647] Congress could add a new subsection—(a)(3)—which states:

> (3) A transfer made pursuant to a Ponzi scheme shall not be considered to be a transfer covered under paragraph (1)(A) in any case in which—
>
> (A) the transfer was consistent with the practices of the debtor;
>
> (B) the aggregate value of transfers from the transferee to the debtor exceeds the aggregate value of the transfers from the debtor to the transferee; and
>
> (C) the transferee was not an insider or acted without good faith.

Definitions for the terms "Ponzi scheme" and "good faith" should be included in § 548(d)(2),[648] which already lists definitions for this section. Two new subsections could be added as (d)(2)(F) and (G):

> (F) "Ponzi scheme" means a fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments, and money from the new investors is used directly to repay or pay interest to

644. For the text and discussion of 11 U.S.C. § 548, see *supra* note 197.

645. *Id.*

646. 11 U.S.C. 548(a)(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.").

647. *Id.*

648. 11 U.S.C. § 548(d)(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 . . . .").

earlier investors, without any operation or revenue-producing activity other than the continual raising of new funds.[649]

(G) "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing.[650]

The result of adding this language would be to codify the well-established principles used prior to the *Agricultural Research* decision. The presumption that Ponzi scheme payments are avoidable under the actual fraud provision would be replaced with a presumption that they are not. This would, at least to the extent that the debtor received value from the transferee, force the bankruptcy trustee to avoid the transfers under the constructive fraud provision. Any "net-loser" victim would be protected from the trustee's avoidance actions unless the trustee could show that the victim had gotten an unusual payment or had acted in bad faith. "Net winner" victims would be vulnerable only to the extent of the fictitious profits received. Further, defining good faith would ensure that transferees would be targeted only if the transferee knew that the transaction was abnormal. This would return the good faith standard to that established by the Supreme Court in *Harrell*,[651] *Van Iderstine*,[652] and *Coder*.[653] Unless Congress creates an exception for Ponzi schemes, the fraudulent transfer doctrine should be applied to Ponzi schemes in the same way it is applied to other bankrupt businesses.

Until Congress acts, courts should return to the well-established principles of the fraudulent transfer doctrine. First, the court must determine if the transfer was a preference or a fraudulent transfer. If the transfer merely prefers one creditor over another, then it is not avoidable under the fraudulent transfer statute—regardless of whether the debtor had actual intent to defraud. Since Ponzi scheme victims have a rescission claim, a transfer up to the amount of principal invested would be safe from the claws of a trustee because such transfers merely prefer an earlier investor creditor over a later one.

Second, a subjective standard of good faith should be applied. Although sometimes phrased as a subjective-objective test, "knew or should have

649. BLACK'S LAW DICTIONARY 1198 (8th ed. 2004).

650. U.C.C. § 1-201(20) (2012).

651. Harrell v. Beall, 84 U.S. 590, 591 (1873). *See* discussion *supra* Part III.C.1.b.

652. Van Iderstine v. Nat'l Disc. Co., 227 U.S. 575, 582–83 (1913). *See* discussion *supra* Part II.B.1.b.

653. Coder v. Arts, 213 U.S. 223, 242 (1909). *See* discussion *supra* Part II.B.1.a.

known," the issue is whether the transferee knew at the time of the *initial transaction* that a fraud was being perpetrated.[654] Such knowledge of or willful blindness regarding the fraud makes the transferee, in essence, a co-perpetrator of the crime. The well-established standard differs from analyzing what a transferee knew about the debtor's insolvency later when payments were received. It is unreasonable to find an investor lacks good faith simply because he suspects the business may be experiencing financial difficulty and withdraws his money.[655] A lack of good faith should be found only when the investor fails to act honestly.

V. CONCLUSION

Ponzi scheme victims face a second wave of financial devastation when courts use an avoidability presumption and employ an objective "prudent investor" standard for good faith. The protection for victims should be restored. Courts should return to well-established principles of fraudulent transfer by carefully distinguishing between fraudulent transfers and mere preferences and by returning to the subjective standard for good faith.

654. *See* discussion *supra* Part III.C.

655. *See* discussion *supra* Part III.C.3.