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Ponzi Schemes and Clawbacks: Investors Pay Twice for the Crimes of Others

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In the last few years, many investors have been victims of what amounts to Ponzi-like investment schemes. These investors surely feel that they have suffered enough when they realize that their investments have been fraudulently mismanaged. Many of these Ponzi-like investment organizations have filed for bankruptcy protection. In these cases, the defrauded investors are also subject to the clawback provisions of the Bankruptcy Code. These clawback provisions include: (1) preferential transfers and (2) fraudulent transfers. This discussion summarizes the clawback provisions of the Bankruptcy Code. And, this discussion focuses on the application of those clawback provisions to Ponzi-like investment schemes.

Introduction

Mrs. Ponzi would be proud. The scheme her son Charles concocted based on postage stamps morphed into a multi-billion dollar enterprise.

Those who are said to have followed in the inauspicious footsteps of Mr. Ponzi—Bernie Madoff, R. Allen Stanford, Shawn Merriman, Weizhan Tang, John Anthony Miller, Norman Hsu, and Norman Petters, all of whom have been charged with, or pled guilty to, having defrauded investors by using later investors' money to pay early investors' fictitious profits—have gained virtual household name recognition for themselves and the person attributed with development of the Ponzi business model.[1]

The pain felt by the duped investors upon realizing that the funds they entrusted to their advisers were not invested, but were instead placed into the hands of similarly mislead investors and the Ponzi scheme perpetrators themselves, may be only the beginning.

Those who invested with the accused perpetrators of these frauds are also in the unfortunate position of learning another term of art—"clawback"—a shorthand term for a legal theory under which defrauded investors not only suffer the loss of what they invested with the Ponzi scheme perpetrators, but may also have to give back whatever limited distributions they did receive.

What Is a Ponzi Scheme?

Ponzi schemes are a type of illegal pyramid scheme named after Charles Ponzi, a Boston business man. Ponzi duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s.

In its classic form, the scheme perpetrator takes money from investors with a promise of delivering an investment return from an investment or business operation. But, instead, the perpetrator makes payments to early investors from monies obtained from later investors.[2]

The fraud consists of channeling proceeds "received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment."[3]

Generally, investors are "promised high rates of return on their investments [and e]arly investors actually receive the promised returns, creating the impression of a legitimate, or at least profitable, business, and thereby enticing new investors into the plan."[4]

However, "[a]s a result of the absence of sufficient, or any, assets able to generate funds necessary to pay the promised returns, the success of such a scheme guarantees its demise because the operator must attract more and more funds, which thereby creates a greater need for funds to pay previous investors, all of which ultimately causes the scheme to collapse."[5]

Recent Examples of Ponzi-like Schemes

There has been no shortage of examples of alleged Ponzi schemes in news of late. Last October, the Securities and Exchange Commission (SEC) charged Democratic fund-raiser Norman Hsu and his company with operating a $60 million Ponzi scheme. That scheme allegedly used investor funds to compensate sales agents, make political contributions, and support Hsu's luxurious lifestyle.

In December, a federal grand jury indicted Minnesota businessman Tom Petters on 20 counts of fraud, conspiracy and money laundering stemming from Petters' alleged role in a 13-year, $3.5 billion Ponzi ring. His trial is expected to begin this summer.

The now most famous of the Ponzi scheme operators, Bernie Madoff, fell soon after. On December 11, 2008, Madoff was arrested by federal agents for violating criminal securities laws. The charges included securities fraud, investment adviser fraud, and mail and wire fraud. These allegations are made in connection with a Ponzi scheme that Madoff operated through his company, collecting as much as $65 billion from investors.

At a plea hearing on March 12, 2009, Madoff pled guilty to an 11-count criminal information filed against him, admitting that he operated a Ponzi scheme through the investment advisory side of Bernard L. Madoff Investment Securities LLC (BLMIS).

The list does not end with Mr. Madoff. On February 17, 2009, the SEC accused Robert Allen Stanford and three of his companies of orchestrating a fraudulent, multi-billion dollar investment scheme. The SEC complaint, filed in federal court in Dallas, alleges that one of Stanford's companies sold approximately $8 billion of self-styled certificates of deposit to investors by promising "improbable and unsubstantiated" high interest rates.

In late March, John Anthony Miller, an Orange County businessman, pled guilty to federal fraud charges related to a long-running Ponzi scheme in which Miller collected more than $15 million from investors with bogus promises of annual returns as high as 18 percent. Miller operated the Ponzi scheme from 2000 through November 2008 when he was taken into custody as he was preparing to leave the country.

The self-proclaimed "Chinese Warren Buffet," Weizhen Tang, faced federal charges in April 2009 of running a Ponzi scheme that primarily targeted Chinese-Americans. Tang raised between $50 million and $75 million from approximately 200 investors. And, according to the SEC's complaint, Tang operated a Ponzi scheme through his Canada-based hedge fund since at least 2006.

Most recently, also in April, the SEC sued Shawn Merriman, a Colorado investment manager, alleging that he ran a Ponzi scheme out of his suburban Denver home for about 15 years, bilking investors out of $20 million. In its complaint, the SEC alleges that Merriman's promises of returns of 7 to 20 percent were fictitious, but at least he had good taste, counting among his personal assets several classic cars and 370 works of art, including paintings by Rembrandt, Rubens, and Picasso.

Allegations have been made against these seven men over the last several months that they have bilked tens of thousands of investors out of many billions of dollars. Several billions of dollars are not accounted for. However, many investors collected profits along the way and other investors were fortunate enough to have redeemed their investments before the schemes unraveled.

At least these investors can breathe a sigh of relief. Right? Thanks to something known as "clawbacks," maybe not.

The Clawback Provisions of the Bankruptcy Code

When a large Ponzi scheme falls, somebody is left to pick up the pieces. Sometimes, that somebody is a bankruptcy trustee. Sometimes, it is a Securities Investor Protection Corporation (SIPC) representative or trustee. Sometimes, it is a government agency, such as the Securities Exchange Commission. Part of the task of picking up the pieces is determining where the missing money went, getting it back, and redistributing it.

While the Ponzi scheme perpetrator is a natural first stop in the effort to recapture misdirected investor money, it is not the only stop. In many cases, especially bankruptcy cases and cases brought by SIPC, which are administered by the bankruptcy court, the appointed trustee will also seek to get back money that was distributed to the victims of the Ponzi scheme.

The underlying philosophy behind actions against defrauded investors is that:

1. some of those defrauded investors received distributions from the money provided by other defrauded investors, and
2. the playing field should be leveled so that all are defrauded to roughly the same degree.

There are two legal theories available to a trustee to seek the return of funds distributed to investors in a Ponzi scheme, which are lumped together under the generic shorthand "clawback." Neither clawback legal theory is unique to Ponzi scheme cases, but both are based on well-established bankruptcy law provisions.

The first provision that clawback cases rely upon is the preferential transfer theory. And, the second provision is the fraudulent transfer theory.

Preferential Transfers

On April 9, 2009, the trustee liquidating Madoff's business filed a complaint in federal court in New York against a bank in Gibraltar and a company in the British Virgin Islands to recover $150 million wired to, or for the benefit of, those companies in late October 2008.

The trustee is seeking the return of the funds on the theory that the wire transfer was a preference under Section 547 of the United States Bankruptcy Code, 11 U.S.C. Section 101 *et seq*. (Bankruptcy Code). A preferential transfer can be avoided under the Bankruptcy Code, and the transferee can be required to return the funds to the trustee to be shared among all creditors.

In order to establish that a preference occurred, a trustee is required to prove (1) that an interest of the debtor was transferred within 90 days prior to the filing of the debtor's bankruptcy case[6] and (2) that the transfer was made:

1. to or for the benefit of a creditor,
2. for or on account of an antecedent debt,
3. while the debtor was insolvent, and
4. enabled a creditor to receive more than he or she would have received if the transfer had not been made and the creditor received distributions in accordance with the Bankruptcy Code.

When applying the provisions of Section 547 to a Ponzi scheme, courts have had little trouble finding that investors in the scheme are creditors of the debtor-company that perpetrated the Ponzi scheme. After investing in the Ponzi scheme, the investor has:

1. a contractual right to the return of the investment, or
2. a claim to get his or her principal back.

The preferential transfer provisions are based on the tort theory of rescission or an equitable claim for restitution because of the debtor's fraud.[7]

The holder of a claim against a debtor under the Bankruptcy Code is a creditor, 11 U.S.C. Section 101(10), and the claim for redemption, rescission, or restitution is an antecedent debt.[8]

Further, courts have held that because by definition a Ponzi scheme is insolvent from the beginning, insolvency is presumed as a matter of law.[9]

This presumption may not be all that important in the context of a preference, however, because the Bankruptcy Code provides for that same presumption of a debtor's insolvency for the 90-day period preceding the commencement of the bankruptcy case.[10]

The only remaining preference requirement that the trustee must establish in order to avoid a transfer as a preference is that as a result of the payments during the 90-day period, the investor received more than he or she would have received as an unsecured creditor in the liquidation of the Ponzi-scheme perpetrator, a determination that turns on a case by case analysis of the amount received by the investor and the assets available to the trustee to pay other creditors.

Defenses to Preferences

In some Ponzi-scheme cases, investors have argued that the monies they received were not property of the Ponzi-scheme perpetrator, but simply delivery of their own funds that the debtor had held in an express or constructive trust. They conclude that, since what they got in the 90 days before the bankruptcy started was their own money, there is no basis for the trustee to take it back.

Courts have generally put the investor making such an argument to the task of tracing the principal invested with the debtor to the payments received by the investor.[11]

Because money is fungible, and generally co-mingled in a single account, the tracing exercise can be difficult. Even success in tracing, however, may not carry the day for the investor.

The Bankruptcy Code does not require that the debtor have *title* to the property transferred in the 90-day period for the distribution to be recoverable by the trustee. Rather, the Bankruptcy Code requires that the debtor merely have an *interest* in the property.[12]

Whether the debtor's interest in the property is the possession of the property or is defeasible title, courts have frequently held that a debtor has an interest in funds obtained from investors in a Ponzi scheme.[13]

In addition to arguing that the monies received by the investor were not property of the debtor, investors have also asserted defenses to preferences recognized under the Bankruptcy Code. The most common defenses asserted by investors to preference actions in Ponzi-scheme cases are the "ordinary course of business" defense and the "new value" defenses.

The Bankruptcy Code provides that a trustee may not avoid as a preference a transfer to the extent that the transfer related to a debt that was incurred and paid in the ordinary course of business.[14]

Courts have tended to find the ordinary course defense unavailing to Ponzi scheme victims who find themselves to be preference defendants, holding that there is no ordinary course when it comes to Ponzi schemes.[15]

Other exceptions to the avoidance of a transfer as a preference are the "new value" exceptions. A trustee may not avoid a transfer as a preference to the extent that the transfer was intended by the debtor and the creditor to be a "contemporaneous exchange for new value given to the debtor."[16]

A transfer also may not be avoided as a preference if, after the transfer, the creditor gave new value to the debtor which was not secured by an otherwise unavoidable security interest and on account of which new value the debtor did not make an otherwise avoidable transfer to the creditor.[17]

New value for purposes of Section 547 is defined as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation."[18]

Therefore, if after receiving a full or partial redemption of an investment, an investor invests new funds with the debtor, the investor is likely to have a defense to avoidance as preferences of at least some of the payments received from the debtor,[19] even if the monies did not provide a material benefit to the Ponzi-scheme estate and were used only to perpetuate the Ponzi scheme.[20]

For preference analysis, intent of the investor in making an investment, or lack of knowledge that they were caught up in a Ponzi scheme, is not relevant. The purpose of affording trustees the ability to recover preferential transfers is two-fold:

1. to discourage creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy and
2. to further the primary bankruptcy policy of equal distribution among similarly situated creditors.[21]

Resolution of a preference action will turn on application of the technical, indeed almost mathematical, provisions of Section 547 of the Bankruptcy Code, even if the investor was legally entitled to the payment and even though the investor made the investment in both subjective and objective good faith.

Fraudulent Transfer Law

In addition to seeking to recover the return of an investor's principal as a preference, a trustee can seek to "clawback" payments made to an investor in a Ponzi scheme under a fraudulent transfer theory.

Fraudulent transfers are defined by Section 548 of the Bankruptcy Code, the Uniform Fraudulent Conveyance Act (UFCA), and the Uniform Fraudulent Transfer Act (UFTA). Almost all states have enacted either the UFCA or the UFTA, which are virtually identical in the provisions utilized in Ponzi scheme clawback cases.[22]

Section 548(a)(1) of the Bankruptcy Code, authorizes a bankruptcy trustee to "avoid any transfer . . . of an interest of the debtor in property" that was made with either actual or constructive fraudulent intent, as more particularly stated in the statute, on or within two years before the date of the filing of the debtor's bankruptcy case.[23]

These same provisions are virtually mirrored under every state's fraudulent transfer law, except that the reach back period under state laws is extended from two years to as many as six years. The ability to avoid fraudulent transfers utilizing state law, including its extended reach back period, is made available to a bankruptcy trustee under Section 544 of the Bankruptcy Code.

Similar to preferences, in pursuing the recovery of funds from an investor in a Ponzi scheme on a fraudulent transfer theory, the trustee must prove that the debtor had a property interest in the funds transferred to the investor. As was discussed in the context of preferences, whether the debtor's interest in the property is the possession of the property or is defeasible title, courts have routinely held that a debtor has an interest in funds obtained from investors in a Ponzi scheme.[24]

Further, as was observed with preferences, because by definition a Ponzi scheme is insolvent from the beginning, insolvency is presumed as a matter of law.[25]

Constructive Fraud

Despite its name, avoidance of a transfer based on constructive fraud requires no fraud at all. Rather, a trustee must only demonstrate:

1. that the debtor was insolvent when the transfer was made and
2. that the debtor received less than reasonably equivalent value in consideration for the transfer.

This analysis is often treated as involving two distinct determinations:

1. Did the debtor receive value?
2. If so, was the value received reasonably equivalent value?[26]

Value is defined for purposes of Section 548 as "property, or satisfaction or securing of a present or antecedent debt of the debtor. . . ."[27] The Bankruptcy Code defines "debt" as "liability on a claim."[28] A "claim" includes any "right to payment . . . " or any "right to an equitable remedy for breach of performance if such breach gives rise to a right of payment. . . ."[29]

Certainly, an investor in a Ponzi scheme has a claim for the return of his or her investment either as the result of a contractual obligation or the investor's right to restitution.[30]

As a result, payments made to an investor up to the amount of his or her investment would satisfy an "antecedent" debt of the debtor, and accordingly, the debtor would receive value in exchange for the transfers. Further, the value would certainly be "reasonably equivalent;" it would be the exact same value—dollar for dollar.[31]

Transfers to investors in excess of their investment, however, are a different matter. Courts are generally of the view that, since there are no actual profits to distribute in a Ponzi scheme, there is no reasonably equivalent value that could be exchanged for something that does not exist. In addition, as a matter of public policy, courts do not want to support early investors profiting at the expense of those investors who invested in the scheme late.[32]

Actual Fraud

Under an actual fraud theory, the trustee may seek to recover all payments made to the investor, including the return of the investor's principal investment. In order to avoid payments to an investor under Section 548(a)(1)(A), the trustee must prove that the transfers were made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted."[33]

The focus of the inquiry is on the debtor's fraud. Several courts have held that if it is established that the debtor was operating a Ponzi scheme, there is a presumption that the debtor acted with the intent to hinder, delay, or defraud creditors as a matter of law.[34]

Further, courts have consistently held that criminal convictions based on operating a Ponzi scheme establish an actual fraudulent intent for purposes of the fraudulent transfer provisions.[35]

Good Faith Defense

The Bankruptcy Code does provide protection from avoidance to a good faith transferee for value.[36] Section 548(c) provides that a transferee "that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer. . . . "[37]

In order to successfully assert the good faith defense, the investor must be able to establish that:

1. value was given for the transfers received from the debtor, and
2. the value was received in good faith.

As is discussed above, an investor in a Ponzi scheme gives value to the extent of the principal investment in the Ponzi scheme on the theory that the investment gives rise to a contractual or equitable claim against the debtor that is satisfied dollar for dollar by the transfer received from the debtor. Thus, even in a case premised on the debtor's actual fraud, an investor has a sound basis for arguing against a trustee's fraudulent transfer action seeking the return of payments towards principal investment.

The burden of demonstrating good faith, however, lies with the investor, and requires meeting an objective good faith standard.[38]

In other words, whether the investor had actual, subjective knowledge that the debtor was operating a Ponzi scheme is irrelevant. Instead, the investor will be called upon to show that there were no facts that would have put a reasonable person on inquiry notice of the debtor's fraud.

At least one court has stated that, even returned principal may not be retained by a Ponzi-scheme victim, "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose"[39] (emphasis in original).

The Bayou Cases

In the summer of 2005, a group of hedge funds organized under the "Bayou" name collapsed.[40] In unraveling the collapse, prosecutors alleged that managers Samuel Israel III and Daniel Marino induced investors to contribute in excess of $450 million into the funds over a period of nine years by generating false performance summaries and financial statements under cover of purported "audits" by an accounting firm.[41]

Ultimately, the Bayou fund operators pled guilty to multiple charges arising from their operation of a massive Ponzi scheme. Several federal lawsuits were filed against the Bayou entities and in April 2006, a receiver was appointed to conduct the liquidation of the hedge funds.

In May 2006, the receiver elected to place the Bayou hedge funds into a Chapter 11 bankruptcy proceeding in the United States Bankruptcy Court for the Southern District of New York, the same court in which the SIPA proceeding for Madoff's company is being administered.

The *Bayou* bankruptcy estate subsequently filed 125 adversary proceedings in the New York bankruptcy court against those investors who had redeemed part or all of their investment interests prior to the fund's collapse in August 2005. Those suits produced various reported decisions regarding the application of fraudulent transfer law to Ponzi schemes.[42]

The adversary proceedings were brought under Section 548(a) of the Bankruptcy Code, and Sections 273 through 276 of the New York Debtor and Creditor Law. The proceedings were brought to recover amounts paid to redeeming investors. These amounts included both (1) the principal invested and (2) "fictitious profits" fraudulently reported by the hedge funds.

As the relevant provisions of the New York statute were substantially similar to Section 548, the court focused its analysis exclusively on the application of Section 548.

The court held that redemption payments from a Ponzi scheme presumptively satisfied the "actual fraud" prong of the fraudulent transfer standard and found that the guilty pleas and allocutions of the hedge fund's prior operators were admissible to establish an "actual intent" to defraud creditors.[43]

Further, the court ruled that, as a matter of law, redemption payments received by investors in excess of their original principal based on "fictitious profits," were required to be refunded to the estate, regardless of the redeemer's good faith.[44]

The bankruptcy court in *Bayou* also provided additional guidance with respect to the parameters of the good faith defense under Section 548(c). The court concluded that the "good faith" affirmative defense requires application of an objective test regarding:

1. whether a reasonable and prudent investor should have been on inquiry notice of the fraud, and, if so,
2. whether the investor was diligent in its investigation such that the investigation "ameliorate[d] the issues that placed the transferee on inquiry notice in the first place."[45]

More specifically, the court evaluated "whether the defendant requested redemption after learning of a 'red flag' which, under an 'objective' standard, should have put the defendant on 'inquiry notice' of some infirmity in [the debtor] or the integrity of its management."[46]

It is unclear just how brightly red the flag must be to put an investor on inquiry notice. "The rule does not require that the 'red flag' be of such specificity as to put the recipient on 'inquiry notice' of the actual fraud, or embezzlement, or looting, or whatever ultimately proves to be the cause of loss. It is sufficient if the red flag puts the investor on notice of some potential infirmity in the investment such that a reasonable investor would recognize the need to conduct some investigation."[47]

The court concluded that a Ponzi scheme investor could establish a good faith defense under Section 548(c) if he or she demonstrates "that his request for redemption was in fact the result of a good faith reason other than his knowledge of 'red flags,' even if he was on inquiry notice and did not make inquiry before redeeming."[48]

By "objective evidence," the court highlighted "independent evidence of facts, as opposed to mere 'subjective assertions of good faith' by the defendant himself or the testimony of others that cannot be objectively verified."[49]

The court held that a redeeming investor cannot utilize the good faith affirmative defense unless the investor can show he or she conducted a diligent investigation of each potential problem or red flag. Failing such evidence, investors were required to return their principal as well as their profits.

Summary and Conclusion

In the Madoff case, the SIPA trustee overseeing the liquidation of BLMIS will be leading the efforts to clawback funds. That process has already started in an action brought against a Gibraltar bank and a British Virgin Islands entity to recover $150 million in alleged preferential transfers under Section 547 of the Bankruptcy Code.

It seems likely, based on the lessons of the *Bayou* decisions, that this action will not be the last, and some Madoff investors who were able to get some of their money out "in time" before the collapse of the scheme will encounter an attempt by the SIPA trustee to clawback funds.

While the actions brought on a preference theory for distributions received in the 90 days leading up to the start of the bankruptcy or SIPA proceeding, or fraudulent transfer actions seeking recovery of fictitious profits distributed, will be a challenge to defend, actions brought seeking return of principal are subject to a good faith defense.

To be sure, the *Bayou* decisions impose some evidentiary issues in actions premised on "actual fraud" as to the presence or absence of "red flags" and the investor's awareness of the existence of those indicators that something was amiss. That suggests that no blanket proclamations of a likely outcome in those cases is possible, but every case warrants a fact-specific analysis.

Notes:

1. Although his name is likely to be forever linked with illegal pyramid schemes, Ponzi was not the originator of the "rob Peter to pay Paul" scam. The first individual credited with developing the scheme was a New York grifter named William Miller, who defrauded investors out of $1 million in 1899, about $25 million today. Miller's nickname was "520 percent" due to the remarkable rate of return he promised to investors in a year's time.
2. See, for example, *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214, 1219 n. 8 (9th Cir. 1988).
3. *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 590 n. 1 (9th Cir. 1991).
4. *In re Canyon Systems Corp.*, 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006) (internal citation omitted).
5. *In re Taubman*, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993).
6. As in the case of the preference action filed in connection with the liquidation of BLMIS, the Ponzi-scheme estate does not have to be a debtor in bankruptcy in order for the preference and fraudulent transfer provisions of the Bankruptcy Code to provide a basis for the clawback of funds paid to investors. The court-appointed trustee filed the preference action in the United States Bankruptcy Court for the Southern District of New York, which is administering the liquidation of BLMIS under the Securities Investor Protection Act (SIPA), 15 U.S.C. Section 78aaa, *et seq*.
7. See *Scholes v. African Enter., Inc.*, 854 F. Supp. 1315, 1326 (N.D. Ill. 1994); see also *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008).
8. *In re Bullion Reserve of North America*, 836 F.2d at 1219. Ironically, while payment of principal amounts may be avoided on a preference theory, payments of fictitious profits are not. Because of the fraudulent scheme, an investor does not have a "claim" for any profits and, consequently, the payment of fictitious profits on a principal investment is not a payment on an antecedent debt. Accordingly, the trustee will not be able to avoid the payment of profits as a preference. As discussed herein, however, the trustee is not without a legal theory to attempt to recover payment of profits.
9. *In re Randy*, 189 B.R. 425, 441 (Bankr. N.D. Ill. 1995); see *In re First Commercial Management Group, Inc.*, 279 B.R. 230, 235 (Bankr. N.D. Ill. 2002).
10. In a SIPA proceeding such as the one commenced against Madoff's company, BLMIS, the filing of the complaint to initiate the SIPA proceeding is deemed to be the date of the filing of the petition and of the commencement of the case within the meanings of the preference and fraudulent conveyance provisions, respectively, under the Bankruptcy Code. 15 U.S.C. Section 78lll(7)(B).
11. See *First Federal of Mich. v. Barrow*, 878 F.2d 912, 915-16 (6th Cir. 1989); *Bullion Reserve*, 836 F.2d at 1218.
12. 11 U.S.C. Section 547(b).
13. *First Federal of Mich.*, 878 F.2d at 916-17; *In re International Loan Network, Inc.*, 160 B.R. 1, 11 (Bankr. D. D.C. 1993) (court described case law indicating that funds transferred to investors in a Ponzi scheme are property of the debtor as being "unanimous").
14. 11 U.S.C. Section 547(c)(2).
15. See, for example, *First Federal of Mich.*, 878 F.2d at 918-19; *Bullion Reserve,* 836 F.2d at 1219; *In re Southern Industrial Banking Corp.*, 159 B.R. 224, 227 (Bankr. E.D. Tenn. 1993) ("The [ordinary course] exception applies to payments by a real business, not to payments by a fake business set up to defraud people.").
16. 11 U.S.C. Section 547(c)(1).
17. 11 U.S.C. Section 547(c)(4).
18. 11 U.S.C. Section 547(a)(2).
19. *In re M&L Business Machine Co., Inc.*, 155 B.R. 531, 538-39 (Bankr. D. Colo. 1993), *aff'd*, 164 B.R. 657 (D. Colo. 1994).
20. Ibid., at 538.
21. *Bullion Reserve*, 836 F.2d at 1217.
22. Section 544(b) of the Bankruptcy Code authorizes the avoidance of any transfer that is avoidable under applicable non-bankruptcy law as to any actual creditor holding an unsecured claim. Accordingly, Section 544(b) incorporates state fraudulent conveyance law into the Bankruptcy Code. If the state statute is the UFCA, Section 544(b) is the UFCA. Similarly, if the state statute is the UFTA, Section 544(b) is the UFTA.
23. Section 548(a)(1) authorizes a bankruptcy trustee to "avoid any transfer . . . of an interest of the debtor in property . . . that was made . . . on or within two years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—(A) made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made . . . indebted; or (B)(i) received less than a reasonably equivalent value in exchange for such transfer . . . ; and (ii)(I) was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer . . . ; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that were beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider . . . under an employment contract and not in the ordinary course of business."
24. *First Federal of Mich.*, 878 F.2d at 916-17; *International Loan Network*., 160 B.R. at 11 (in action seeking recovery of monies paid to investors in Ponzi scheme as fraudulent

conveyances, debtor had an interest in property that trustee sought to recover).

25. *Randy*, 189 B.R. at 441.
26. *In re Universal Clearing House*, 60 B.R. 985, 998 (D. Utah 1986).
27. 11 U.S.C. Section 548(d)(2)(A).
28. 11 U.S.C. Section 101(12).
29. 11 U.S.C. Section 101(5)(A) – (B).
30. *Eby v. Ashley*, 1 F.2d 971, 973 (4th Cir. 1924) (investor in fraudulent scheme had a right to recover his principal from the moment he was deceived into paying it), *cert. denied*, 266 U.S. 631, 45 S.Ct. 197 (1925).
31. *Independent Clearing House Co.*, 77 B.R. 843, 857 (D. Utah 1987). In analyzing whether the underlying debt's satisfaction constitutes reasonably equivalent value, some courts have focused on the subjective knowledge of the defendant at the time the investment was made to assess the merits of the wholly or partially satisfied restitution or rescission claim, holding, "[i]f investments were made with culpable knowledge, all subsequent payments made to such investors within one year of the debtors' bankruptcy would be avoidable under Section 548(a)(2) regardless of the amount invested, because the debtors would not have exchanged a reasonably equivalent value for the payments." *In re United Energy Corp.*, 944 F.2d 589, 596 n.7 (9th Cir. 1991). This seems to ignore the contract-based claim, and is probably better suited for an "actual fraud" analysis, as discussed herein.
32. *In re Hedged-Invs. Assocs., Inc.*, 84 F.3d 1286, 1290 (10th Cir. 1996) (holding that a debtor operating a Ponzi scheme does not receive reasonably equivalent value in exchange for any amounts paid to an investor in excess of investor's principal investment); *Eby v. Ashley*, 1 F.2d at 973 (amounts paid in excess of principal investment deemed without consideration).
33. 11 U.S.C. Section 548(a)(1).
34. *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995); *In re M&L Business Machine Co.*, 198 B.R. 800, 806 (D. Colo. 1996); *Randy*, 189 B.R. at 438.
35. *Scholes v. Lehmann*, 56 F.3d at 762; *In re McCarn's Allstate Fin., Inc.*, 326 B.R. 843, 851 (Bankr. M.D. Fla. 2005); *In re Ramirez Rodriguez*, 209 B.R. 424, 433 (Bankr. S.D. Tex. 1997); *Randy*, 189 B.R. at 439.
36. An exception to this protection is the extent to which the transfer is avoidable under, among other sections, Sections 544 (avoidable under applicable state fraudulent conveyance law) or 547 (preferences) of the Bankruptcy Code.
37. 11 U.S.C. Section 548(c).
38. *In re M&L Business Machine Co.*, 84 F.3d 1330, 1337-38 (10th Cir. 1996); *Bayou Group*, 396 B.R. 844-45.
39. *M&L Business Machine*, 84 F.3d at 1338 quoting *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 536 (9th Cir. 1990) (internal citations omitted).
40. See *Bayou Group, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC)*, 362 B.R. 624, 628 (Bankr. S.D.N.Y. 2007).
41. See *In re Bayou Group, LLC*, 396 B.R. at 829.
42. See, for example, *Bayou*, 396 B.R. 810; *Bayou*, 362 B.R. 624.
43. See *Bayou*, 396 B.R. at 835.
44. See Ibid., at 843.
45. See Ibid., at 846.
46. See Ibid., at 848.
47. Ibid.
48. Ibid., at 848-49.
49. Ibid.

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