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Innocent Investors in Ponzi Schemes Should be Entitled to Equitable Credit

The Plight of the Innocent Investor

By Paul Rubin

Once a Ponzi scheme is uncovered, investors deceived by the scam typically suffer two blows. First, they learn that they have been victimized by a con artist, that they may recover only a fraction of their investment, and that they will probably have to wait years before getting any of their money back. Worse, such investors are also likely to be sued in so-called "claw-back" lawsuits, in which a bankruptcy trustee seeks to compel them to return monies they received that they thought were either returns of principal or returns on their investments.

It is not uncommon for the investor to have invested new funds in the Ponzi scheme after receiving a distribution from the fraud perpetrator but before the ruse was uncovered. The question arises whether defendants in fraudulent conveyance actions should be entitled to a credit for such reinvestments. For example, assume the defendant originally invested $10 million, received a $1 million distribution in the form of a "dividend" one year later, and then invested an additional $200,000, all without having any reason to know that he or she was being deceived by a Ponzi scheme. Once the scheme comes to light, bankruptcy ensues and a trustee is appointed, should the trustee be permitted to recover the full $1 million from the investor? There is ample precedent to support the conclusion that it is appropriate for courts to exercise their equitable discretion so as to credit recipients of fraudulent transfers for pre-petition, post-transfer payments made to debtors.

The Single Satisfaction Rule and the Need to Avoid Windfalls

The decision of the bankruptcy court in *Bakst v. Wetzel* (*In re Kingsley*), 2007 WL 1491188 (Bankr. S.D.Fla. May 17, 2007) and the

Eleventh Circuit Court of Appeals’ affirmance in *Kingsley v. Wetzel*, 518 F.3d 874 (11th Cir. 2008) explain why innocent investors are entitled to such an equitable credit. There, the debtor deposited a tax refund, and issued a check the next day for nearly the same amount to the defendant, his father-in-law, in an effort to move the funds beyond the reach of a bank to whom the debtor was liable. The defendant used almost all of that money to make payments back to the debtor or to his creditors. The bankruptcy court found that the transfer to the defendant was avoidable as both an actual and constructive fraudulent transfer.

At the same time, the court also observed that avoidance of a fraudulent transfer under Section 548 of the Bankruptcy Code does not always translate into a recovery under Section 550. The purpose of Section 550 is to restore the estate to the financial condition it would have enjoyed had the transfer not occurred. 2007 WL 1491188 at *3. Accordingly, a trustee’s recovery under Section 550(a) is limited to a single satisfaction by Section 550(d). Additionally, the bankruptcy court noted that Florida (Fla. Stat. § 726.109(3)) and some other states that adopted the Uniform Fraudulent Transfer Act permit equitable adjustments to recoveries of fraudulent transfers in order to prevent windfalls to bankruptcy estates where a transferee has partially repaid the fraudulent transfer. *See Id*. at *5. Despite the finding of actual fraud, the bankruptcy court held that the defendant’s liability was subject to an adjustment for the pre-petition repayments made to or on behalf of the debtor.

The Eleventh Circuit affirmed. It emphasized that "the cornerstone of bankruptcy has always been the doing of equity." *Kinglsey*, 518 F.3d at 877 (quoting *In re Waldron*, 785 F.3d 936, 941 (11th Cir. 1986)). The appellate court recognized that other courts, including the court in *In re Jackson*, 318 B.R. 5 (Bankr. N.H. 2004), aff’d, 459 F.3d 117 (1st Cir. 2006), have applied equitable principles to reduce or eliminate a trustee’s recovery where the recipient of a fraudulent transfer returned the funds to the debtor or used them to pay the debtor’s expenses pre-petition. It agreed that recovery of the full amount of the pre-petition transfers would result in a windfall to the bankruptcy estate. While acknowledging that the defendant had unclean hands because he participated in an actual fraud, the Eleventh Circuit held it was not an abuse of discretion for the bankruptcy court to grant him some equitable relief because the bankruptcy court had awarded the trustee a partial recovery in the case — it had refused to credit the defendant for post-petition repayments.

In *In re Clarkston*, 387 B.R. 882 (Bankr. S.D.Fla. 2008), the bankruptcy judge in the *Kingsley* case reached a similar result. The debtor there transferred real property to his wife, who sold the property and gave the debtor approximately half the sale proceeds. Again, the bankruptcy court found the transfer was avoidable due to actual fraud, but invoking the single satisfaction principle, it limited the trustee's recovery by awarding the defendant a credit for payments she made to or on behalf of the debtor between the dates of the fraudulent transfer and his bankruptcy filing. 387 B.R. at 890-91. The court held that if the trustee were permitted to recover the value of everything that the defendant had received from the debtor, the estate would essentially recover the payments twice, and receive a windfall. 387 B.R. at 891. It held that awarding the credit would restore the estate to the financial condition that would have existed had the fraudulent transfer never occurred. *See Id*.

Further Support: *In re Cybridge*

The reasoning of the court in *Dobin v. Presidential Fin. Corp. of Del. Valley* (*In re Cybridge*), 312 B.R. 262 (D.N.J. 2004), which involved a different fact pattern, provides strong support for awarding credit to claw-back defendants who are innocent victims of Ponzi schemes. In *Cybridge*, the debtor did not inform its factor of its bankruptcy filing. Post-petition, the factor proceeded to collect nearly $168,000 of the debtor's accounts receivable, but it also made new loans to the debtor totaling over $192,000 — all without knowing of the debtor's Chapter 11 case. After the case was converted to Chapter 7, the trustee sought to recover the receivables that the factor had collected as unauthorized post-petition transfers.

The bankruptcy court in *Cybridge* granted the trustee summary judgment on his avoidance claim, but citing Section 550(d)'s single satisfaction rule and Section 105(a) of the Bankruptcy Code, it also held that the trustee's recovery from the factor should be zero. The bankruptcy court stated that cash is fungible and allowing the credit merely recognizes that the defendant had already returned that which the trustee was seeking to recover. 312 B.R. at 266.

The district court affirmed, noting that bankruptcy courts have long possessed equity jurisdiction to safeguard against unjust results. It quoted the Supreme Court's well-known statement that bankruptcy courts exercise their equitable powers "to the end that fraud will not prevail, that substance would not give way to form, that technical considerations will not prevent substantial justice from being done." *Cybridge*, 312 B.R. at 269 (quoting *Pepper v. Litton*, 308 U.S. 295, 304-305 (1939)). The district court held that permitting the trustee to recover the receivables after the factor had advanced a larger amount would allow the trustee to receive a second satisfaction in violation of Section 550(d). It further agreed that money is fungible, and the net result of the collection of accounts receivable and the new monies loaned was the estate's recovery of more than the sum sought by the trustee in the avoidance proceeding.

The district court identified Code Section 105(a) as an additional (but certainly not exclusive) basis to grant equitable credit to transferees of avoidable post-petition transfers where doing so would not otherwise conflict with the Bankruptcy Code. It stated that it "is not the objective of the bankruptcy laws to confer windfalls on debtors." *Cybridge*, 312 B.R. at 272-73 (quoting *In re Chicago, Milwaukee, St. Paul &P. R.R. Co.*, 791 F.2d 524, 527 (7th Cir. 1986)). Because the factor had been deceived into continuing its relationship with the debtor, had advanced over $192,000, $28,000 of which it would likely never recoup, and had been forced to defend itself in bankruptcy proceedings at considerable cost, the district court held that the bankruptcy court had not abused its discretion by invoking its equitable powers to grant the factor an equitable credit.

Nostalgia Network **Is Inapposite**

Those arguing against recognition of a credit for post-fraudulent transfer returns of funds to a debtor may cite the Seventh Circuit Court of Appeals' decision in *The Nostalgia Network, Inc. v. Lockwood*, 315 F.3d 717 (7th Cir. 2002). In that case, a judgment debtor transferred nearly $350,000 to the defendant, his girlfriend, who used all or most of the funds to pay his personal and business expenses. 315 F.3d at 719. The Seventh Circuit affirmed the district court's holding that the transfers were avoidable as constructive fraudulent transfers under Illinois and Indiana state law, while adding that the evidence of actual fraud was "overwhelming." *Id*. at 718.

Judge Richard A. Posner wrote that the girlfriend's use of the transferred funds to pay expenses of the judgment debtor was irrelevant: "[W]e think the inquiry should stop at the first stage of analysis, that is, should stop after it is determined that the transfer was not supported by consideration. If it was gratuitous, the fact that some or for that matter all of it may later have seeped back to the debtor does not legitimize the transfer." *Id*. at 720. Indeed, the court observed that "seeping back of the transferred money or property to the transferor is strong evidence of actual fraud by him." *Id*.

But *Nostalgia Network* did not involve a case under the Bankruptcy Code. Accordingly, Code Section 550(d)'s single satisfaction rule was inapplicable. Moreover, the plaintiff there held a judgment for $3 million and it had only recovered $36,000 against the judgment debtor *See Id*. at 718-719. It is not difficult to understand why the Seventh Circuit would refuse to reduce the recovery against a defendant whom it believed was complicit in an effort to defeat the legitimate rights of a judgment creditor.

Conclusion

Innocent investors in Ponzi schemes cannot be faulted for feeling doubly punished: First, their investments are revealed to have been obtained through fraud and they may never recover the amounts they entrusted to a scam artist. Secondly, they may have to defend themselves against fraudulent transfer claims that seek to compel them to return monies they thought they had properly received, sometimes years before the scheme was discovered. Bankruptcy courts are courts of equity, and equity abhors a windfall. *Prudential Ins. Co. of America v. S.S. American Lancer*, 870 F.2d 867, 871 (2d Cir. 1989). Bankruptcy courts may and should exercise their equitable discretion to credit such victims for amounts that they returned to the estate after receipt of an avoidable transfer but before the bankruptcy filing.

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