

# Defending Fraudulent-Transfer Avoidance Actions in Ponzi-Scheme Cases

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*It is generally not a good way to start off the week by tearing into an envelope holding a demand letter (or, even worse, a complaint) from a bankruptcy trustee claiming that over three years ago, some unfamiliar company paid the hundreds of thousands of dollars in debt accumulated by its affiliate, a name you only remember because of the big bill you thought would not get paid. To make matters worse, you learn that the trustee is claiming that the unfamiliar company was part of a Ponzi-scheme and that you may be on the hook for decades of actual fraud and perhaps millions of dollars in potentially avoidable transfers.*

*This discussion focuses on the reach-back period applicable to avoidance of actual and constructive fraudulent transfers under the Uniform Fraudulent Transfer Act (the "UFTA") versus the U. S. Bankruptcy Code, including the possibility of an indefinite reach-back period for actual-fraud claims under the UFTA. This discussion also highlights strategies for defending an actual-fraud Ponzi-scheme lawsuit.*

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## INTRODUCTION

It is in the blurred lines between a distressed company and its affiliates or owner where a bankruptcy trustee sees a fraudulent transfer lawsuit take shape.<sup>1</sup>

Generally, the allegation is one of "constructive fraud" (i.e., a transfer by an insolvent debtor corporation for less than reasonably equivalent value), though the trustee may throw in a boilerplate actual-fraud count for good measure.

For years, it was a good bet that, in most cases, actual fraud would be too hard to properly plead with the required particularity, much less prove. Thus, the real value for the bankruptcy estate was in the constructive-fraud claim. The commonly accepted notion among defendants was that there was little to be done after the fact, beyond assessing exposure and negotiating a reasonable settlement based on any value that was actually provided and the equities of the case.

Consequently, for better or worse, these matters were, and still are, often handled in-house, and often at the demand stage.

But, as a result of the post-Madoff crackdown on Ponzi schemes and the inevitable bankruptcies that followed, bankruptcy trustees, aided by the judicially created presumption of actual fraud that arises with the finding of the existence of a Ponzi scheme, have been invigorated in their prosecution of actual fraudulent-transfer lawsuits.

The implications of increased litigation with respect to actual fraudulent-transfer claims are concerning. For example, some courts have held that it is unnecessary for the trustee to prove harm in the context of an actually fraudulent transfer.<sup>2</sup>

Perhaps most troubling, however, the rules governing how far back a trustee may look to avoid a transfer (commonly referred to as the "reach-back," "look-back," or "claw-back" period) differ substantively from applicable state law relative to

the Bankruptcy Code and between actual versus constructive fraud claims.

Because of a longer, possibly indefinite, reach-back period known as the “discovery rule,” the exposure for actual fraud under state law is often much greater than it is for other fraudulent transfer claims.

Accordingly, where an allegation of actual fraud is made under state law, it is especially prudent to retain qualified counsel to assess the weaknesses in the trustee’s case as well as any possible defenses.

## THE BANKRUPTCY TRUSTEE’S FRAUDULENT TRANSFER AVOIDANCE POWER

A bankruptcy trustee has two nonexclusive options for avoiding fraudulent transfers.<sup>3</sup> First, Bankruptcy Code Section 548 specifically provides for avoidance of both actual and constructive fraudulent transfers.<sup>4</sup> Second, Section 544 equips a trustee with all of the rights and powers of an unsecured creditor under applicable nonbankruptcy law (the so-called “strong-arm powers”).<sup>5</sup>

Using the strong-arm powers, a trustee can assert state-law fraudulent-transfer claims. In most states, these causes of action were codified with the adoption of the Uniform Fraudulent Transfer Act (the “UFTA”).<sup>6</sup>

Section 546 provides that a trustee has until the later of two years from the order for relief<sup>7</sup> or one year from his appointment, if he was appointed within the two-year period, to file suit under either Section 548 or Section 544 (and applicable state law).<sup>8</sup>

## THE DIFFERENCES BETWEEN THE UFTA AND BANKRUPTCY CODE SECTION 548

Although similar, Bankruptcy Code Section 548 and the UFTA are not identical. A notable difference is structural and relates to the applicable statute of limitations, discussed below.

Unlike the Bankruptcy Code, which groups fraudulent transfers into constructive and actual fraudulent transfers, both of which are avoidable by a trustee, the UFTA groups fraudulent transfers into those that can be avoided by creditors in existence at the time of the subject transfer and those that can be avoided by both existing and future creditors.<sup>9</sup>



The first group, those transfers that can be avoided only by existing creditors, comprises what are commonly referred to as “constructive fraudulent-transfer claims” (i.e., a transfer by an insolvent debtor corporation for less than reasonably equivalent value) as well as insider preference payments.

The second group, those that may be brought by either existing or future creditors, comprises what are commonly referred to as “actual fraudulent-transfer claims” (i.e., transfers made with the actual intent to hinder, delay, or defraud a creditor) as well as constructive fraudulent transfers where, rather than showing that the debtor corporation was insolvent, a trustee is only required to demonstrate that the debtor corporation was undercapitalized or knowingly incurring debts without the ability to repay creditors.

Perhaps the most material distinction<sup>10</sup> between Bankruptcy Code Section 548 and the UFTA is the length of the reach-back period. Under Section 548, a bankruptcy trustee can only avoid transfers that were made within two years of the bankruptcy filing—that is, a trustee has a two-year reach-back period.<sup>11</sup>

In contrast, the reach-back period under the UFTA is at least four years and may be much longer.

Under the UFTA, the statute of limitation for avoiding both constructive and actual fraudulent transfers is four years (i.e., the plaintiff may avoid and recover transfers made up to four years prior to filing suit).<sup>12</sup> Once a bankruptcy is filed, all claims are preserved.

As a result, this four-year statute of limitations period becomes a four-year reach-back period for a bankruptcy trustee. As noted above, the trustee

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then has two years from the filing of the case (or one year from his appointment, if he was appointed within the two-year period) to file suit.

Additionally, under the UFTA, an actual fraudulent transfer may be avoided one year from the date “the transfer was or reasonably could have been discovered by *the* claimant.” (emphasis added).<sup>13</sup>

Where “the claimant” is a trustee, who does not come into existence until sometime after a bankruptcy proceeding is filed and is, therefore, unable to discover a transfer until his appointment, this second limitation period arguably creates an indefinite reach-back period.<sup>14</sup>

Even if the trustee is held to the knowledge of other creditors or a “reasonable creditor,” the reach-back could be tolled under the theory of adverse domination, which provides that the discovery period would not begin to run until the bad actors were removed from control of the company.<sup>15</sup>

## **HOW DO YOU DEFEND THE ACTUAL-FRAUD PONZI LAWSUIT?**

In a constructive-fraud avoidance action, the defense will generally focus on the primary elements of the claim:

1. The debtor’s solvency or insolvency at the time of the subject transfers
2. The value, if any, given in exchange for the subject transfers

If the trustee has proven his case, the defendant will then look to one of the handful of defenses related to avoidance and recovery laid out in the statute—such as the Section 548(c) good-faith-transferee defense.<sup>16</sup>

Oftentimes, this is fairly straightforward, although a prudent defendant should generally consult with outside counsel.

A claim of actual fraud, on the other hand, is generally much harder for the trustee to prove.

Unless someone confesses an actual intent to hinder, delay, or defraud creditors (which sometimes happens when the debtor corporation or its agents are subject to criminal charges), the trustee

will typically rely on certain “badges of fraud” as circumstantial evidence of the actual intent to defraud (e.g., a transfer made to an insider at a time that the debtor corporation was insolvent and was subject to post-judgment garnishment).<sup>17</sup>

## **The Ponzi-Scheme Presumption**

In the case of Ponzi schemes, some courts have significantly relaxed the requirement of proving actual fraud, and have held that the debtor corporation’s fraudulent intent is demonstrated by the mere fact that the subject transfer was made as part of Ponzi scheme. This is the so-called Ponzi-scheme presumption.<sup>18</sup>

Of course, a defendant might consider tackling the Ponzi scheme presumption head on, by challenging the finding of a Ponzi scheme.<sup>19</sup>

However, this approach will be met with mixed results—in some cases, the scheme is simply undeniable. In those circumstances where the trustee’s case in chief is not in dispute, obvious defenses will be few—other than a good-faith-transferee defense.

## **DEFENDING AN AVOIDANCE ACTION RELATED TO A PONZI SCHEME**

One of the first things to consider in defending an action to recover a transfer made in connection with a Ponzi scheme is whether the subject transfers were actually made in furtherance of the Ponzi scheme, as opposed to the transfers made to pay an ordinary-course-of-business transaction that was unrelated to a fraudulent scheme.

It is important to distinguish between fraudulent-transfer actions against “investors” in the scheme and fraudulent-transfer actions against other types of creditors of the business. Transfers made “in furtherance of the scheme are presumed to have been made with the intent to defraud for purposes of recovering the payments under §§ 548(a) and 544(b).”<sup>20</sup>

This inference is based on the fact that “[a] Ponzi scheme is by definition fraudulent” and therefore, “any acts taken in furtherance of [a] Ponzi scheme . . . are also fraudulent.”<sup>21</sup>

The commonly accepted notion is that a Ponzi-scheme relies on the perception of successful returns to perpetuate the on-going fraud.

Therefore, fictitious returns to investors bolster the illusion of a legitimate business and thereby

further the scheme. By in large, investors in a Ponzi scheme rely on one of the good-faith-transferee defenses and, even then, repay returns in excess of their investment (i.e., “net winnings”).

The same is not necessarily true for other creditors of the Ponzi scheme.<sup>22</sup>

[T]he existence of a Ponzi scheme coupled with transfers by the debtor, without evidence tying the transfers to perpetuation of the scheme, will not implicate the Ponzi scheme presumption.<sup>23</sup>

The Ponzi scheme presumption must have some limitations, lest it swallow every transfer made by a debtor, whether or not such transfer has anything to do with the debtor’s Ponzi scheme.<sup>24</sup>

Accordingly, some courts have held the ordinary expenses, such as utilities, are not made with actual intent to defraud creditors (absent the existence of other badges of fraud) simply because the payor was involved in a Ponzi scheme.

Additionally, even if the debtor corporation was a Ponzi scheme at the time it filed for bankruptcy, it might have had an existence as a legitimate enterprise at some point. Accordingly, in the Ponzi scheme context it is essential to explore the debtor’s business history to determine whether the Ponzi-scheme presumption should even apply to the subject payments in the first instance, particularly when those payments were made long ago.

Even if the trustee can establish that the debtor corporation was a Ponzi scheme at the relevant time and the subject transfers were made in furtherance of the scheme, the transfer is not avoidable if it was taken in good faith and for reasonably equivalent value.<sup>25</sup>

Where value is not “reasonably equivalent,” liability should still be reduced by any value given in exchange for the transfer. In this context, value should be measured from the perspective of the defendant.<sup>26</sup>

For example, a Ponzi scheme debtor corporation pays an office-supply company for office supplies delivered to—but never used by—the debtor. The trustee successfully argues that the office supplies were part of an elaborate façade used to entice investors and, therefore, the payment was “in furtherance” of the scheme.

The office supply company naturally argues that it was unaware of the fraud—it simply delivered the goods that were ordered, as it routinely does. The trustee counters that because the supplies were left untouched, they had no value to the



debtor corporation, beyond their role as a prop in the scheme.

Even if the court were to find that the office supplies did not have a reasonably equivalent value (from the debtor’s perspective), the company should argue that the value of such goods is easily calculated as the price for which the goods are routinely sold. At the very least, the company should have a defense up to this amount.

## CONCLUSION

Of course the facts will influence how a defendant proceeds, but when so much depends on the nuanced and complex relationship between state law and the Bankruptcy Code, discretion demands a thorough review by competent counsel.

With a slow recovery and an intensified enforcement effort, Ponzi schemes will continue to fall or be pushed into bankruptcy.

Armed with a Ponzi-scheme presumption and the discovery rule and hounded by innocent victims eager for a recovery, bankruptcy trustees will continue to look to fraudulent transfer lawsuits to fund bankruptcy estates, and Monday mornings will continue to be ruined by the arrival of their unwelcome demands.

### Notes:

1. Although this discussion addresses suits brought by bankruptcy trustees, the same lawsuits can be brought by debtors-in-possession, as well. Additionally, the state-law claims discussed can generally be brought by federal or state court appointed receivers.
2. See *Model Imperial Liquidating Trust v. Hamilton Bank (In re Model Imperial, Inc.)*, 250 B.R. 776, 793-94 (Bankr. S.D. Fla. 2000) (court held that



- a finding of actual harm is unnecessary to avoid a transfer made with actual intent to hinder, delay or defraud creditors reasoning that unlike section 548(a)(2), which requires an absence of reasonably equivalent value, the plain meaning of section 548(a)(1) merely requires the requisite level of intent).
3. The Bankruptcy Code equips debtors-in-possession with the same remedies. See 11 U.S.C. § 1107(a).
  4. See 11 U.S.C. Sections 548(a)(1)(A)(relating to actually fraudulent transfers) and 548(a)(1)(B) (relating to constructively fraudulent transfers).
  5. See 11 U.S.C. Section 544(b)(1).
  6. To date, 41 states have adopted the UFTA.
  7. This may be later than the petition or filing date in the context of an involuntary bankruptcy filing.
  8. See 11 U.S.C. Section 546(a).
  9. See UFTA Section 4—transfers fraudulent as to present and future creditors—and UFTA Section 5—transfer fraudulent as to present creditors only.
  10. Other distinctions, including burden of proof, statutorily identified badges of fraud, and the definition of reasonably equivalent value, also exist.
  11. See 11 U.S.C. Section 548(a)(1).
  12. See UFTA Section 9(b).
  13. See UFTA Section 9(a).
  14. See e.g., *Wing v. Dockstader, et al.*, 482 Fed. Appx. 361 (10th Cir. 2012) (applying the principle in the context of a receiver); but see *Wing v. Buchanan*, No. 12–4123, 2013 U.S. App. LEXIS 16522 (10th Cir. Aug. 9, 2013) (“The receiver has no claims to bring on his own behalf; instead, he brings them on behalf of the companies. Therefore, it is the companies and the creditors that are the ‘claimants’ that benefit from the discovery rule. The receiver’s mere appointment cannot resurrect otherwise stale claims.”)
  15. *Wing v. Dockstader*, 482 Fed. Appx. at 364.
  16. Section 548(c) provides that a transferee who takes for value and in good faith may retain an interest transferred to the extent of the value given). Its UFTA counterpart is Section 8(d) (3), which provides that a good-faith transferee is entitled to reduction in liability to the extent of any value given in exchange for the transfer. These defenses apply to either actual or constructive fraud and should not to be confused with the good-faith-transferee defense that applies to actual fraud only under the UFTA, Section 8(a), discussed below, which provides that a transfer is not avoidable as actual fraud if the transferee took in good faith and for “reasonably equivalent value.”
  17. The UFTA contains a nonexclusive list of 11 statutory badges of fraud. See UFTA Section 4(b).
  18. See, e.g., *Wing*, 482 Fed. Appx. 361; *Perkins v. Haines*, 661 F.3d 623, 626-27 (11th Cir. 2011); *Donell v. Kowell*, 533 F.3d 762, 770-71 (9th Cir. 2008); *Warfield v. Byron*, 436 F.3d 551, 558-59 (5th Cir. 2006)
  19. A Ponzi-scheme is generally understood to be a fraudulent enterprise whereby early-investor returns are paid from new-investor contributions.
  22. *Perkins v. Haines*, 661 F.3d 623, 626 (11th Cir. 2011).
  21. *Cuthill v. Greenmark (In re World Vision Entm’t, Inc.)*, 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002).
  22. *Kapila v. Phillips Buick-Pontiac-GMC Truck, Inc. (In re ATM Fin’l Svcs., LLC)*, No. 6:08–bk–969–KSJ, 2011 Bankr. LEXIS 2394, at \*17 (Bankr. M.D. Fla. June 24, 2011) (explaining that “transfers made by the debtor unrelated to the Ponzi scheme do not warrant th[e] inference” of actual fraud.); see also *Welt v. Publix Super Mkts., Inc. (In re Phoenix Diversified Inv. Corp.)*, No. 08–15917–EPK, 2011 Bankr. LEXIS 4100, at \*9-10 (Bankr. S.D.Fla. June 2, 2011) (denying Plaintiff’s motion for summary judgment on basis of insufficient evidence to show that transfers were made in furtherance of Ponzi scheme and that presumption of actual fraud should apply).
  23. *Phoenix Diversified*, 2011 Bankr. LEXIS at \*8-9.
  24. *ATM*, at \*17-8.
  25. See UFTA Section 8(a).
  26. *Jimmy Swaggart Ministries v. Hayes (In re Hanover Corp.)*, 310 F.3d 796, 802 (5th Cir. 2002).

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