Ponzi Schemes: Keeping Your “Return” on “Investment”

I. Introduction

Nearly all investors in Ponzi schemes consider themselves innocent victims. Investors may end up net winners or net losers in the scheme, but most investors will feel betrayed by the operator—even those who made money during the operation.

The essence of a Ponzi scheme is to use newly invested money to pay off investors and convince them that they are earning profits rather than losing their shirts.[1]

Until the collapse of Bernard Madoff’s reported $65 billion investment scheme a few years ago, many people had heard the term “Ponzi scheme” or knew what the term meant. Despite all the recent notoriety, many people do not understand what happens when Ponzi schemes collapse. Given the prevalence of these schemes and the rate at which they are being discovered, investors should understand their potential liability on investments in their business ventures.

Operators of Ponzi schemes typically represent themselves as legitimate businesses on the rise, providing their investors substantial returns. However, the “returns” are actually funds paid in by newer investors. To keep the scheme going, Ponzi operators must continually attract more new investors who provide principal investments to provide “returns” to existing investors.

While Ponzi schemes can last for years, eventually and inevitably their operators are unable to recruit enough new investors to fund the withdrawal requests and returns of the earlier investors. Thus, like death and taxes, the ultimate failure of a Ponzi scheme is certain.[2]

With failure certain, the entities and individuals responsible for a Ponzi scheme will ultimately end up in bankruptcy court or state court proceedings. The following discussion will explore the significance of Ponzi schemes in bankruptcy cases and inform investors regarding their potential liability for disgorging payments received prior to the collapse of the Ponzi scheme.

II. The Basics

Where state statutes are similar to the Bankruptcy Code, cases analyzing the Bankruptcy Code provisions are persuasive authority.[3]

Powerful remedies are available to a Trustee who succeeds in carrying the initial burden of proving that the debtor was conducting a Ponzi scheme.[4] All “interest” or other “profit” payments to investors are at risk, regardless of the relative guilt or innocence of the individual investors.[5]

By looking at a Ponzi operation’s cash-in from investors and cash-out to investors, a Trustee can determine whether the investors’ fictitious profits may be recoverable to the estate. Bankruptcy trustees may choose to avoid the rights of a creditor under state law and bring a fraudulent transfer claim.[6] In addition to fraudulent transfers under state law, the Bankruptcy Code includes its own fraudulent transfer provisions.[7]
A trustee’s job [or receiver’s] is to investigate, assess, and account for the finances of the Ponzi operator's personal estate and any business entities associated with the scheme. A Trustee (or appointed receiver) will rely on bank records to re-create the activity of the Ponzi operation and often will need to retain forensic accounting experts to ensure a proper investigation. The Trustee’s job [or receiver’s] includes a duty to 1) identify creditors [those who are owed money], 2) identify debtors [those who owe money to the estate], 3) initiate litigation against the debtors to recover the sums owed, and 4) ultimately distribute the proceeds to the creditors.

Regarding preferential transfers, generally cases hold there is no “ordinary course of business” defense in a Ponzi scheme case. Since Ponzi operators tend to pay the greatest number of payments—and the highest payment amounts—immediately prior to the operation collapse, a great proportion of the dollars distributed be the Ponzi operator are recoverable as preferences. However, a Trustee may also recover from fraudulent transfers.

III. Major Cases


Defendant investor was among thousands of investors in a Ponzi scheme operated by plaintiff's investment corporation. The corporation promised investors a 20 percent return in 90 days, by using their money to provide working capital to Malaysian latex glove manufacturers. However, the money never made it to the Malaysian manufacturers. The money was used to provide “returns” to other investors.

Courts have routinely applied Uniform Fraudulent Transfer Act (“UFTA) to allow receivers or trustees in bankruptcy to recover monies lost by Ponzi scheme investors. In Donnell, Plaintiff receiver filed a complaint seeking to avoid the transfers to the investor as fraudulent and to recover property transferred. The investor contended that he was an innocent and dubious in regard to being asked to disgorge his profits as fraudulent transfers under the UFTA, Cal. Civ. Code § 3439.04. California’s fraudulent transfer act and the federal bankruptcy code's fraudulent transfer provisions are almost identical in form and substance; therefore, the court draws upon cases interpreting both.

Where causes of action are brought under UFTA against Ponzi scheme investors, the general rule is that to the extent innocent investors have received payments in excess of the amounts of principal that they originally invested, those payments are avoidable as fraudulent transfers. The appellate court noted that it possessed ancillary jurisdiction, even state law causes of action were alleged. Comparing the total he received, $73,290.70, with the amount he had to return, $31,555.32, showed that the investor would be permitted to retain $41,735.38. This represented a total return of approximately 83 percent of his investment. The court noted that most of the scheme's 5200 net losers were likely to recover only pennies on the dollar for their initial investment. The appellate court affirmed the district court's decision and held that UFTA had treated the investor fairly.

Where causes of action are brought under California Uniform Fraudulent Transfer Act against Ponzi scheme investors, the general rule is that to the extent innocent investors have received payments in excess of the amounts of principal that they originally invested, those payments are avoidable as fraudulent transfers. Defendant should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud. All he is being asked to do is to return the net profits of his investment—the difference between what he put in at the beginning and what he had at the end. The policy justification is ratable distribution of remaining assets among all the defrauded investors.

B. In re AFI Holdings

1. Reach Back Provisions

In AFI, the Defendant invested approximately $73,000 with AFI between 1995 and 1996 and received a total return of approximately $89,000 on his principal investment. The Trustee commenced adversary proceedings against the Defendant investor to avoid and recover the transfers made from AFI under 11 U.S.C. § § 544(b) and 500 and CAL. CIV. CODE § 3439.04 and 3439.09. The district court affirmed the bankruptcy court as to the remaining $16,424, the fictitious gain on Mackenzie's principal investment, as it was in excess of Mackenzie's restitution claim, and it was not transferred in connection with Mackenzie's withdrawal from the partnership. However, the Trustee appealed the decision and argued that the debtor’s estate is entitled to receiver the entire amount transferred to the Defendant investor plus interest.

A trustee may bring preference actions to recover funds that were transferred out of a Ponzi scheme during the 90 days prior the commencement of the bankruptcy to any creditors and one year prior to the filing date for insiders. To establish a preference claim, the trustee must prove: 1) the transfer occurred within the applicable period; 2) the debtor was insolvent at the time of the transfer; and 3) the transfer was a return of...
principal (existence of an antecedent debt).[29] The trustee may generally only bring a preference claim to recover transfers that constituted the return of an investor’s principal, and not to recover fictitious profits.[30] Good faith defense does not apply to preference claims; therefore, the Trustee is not required to plead or prove that the investor was on inquiry notice to recover preference funds.[31]

On appeal, the court in AFI noted that 11 U.S.C. § 548(a)(1) could not be used to avoid the transfer because the transfer occurred over one year from the date of the bankruptcy proceedings and 11 U.S.C. § 547 because the transfer was made long before the ninety-day reach back period. Also, this case arose before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which extended the one-year period for avoidance of fraudulent transfers under the Code to two years.[32] The facts showed AFI was a Ponzi scheme before Defendant “invested” in the partnership and before the transfers were made from AFI to Defendant.[33] No genuine issue of material fact was shown otherwise and therefore the record is enough to establish the transfers were made with actual fraudulent intent.[34]

How far back can the trustee or receiver “reach back” to avoid the fictitious profits distributed to investors? Federal bankruptcy law provides a general 90-day reach back period for preferential payments, but a two-year reach-back period for fraudulent transfer claims.[35] The Bankruptcy Code also empowers a trustee to bring fraudulent transfer claims under applicable state law.[36] State law claims regarding recovery of fraudulent transfers vary and may exceed the Bankruptcy Code’s two-year reach-back period.[37] For example, the New York Debtor & Creditor Law (the “NYDCL”) allows the trustee to recover transfers made within six years of the petition, as well as transfers made beyond such six-year period based upon the discovery rule.[38] The underlying analysis is substantially the same: a transfer may be avoided by the trustee, unless the transfer was taken both for value and in good faith.[39]

2. Reasonably Equivalent Value and a Proportionally Reduced Restitution Claim

However, one of the main issues in AFI was whether the transfers were a distribution of “reasonably equivalent value” or a transfer in exchange for a “proportionally reduced restitution claim.”[40] AFI examined two leading cases, Agretech[41] and United Energy[42] to determine the nature of the transfers.

a. Agretech and “Reasonably Equivalent Value”

In Agretech, the bankruptcy trustee sought to avoid the transfers pursuant to 11 U.S.C. 544(b) and applicable state statutes.[43] In this case, the good faith exception was found to not apply to the investor and thus the transfers were avoidable and recoverable by the Trustee.[44] In fraudulent transfer litigation, “good faith” has a different meaning than it does in other areas of the law. Courts apply an objective standard in determining what the recipient “knew or should have known.”[46] The burden to establish good faith falls on the transferee.[47] Because the investors held limited partnership interests or “equity securities” under 11 U.S.C. § 101(15) and not value, which is defined as satisfaction of a debt, the good faith exception did not apply[48]. The court allowed the Trustee to avoid the fraudulent transfers to the limited partners because the transfers were merely a receipt of money on account of the limited partners’ equity interests held because of their capital contributions.[49] The Court held that a distribution on account of a partnership interest relative to an investor’s capital contribution was not “reasonably equivalent value” as defined by the Bankruptcy Code and state law.[50]

b. United Energy and “Proportionally Reduced Restitution Claim”

In United Energy, the Bankruptcy Appellate Panel held that the payments given to the defrauded investors would be deemed to partially satisfy or release fraud or restitution claims.[51] In connection with the fraudulent transfer question, did the investors give “reasonably equivalent value” in exchange for the payments they received?[52] The investors were duped into buying products. Therefore, the investors had claims for rescission and restitution, which arose at the time of purchase.[53] The Court did not allow the Trustee to avoid the transfers because the investors exchanged “reasonably equivalent value” when their rights to restitution were proportionately reduced by the payments they received.[54]

The Trustee’s argued that Agretech controlled AFI on the fact that both cases contain limited partnership investors.[55] However, the discussion of “reasonably equivalent value” was only relevant as to the good faith analysis of the transfer. Just as the investors in United Energy acquired a restitution claim at the time they invested in the fraudulent company, investors in AFI acquired a restitution claim at the time of their principal investment.[56] Payments received from AFI, thought to be “returns” on their “investment” were actually funds received ending their interest in the so-called partnership.[57] The district court in AFI was correct to conclude that the good faith exception to actually fraudulent transfers was not barred as a matter of law because the investor’s right to rescission and restitution were “reasonably equivalent value.”[58]

c. Perkins v. Haines: Does the Type of Investment Matter?
1. Fraudulent Transfers and “For Value”

In *Perkins*, the Trustee argued that the transfers from the debtors to the investors, prior to the collapse of the Ponzi scheme were “fraudulent transfers” under 11 U.S.C. § 548(a)(1)(A) and applicable state law. The investors claimed the transfers were “for value”, an affirmative defense, under 11 U.S.C. 548(c). During the course of operation of the Ponzi scheme, the investors received one or more transfers of property from the debtors, representing returns or profit on their investment with the debtors.

A fraudulent transfer must be made with the “actual intent to hinder, delay, or defraud any creditor of the debtor,” generally requires an inquiry into the Ponzi operator's subjective state of mind.[59] To establish a Ponzi operator's subjective intent, courts have held guilty pleas and other admissions of debtors to be admissible and binding to establish actual intent to defraud.[60] Similarly, actual intent to defraud can be established if the court finds that the operator was in fact running a Ponzi scheme.[61]

When acting as transferees in good faith, 11 U.S.C. 548(c) provides an affirmative defense to investors who received property exchange for the “value” given to debtors. “Value” includes “satisfaction or securing of a present or antecedent debt of the debtor.”[62] A defrauded investor receives “value” from the debtor in exchange for a return on their principal investment, but not as payments in excess of principal.[63] The Trustee argued that the general rule should not apply to this case, because “the payments to investors operated to redeem the equity interests and were not made in satisfaction of a debt.”

A recipient of a fraudulent transfer—-even a transfer made by a debtor with the actual intent to defraud his or her creditors—-may establish a defense if the recipient provided “reasonably equivalent value” and received the payment in “good faith.”[64] Whether the recipient provided reasonably equivalent value turns on the nature of the payments received. Some courts have held that no reasonably equivalent value can be given for the fictitious profits of a Ponzi scheme.[65]

2. Substance Over Form

Although circumstances of the exchange were clocked in terms of a partnership interest, [we have looked] beyond the ‘form’ to the ‘substance’ of the transaction.[66]

*AFI* held that the general rule does apply to equity investors of a Ponzi scheme and rejected distinguishing between the forms of investment. The Trustee’s argument in *Perkins* rejects *AFI* and asks the court to differentiate the cases by the form of investment made by the investors. Because the debtors were all insolvent at the time of the transfers to the investors, the Trustee argues, the transfers served only to redeem their worthless equity interests. The court rejected the Trustee’s argument and reiterated *AFI* and the general rule that later transfers from the debtors, up to the amount of an individual’s investment, provided “value” to the debtors and satisfied the investor’s restitution and fraud claims.

IV. Conclusion

All Ponzi schemes eventually fail. When the scheme finally collapses some entities have received back more than their initial investment, while others have received back less. A Trustee’s duty is to seek avoidance actions to distribute the funds of the estate among the victims of the fraudulent scheme. By seeking to recover from those entities who received more than they invested, the trustee is able to make a distribution to those entities who received less than they invested. The winners in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to enjoy an advantage over later investors who were not so lucky.[67] Most courts will allow innocent investors to retain the payments they received, up to the amount of their principal investment.[68]

[5][d].
[12] id.
[16] id.
[17] id.
[18] id. at 768.
[19] id. at 770.
[21] id.
[22] id.
[23] id.
[26] id.
[27] id.
[31] id.
[33] id. at 704.
[34] AFI Holding, Inc. v. Mackenzie, 525 F.3d 700, 704 (9th Cir. Cal. 2008) [hereinafter AFI Holding].
[37] Ponzi Schemes, supra note 29.
[38] See N.Y. C.P.L.R. 203(g), 213(b) (2010).
[40] AFI Holding, supra note 34 at 705.
[41] In re Agricultural Research & Tech. Group, Inc., 916 F. 2d 528 (9th Cir. 1990).
[42] In re United Energy Corp., 944 F.2d 589 (9th Cir. 1991).
[43] AFI Holding, supra note 34 at 705.
[44] Id.
[45] 11 U.S.C. § 548(c); CIV. CODE § 3439.08(a).
[47] Id.
[48] AFI Holding, supra note 34 at 705.
[50] Id. at 705.
[51] Id. at 706.
[52] In re United Energy Corp., 944 F.2d 589, 594-5 (9th Cir. 1991)
[53] Id. at 594.
[54] Id. at 596.
[56] Id.
[57] Id.
[58] AFI Holding, Inc. v. Mackenzie, 525 F.3d 700, 709 (9th Cir. Cal. 2008) [hereinafter AFI Holding].
[60] See, e.g., In re Slatkin, 525 F. 3d 805, 811-15 (9th Cir. 2008); Scholes v. Lehmann, 56 F. 3d 750, 762 (7th Cir. 1995); In re Bayou Group, LLC, 396 B.R. 810, 835 (S.D. N.Y. 2008).
[63] See e.g., Donell, supra note 20 at 770.
[64] Id.
[65] See, e.g., In re United Energy Corp., 944 F. 2d 589, 595 n.6 (9th Cir. 1991).
[66] AFI Holding, supra note 58 at 708.
[67] Donell v. Kowell, 533 F.3d 762, 770 (9th Cir. Cal. 2008).
[68] Ponzi Schemes, supra note 29.
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