ALERTS

Eleventh Circuit Insulates Hedge Fund Investors in Ponzi Scheme From Fraudulent Transfer Attack

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The U.S. Court of Appeals for the Eleventh Circuit, on Oct. 27, 2011, held "that a defrauded investor [in a Ponzi scheme] gives 'value' to the Debtor[s] in exchange for a return of the principal amount of the investment, but not as to any payments in excess of principal." *Perkins v. Haines*, 661 F.3d 623, 627 (11th Cir. 2011). Although the defendant investors "held an equity interest in the insolvent debtors," the court reasoned that "defrauded investors have a claim for fraud against the debtor arising as of the time of the initial investment." *Id.* (citing decisions from the Fourth, Seventh, Ninth and Tenth Circuits). According to the court, it was ruling on a single narrow "issue of first impression in this Circuit": whether the return of a nominal equity investment to a defrauded hedge fund investor constituted "value." *Id.* at 625.

Facts

Each of the debtors "was structured either as a limited liability company or a limited partnership." *Id.* at 626. Typical of other Ponzi schemes, "capital contributions made to the Debtors by later equity investors were used to repay earlier investors more than their investments were actually worth, as well as fictitious profits." *Id.*[1] The debtors were able to "induce prospective investors to make new equity investments . . . through execution of a limited liability company agreement, a limited partnership agreement, and/or a subscription agreement." *Id.* Thus, "each investor

defendant held an equity interest in one or more of the debtors, denominated as a membership unit or limited partnership interest." *Id.*

The Lower Court

The trustee sued to recover the distributions made to the investors, alleging that all payments made to the investors prior to the collapse of the debtors' Ponzi scheme were fraudulent transfers under Bankruptcy Code ("Code") § 548(a)(1)(A) and applicable state law ("made . . . with actual intent to hinder, delay, or defraud" creditors). *Id.* at 625. In response, the investors asserted an affirmative defense under Code § 548(c), claiming that the transfers were "for value and in good faith." *Id.* After the bankruptcy court denied the trustee's motion for partial summary judgment on the sole issue of "value," it certified the trustee's appeal to the Eleventh Circuit. Because transfers "made in furtherance of [a Ponzi] scheme are presumed to have been made with the intent to defraud" creditors, the trustee argued that "transfers to redeem an equity investment in an insolvent entity (initially made free of fraud) cannot constitute a transfer 'for value.' " *Id.* at 626-27.

Court of Appeals

The Eleventh Circuit accepted the "general rule" adopted by other Circuits that the "return of the principal amount" of the defrauded investor's investment constituted "value." *Id.* at 627 (citing *Donell v. Kowell*, 533 F.3d 762, 770 (9th Cir. 2008); *Scholes v. Lehman*, 56 F.3d 750, 757-58 (7th Cir. 1995)). "Courts have recognized that defrauded investors have a claim for fraud against the debtor arising as of the time of the initial investment." *Id.* (citing *Jobin v. McKay (In re M&L Business Mach. Co., Inc.)*, 84 F.3d 1330, 1340-42 (10th Cir. 1996); *Wyle v. Ryder (In re United Energy Corp.)*, 944 F.2d 589, 596 (9th Cir. 1991)). Any "fictitious profits" paid to the investors, however, are recoverable by the trustee because "they exceed the scope of the investors' fraud claim" and are thus not made for "value." *Id.* (citing *Sender v. Buchanan (In re Hedge- Investments, Assoc., Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996); *In re United Energy*, 944 F.2d at 595, n.6).

The trustee argued that the other Circuit decisions were based on either tort or contract claims held by the defrauded investors. Because the investors in *Perkins* held an equity interest in the insolvent debtors, payments to the defendant investors, asserted the trustee, were redemptions of "their equity interests and were not made in satisfaction of

a debt." 661 F.3d at 627. Because "transfers to redeem an equity investment in an insolvent entity . . . cannot constitute a transfer 'for value,' " reasoned the trustee, cases such as *Donell*, *Scholes* and *Jobin* did not apply. *See, e.g.*, *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (1st Cir. 1983) (held corporate debtor received less than reasonably equivalent value when shareholder redeemed equity investment).

The Court of Appeals in *Perkins* rejected the trustee's argument because of the existence of a Ponzi scheme. *Id.* at 628. Unlike the routine equity redemption case, investors here "were fraudulently induced into making their initial investments," and "possessed fraud claims that would be satisfied in whole or in part by virtue of the later transfers." *Id.* Although the trustee "asked the court to focus solely on the form of the investment to the exclusion of all other factors, and to ignore the realities of how Ponzi schemes operate," the Eleventh Circuit would not apply a "form over substance rule in fraudulent transfer actions involving Ponzi schemes." *Id.* Indeed, the Ninth Circuit had been "the only [other] court of appeals to address this issue" and to apply "the general rule to equity investors in a Ponzi scheme," rejecting "any attempts to distinguish between the forms of the investment." *Id.* (citing *AFI Holding*, 525 F.3d at 708-09 (investor "acquired a restitution claim at the time he bought into [the] Ponzi scheme, . . . [and] [i]t is this restitution claim, in toto, that [the investor] exchanged when [the debtor] returned [the investor's] principal 'investment' amount.")). As explained by the Eleventh Circuit, the "general rule applies in a Ponzi scheme setting regardless of whether good faith investors have an equity interest in, or some other form of claim against, the legal equity constituting the instrument of the fraud." *Id.* at 628-29. In short, "later transfers from the debtors up to the amount of the investment satisfied the investor defendants' restitution or fraud claims and provided value to the Debtors." *Id.* at 629.

Comment

The battle is not over for the defendant investors. They still have to convince the bankruptcy court that they acted in "good faith" to prevail on their defense under Code § 548(c). *See, e.g.*, *Orlick v. Kozyak (In re Financial Federated Title & Trust, Inc.)*, 309 F.3d 1325 (11th Cir. 2002) (held commissions paid to transferee, to extent they did not exceed value of services rendered in good faith, without knowledge of debtor's Ponzi scheme, not subject to avoidance as constructively fraudulent transfers); *Jimmy Swaggart Ministries v. Hays (In re Hannover Corp.)*, 310 F.3d 796

(5th Cir. 2002) (held when transferee had no way of knowing that debtors were insolvent and when, upon reading newspaper stories about a fraud suit against the debtor, transferee undertook its own investigation, contacting SEC and Federal District Court, and receiving assurances that it could continue to accept payments from debtor, transferee had received payments in good faith); *In re Bayou Group LLC*, 439 B.R. 284, 314 (S.D.N.Y. 2010) (held bankruptcy court improperly granted summary judgment against defendants in Ponzi scheme fraudulent transfer case on bad faith ground because it had "significantly expanded the scope of information prior courts have found sufficient to require inquiry"; rejected bankruptcy court's test of "some infirmity in" debtor's business or "integrity of management" as "so broad as to be indefinable"; instead, defendant on inquiry notice only when it has information "suggesting [debtor's] insolvency or a fraudulent purpose in making a transfer . . . ."); *In re Manhattan Invs. Fund Ltd.*, 2009 WL 1528764 (2d Cir. 2009) (affirmed jury verdict in favor of defendant who "had conducted itself in good faith throughout the period of the transfers in question.").[2]

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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[1] "The essence of a Ponzi scheme is to use newly invested money to pay off old investors and convince them that they are earning profits rather than losing their shirts." *Id.* at 625 n.1.

[2] SRZ represented defendants in both *In re Bayou Group LLC* and *In re Manhattan Invs. Fund Ltd.*

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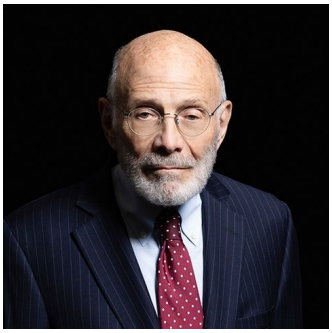

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