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The Sad Tale of Fraudulent Transfers: Part III

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In two *ABI Journal* articles in 2009, the good-faith defense under §548(c) of the Bankruptcy Code was discussed.[1] This article continues the discussion of what is practically the only defense for investors who are sued by Ponzi scheme bankruptcy trustees[2]—and those defendants must prove that they received the payments "for value and in good faith." The previous articles focused on good faith in the context of payments received for return of principal invested with Ponzi operators. Both explored the meaning of good faith, and whether it meant general honesty of purpose, lack of knowledge of the fraud, or as determined in some cases, knowledge or would have had knowledge with a high degree of due diligence. This article focuses on the defense with respect to payments other than a return of principal.

Paul Sinclair

In the context of return of principal, "value" is a given because §548(d)(2)(A) defines "value" to include antecedent debt. Furthermore, under a theory of constructive fraud, whether under the Bankruptcy Code, the Uniform Fraudulent Conveyance Act (UFCA)

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or the Uniform Fraudulent Transfer Act (UFTA), a trustee must prove lack of "reasonably-equivalent value," and again, "value" includes antecedent debt.[3] In fact, courts have held that the recipient's rescission claim constitutes adequate

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value.[4] Therefore, the remaining prong of the legal defense is solely "good faith."

Brendan McPherson

When first reading through the law, it is too easy to take a broad brush statement as true, such as: "Suffice it to say that *Independent Clearing House* stands for the universally-accepted rule that investors may retain distributions from an entity engaged in a Ponzi scheme to the extent of their investments, while distributions exceeding their investments constitute fraudulent conveyances which may be recovered by the Trustee."[5] While the court qualified this statement in a later opinion in a different case,[6] it is more plausible to say that investors may retain their original investments if the courts do not take too broad a view of the "objective" standard of "good faith," applying a "knew or should have known" formula. Likewise, it is more plausible to state that brokers, lenders with a reasonable rate of interest and trade creditors may retain their full payments, while those promised profits or high rates of interest may not.

As discussed in the previous articles, there is a clear disparity in court opinions between those courts arguing for an objective, broad view, and holding that agreements with Ponzi operators are unenforceable as a matter of public policy,[7] thus requiring forfeiture of any payments, as compared with courts that closely parse the statutory language and refuse to extend the purposes of fraudulent-transfer law beyond what they argue is plainly written.[8]

Setting the Stage: Commission Payments to Brokers

One of the first modern cases to address commissions as fraudulent transfers was *In re Universal Clearing House Co. (Merrill v. Allen)*.[9] In *Universal*, 127 brokers were sued by the trustee of a Ponzi scheme for the return of commissions they earned in bringing investors into the scheme. They were

1 *See* Sinclair, Paul, "The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished," April 2009 *ABI Journal*, and Sinclair, Paul, "The Sad Tale of Fraudulent Transfers (Part II): When Did Ponzi Preferences Morph into Fraudulent Transfers?," May 2009 *ABI Journal*.

2 While fraudulent-transfer cases may be brought under theories of actual or constructive fraud, because courts have generally accepted the presumption that if a Ponzi scheme is proven that there is actual fraudulent intent, *In re Bayou Group LLC*, 396 B.R. 810, 843 (Bankr. S.D.N.Y. 2008), and *In re Manhattan Investment Fund Ltd.*, 397 B.R. 1, 8 (S.D.N.Y. 2007), actual fraud is almost invariably in play, and the only defense to actual fraud is under §548(c)—the defense of good faith and value.

3 "The three terms—'reasonably equivalent value' in §548(a)(1)(b), "fair consideration" in the NY D&CL and 'value' in §548(c)—have the same fundamental meaning. Because the D&CL parallels §548, the two statutes are interpreted similarly by the courts." *In re Churchill Mortgage Investment Corp.*, 256 B.R. 664, 677 (Bankr. S.D.N.Y. 2000).

4 *In re M&L Business Machine Company Inc. (Jobin v. McKay)*, 84 F.3d 1330, 1341-42 (10th Cir. 1996).

5 *In re Churchill Mortg. Inv. Corp. (Balber-Strauss v. Sixty-Five Brokers)*, 256 B.R. 664, 682 (Bankr. S.D.N.Y. 2000).

6 *In re Bayou Group LLC (Bayou Superfund LLC v. WAM Long/Short Fund II LP)*, 362 B.R. 624, 637-38 (Bankr. S.D.N.Y. 2007).

7 *See, e.g., In re Randy (Martino v. Edison Worldwide Capital)*, 189 B.R. 425 (Bank. N.D. Ill. 1995); *In re Indep. Clearing House Co. (Merrill v. Abbott)*, 77 B.R. 843 (D. Utah 1987).

8 *See, e.g., In re Churchill Mortg. Inv. Corp. (Balber-Strauss v. Sixty-Five Brokers)*, 256 B.R. 664 (Bankr. S.D.N.Y. 2000); *In re Universal Clearing House Co. (Merrill v. Allen)*, 60 B.R 985 (D. Utah 1986). For a more detailed explanation of plain meaning, see "The Sad Tale of Fraudulent Transfers" in the April 2009 *ABI Journal*.

9 *In re Universal Clearing House Co. (Merrill v. Allen)*, 60 B.R 985 (D. Utah 1986).

paid approximately 10 percent of the amounts raised. The bankruptcy court found that the payments of commissions were fraudulent transfers, relying on *In re Ponzi*, 15 F.2d 113 (D. Mass. 1926), which held that such commissions did not constitute value because the services the agents rendered were actually detrimental as they deepened Ponzi's insolvency.[10]

The district court in *Universal* claimed that this question had not been addressed in the 60 years since *In re Ponzi*. The brokers argued that under the present Bankruptcy Code, satisfaction of a present or antecedent debt constituted value under §548(d)(2)(A). Pursuant to their contracts, they performed services, therefore giving consideration for which the debtor was obligated to pay. The payments satisfied that antecedent obligation.[11] The district court reversed the bankruptcy court, distinguishing *In re Ponzi* because it was decided under the Bankruptcy Act of 1898, which did not define antecedent debt as constituting value.[12] Under the present Code, this is not so. The court concluded that "the determination of whether value was given under §548 should focus on the value of the goods and services provided rather than on the impact that the goods and services had on the bankrupt enterprise."[13] It then remanded the case to the bankruptcy court to make the determination of whether the value of the services provided was reasonably equivalent to the value of the transfers received (the 10 percent commission).[14]

More recently, in *In re Churchill Mortg. Inv. Corp.*,[15] the trustee brought an adversary proceeding against brokers who, in good faith, originated mortgages and solicited investors into a Ponzi scheme. Relying on the *Universal*[16] case, the court found that the debtor received reasonably-equivalent value for the brokers' services, and therefore the brokers could retain commissions.[17] Because the debtors incurred the obligation to pay brokers for their services, that obligation constituted a debt that was satisfied by the payment of commissions pursuant to the contracts. The satisfaction of the debts falls squarely within the definition of value found in §548(d)(2)(A).[18] Furthermore, the court found that the basis for reasonably-equivalent value lies in an evaluation of the specific consideration exchanged by the debtor and the transferee in the specific transaction, "*i.e.,* the *quid pro quo* exchange between the debtor and the transferee" and not in an evaluation of the overall Ponzi scheme.[19] The *Churchill* court highlighted the critical definitional statutory language:

1. Section 548(a)(B)(i) defines the test as whether the debtor "received less than a reasonably equivalent value in exchange *for such transfer*."
2. Section 548(d) states the test to be whether the "transferee or obligee gave value to the debtor in exchange *for such transfer*."
3. D&CL §272 states the test as whether there is an exchange of property obligation or antecedent debt that is "a fair equivalent therefor" or "not disproportionately small *as compared with the value of the property, or obligation obtained*."[20]

Churchill expressly rejected a line of cases that held that agreements with Ponzi operators are unenforceable as a matter of public policy. *In re Randy (Martino v. Edison Worldwide Capital)*[21] is representative of cases that hold "that the contract that underlies the transaction is illegal, and therefore no value could have been given by the transferee to the debtor for the transfers" and "the interest of the public, rather than the equitable standing of individual parties, is of determining importance."[22] In *Randy*, the trustee sought commissions paid to three defendant brokers for their efforts in bringing new investors into the scheme and inducing persons already invested in the scheme to keep their principal investments in place. Thus, the facts are similar to those in *Independent Clearing House* and *Churchill*.

In re Randy relies on *In re Indep. Clearing House Co. (Merrill v. Abbott)*,[23] a later decision in the *Independent Clearing House (Universal)* litigation. In relying on the 1987 *Independent Clearing House* opinion, the court, providing no explanation, found that the argument that the underlying contract is illegal and no value can be given "applies even more forcefully to brokers who have received commissions for helping perpetrate the Ponzi scheme."[24] Curiously, the 1987 *Independent Clearing House* case is based on the recovery of interest payments made in excess of the investors' principal recoveries within one year of the petition date, while *Randy* involved the recovery of commissions. While the court in *Randy* had available the pertinent 1986 *Independent [Universal] Clearing House* decision on recovery of commissions, there is no mention of this decision in *Randy*.

The Eleventh Circuit, in *In re Financial Federated Title & Trust Inc. (Orlick v. Kozyak)*,[25] reversed a ruling of the bankruptcy court, following *Randy* and holding that payments that the corporate employee had received for bringing new investors into a Ponzi scheme were fraudulent transfers as a matter of law. It expressly declined to follow the *Randy* decision because it improperly relied on the 1987 *Independent Clearing House* decision and not the "better reasoned" 1986 case.[26] It adopted the principle that the focus under §548 is on the goods and services provided rather than on the impact that the goods and services had on the bankruptcy enterprise.[27] The *Randy* decision was based on incorrect precedent and continues to spawn the erroneous notion that the payment of commissions, interest and profits by a Ponzi operator never constitutes reasonably equivalent value.

Retention of Interest

In *In re Unified Commercial Capital Inc. (Lustig v. Weisz & Assocs. Inc.)*,[28] investors received returns of interest of 12 percent per year on loans made to an alleged Ponzi scheme. After the scheme collapsed, the chapter 7 trustee bought an adversary proceeding against defendant investors to recover payments made in excess of their initial principal payments. On the value issue, the trustee urged the court to adopt an "objective standard" as in *Independent Clearing House*, claiming that if the use of the debtors' money was of value to the debtors, it was only because it allowed them to defraud more people out of more money. Therefore, the trustee concluded, the money cannot "objectively" be called reasonably-equivalent value.

10 *Id.* at 999.
11 *Id.* at 998-99.
12 *Id.* at 1000.
13 *Id.*
14 *Id.*
15 *See* note 4, *supra*.
16 *In re Universal Clearing House Co.* arises out of the bankruptcy of the entity that was known as "Independent Clearing House" and is related to *In re Indep. Clearing House Co (Merrill v. Abbott)*, 77 B.R. 843 (D. Utah 1987).
17 *Id.* at 679.
18 *Id.* at 679-80.
19 *Id.* at 680.
20 *Id.* at 678 (emphasis in original).
21 *In re Randy (Martino v. Edison Worldwide Capital)*, 189 B.R. 425 (Bank. N.D. Ill. 1995).
22 *Id.* at 441.
23 *In re Indep. Clearing House Co. (Merrill v. Abbott)*, 77 B.R. 843 (D. Utah 1987).
24 *Id.* at 441.
25 *In re Financial Federated Title & Trust Inc. (Orlick v. Kozyak)*, 309 F.3d 1325 (11th Cir. 2002).
26 *Id.* at 1331-32.
27 309 F.3d at 1332.
28 *In re Unified Commercial Capital Inc. (Lustig v. Weisz & Assocs. Inc.)*, 260 B.R. 343 (Bankr. W.D.N.Y. 2001).

Although the payments at issue were interest payments and not commissions, the court came to the same conclusion as the *Churchill* court: that (1) the debtor received a dollar-for-dollar forgiveness of a contractual debt, which was a satisfaction of an antecedent debt and, therefore, reasonably-equivalent value;[29] and (2) "the proper focus of a fraudulent transfer inquiry is on the transfer itself, not on the overall business practices of the Debtor."[30] The *Unified Commercial* court added an additional element of reasonableness, stating that the "interest rates were reasonable, and there is no suggestion in the record that Defendants were anything but innocent investors... This was not the typical 'too-good-to-be-true' investment scheme."[31] The court found that while opinions such as *Independent Clearing House* believe it unfair, unjust and against public policy for an innocent investor victim of a Ponzi scheme to receive reasonable contractual interest, it considered it to be an injustice to the fraudulent-conveyance statutes to ignore "the universally accepted fundamental commercial principle 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."[32]

The court shared the same concerns as the 1986 *Independent Clearing House* opinion, but from an opposite perspective, including a desire to avoid sweeping equity and not to create a "super preference," which merely reallocates and redistributes the debtor's estate. The *Unified Commercial* court called for congressional action on the issue, stating that "it has been more than 16 years since *Independent Clearing House* was decided by the Bankruptcy Court and 13 years since it was decided by the District Court, [and] Congress [still] has not provided the comprehensive, and, therefore presumably 'just' solution to the losses occasioned by a 'Ponzi' scheme that the District Court in *Independent Clearing House* realized was necessary."[33] In the absence of such congressional action, the court rejected "the existing partial solution advanced by many courts in this developing area of law, which is to unfortunately and inappropriately utilize the fraudulent conveyance statutes as a super preference."[34] It could not see why that solution "is any better, more fair or more just than leaving those innocent investors who received interest payments more than ninety days before the petition where they were."[35]

Similarly, in *In re Carrozzella & Richardson (Daly v. Deptula)*,[36] the district court, in overturning the bankruptcy court, determined that interest payments made in excess of principal contributions were not recoverable by the trustee. The *Carrozzella* opinion further criticizes *Randy, et al.,* and neatly hones in on a point made in *Unified Commercial* that "allowing an investor to retain reasonable contractual interest does not further a Ponzi scheme any more than allowing that investor to retain repaid principal."[37] In other words, if a Ponzi investor can retain principal payments, then they should also retain interest payments in excess of principal.

Unified Commercial and *Carrozzella* clearly detest the overreaching equitable outcome in *Randy*, yet they still mandate reasonableness, and a significant basis for their departure from *Randy* is based on reasonableness. The *Carrozzella* court determined that 8 to 15 percent interest returns per year were not unreasonable and pointed to external rates at that time to support this finding.[38] The 15 percent rate of return was offered to an investor in 1981, when the prime rate of interest was in excess of 15 percent.[39]

This reasonableness-of-return standard has been relied on in other opinions. In *In re Canyon System Corp.*,[40] the bankruptcy court ruled against investors who received 35 percent or higher annual interest returns, calling the scheme at issue the "textbook too-good-too-be-true investment scheme."[41] Viewed in another light, the 35 percent rate of return is "subjectively" not in good faith, precisely because it is too good to be true. Thus, payments from high-return schemes can be found to be not defensible because (1) they are subjectively not in "good faith," or (2) alternatively, not a reasonable *quid pro quo*, and therefore do not constitute value under the other prong of §548(c).

Retention of Profits

Unified and *Carrozzella* address the right to interest payments made above and beyond the return of initial principal. Whether an investor may retain "fictitious profits," or payments made to the investor in excess of its invested principal, is a different and more problematic question. In *In re Bayou Group LLC (Bayou I)*,[42] the trustee sued various recipients of distributions, some of which had received both a return of principal and profits. As to the profits, relying on *Carrozzella* and *Unified Commercial,* those defendants argued that "the fictitious profits portion of redemption payments [that] they received should be deemed to constitute payment on antecedent debts for interest."[43] The court disagreed and clearly distinguished *Carrozzella* and *Unified Commercial* because "both involved contractual rights to interest." Bayou investors had no contractual right to interest.[44] Their rights were only in profits.

The *Bayou* court agreed with *Carrozzella, Unified Commercial* and *Churchill* (implicitly denying the opposing view in the *Randy* and 1987 *Independent Clearing House* opinions) that the focus should be "on the specific transaction or transfer sought to be avoided in order to determine whether that transaction falls within the statutory parameters of either an intentional or constructive fraudulent conveyance."[45] However, the court came to a different conclusion, finding that the transfers were made with the actual intent to hinder, delay or defraud the debtor's creditors, and therefore were recoverable by the trustee.[46] The redemption payments at issue in *Bayou* were made on "nonexistent investor account balances misrepresented in fraudulent financial statements [and] were themselves inherently fraudulent and constituted an integral and essential component of the fraudulent Ponzi scheme alleged."[47] While the court's decision and rationale was sound, it also seems rational to reach the same conclusion because the only contractual right the investors had was in profits. Since there were no profits to distribute, contractually, investors received that to which they were entitled.

Trade Payments: Support for the Retention of Interest

Churchill and *Unified Commercial* raise common-sense arguments that were important to those respective opinions.

29 260 B.R. at 491.
30 260 B.R. at 490.
31 260 B.R. at 491.
32 260 B.R. at 351-52.
33 *Id.* at 349.
34 *Id.* at 354.

35 *Id.*
36 *In re Carrozzella & Richardson (Daly v. Deptula)*, 286 B.R. 480 (D. Conn. 2002).
37 *Id.* at 490.
38 *Id.* at 484.
39 *Id.*
40 *In re Canyon Sys. Corp (Rieser v. Hayslip)*, 343 B.R. 615 (Bank. S.D. Ohio 2006).
41 *Id.* at 645.
42 *See* note 5, *supra.*

43 *Id.* at 635.
44 *Id.*
45 *Id.* at 638.
46 *Id.* at 637-38.
47 *Id.* at 638.

Each opinion juxtaposes investors' and brokers' retention of interest and commissions with employees' and trade creditors' retention of payments from the debtor. The classic trustee argument is that "no value is conferred as a matter of law, since such services only exacerbated the harm to creditors by increasing the amount of claims while diminishing the debtor's estate."[48] *Churchill, Unified Commercial* and *Carrozzella* dismiss this argument, stating that its "fatal legal flaw" is that the trustee's focus is on the entire scheme and not on the specific transaction at issue. As additional support for this decision, *Churchill* points out that others, such as "the debtor's landlord, salaried employees, accountants and attorneys, and utility companies" provided services to the debtors, and these services and goods constituted value.[49] The court reasoned that there is no material distinction between those creditors and the brokers who received the payments in question.[50] It is particularly singled out as untenable, the distinction drawn by the trustee that there should be a difference between brokers who received payments as independent contractors and received 1099s, and those brokers who were W-2 employees.[51]

Unified Commercial addresses the same issue with respect to investors' return of interest. Although goods and services provided by trade creditors such as telephone service, office space and electricity allowed Unified Commercial to appear to be a legitimate business and furthered the fraudulent scheme, the trustee did not pursue those creditors. The court cleverly posed the question: "What did the innocent investor victims that received reasonable contractual interest payments do so wrong to diminish the estate of *Unified Commercial* that trade creditors did not do?"[52] There would seem to be little logical basis for treating an investor who received a 10 percent per annum contractual interest payment differently from the payment on a credit card that charges 24 percent per annum interest on the Ponzi operator's monthly bill.

Conclusion

As previously argued in the *Journal* articles, the 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.[53] In §548, the Bankruptcy Code uses the term "for such transfer" in connection with the word "value." As such, the focus is clearly not on the overall impact of the transfer on the Ponzi scheme, but rather on the *quid pro quo* for the specific transaction. Was there a fair exchange of consideration? Is the amount paid reasonable? If so, and if supported by the recipient's contractual rights, the transfer should not be avoidable. Likewise, if the investor is contractually bound to receive profits or the increase or decrease in the value of its investment, then by definition, in the Ponzi scheme, there is no such profit, and no profit for the investor to retain. Cases that wish to "do justice" from their own "objective" point of view ignore the statutes, and their "just" results should be left up to Congress to bring about the change they seek. ■

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48 256 B.R. 664 at 680.
49 *Id.* at 681.
50 Notably, there is no ordinary-course defense in §548(c) as there is in §547.
51 *Id.*
52 260 B.R. 343 at 352.
53 *United States v. Ron Pair Ent. Inc.*, 489 U.S. 235 (1989).