WHEN FAIR CONSIDERATION IS NOT FAIR

*David F. Kurzawa II**

INTRODUCTION

Suppose as you near retirement, you would like to make short term investments. After consulting with your financial advisor, you decide to invest $10,000 in a promissory note from X Corporation. Over the course of twenty months the interest rate on this investment fluctuates between 6% and 8%. During this time, you decide to invest another $10,000 with a variable interest rate that fluctuates between 6% and 7.5%. When both of your investments finally mature, you accept payment and do not enter into any other transactions. Your $20,000 investment realized a total return of $22,200. While other investments could have yielded a better rate of return, this investment, although relatively conservative, still earned more than a traditional savings account.

Seven years later and five years into your retirement, you receive a complaint in the mail that names you as the defendant in a lawsuit. The complaint alleges fraudulent transfers and mentions recovery of invested funds. You flip to the last page of the complaint and there are the figures from the short-term investment made in X Corporation almost seven years ago. The complaint states that X Corporation has filed for Chapter

* J. D. expected 5-12-02 Cornell Law School.

11 bankruptcy and the U.S. trustee appointed to the bankruptcy is attempting to recover a fraudulent transfer paid to you by the corporation. The trustee alleges that the corporation was conducting a "Ponzi" or pyramid scheme, which pervaded its entire business. Because of the fraudulent activities, the investment payments made to you over seven years ago must be returned to the trustee. You do not understand how fraud or a pyramid scheme could have been involved. The rate of return was lower than what other securities were paying. In addition to using a broker, the 6% to 8% annual interest rate you received was well within the state's legal rate of 16%. Nearly seven years have passed since those funds were paid to you. Now living on social security benefits and a fixed income, there is no way that you can pay the trustee $2,200, let alone hire an attorney to represent you in this lawsuit.

The situation described above happened to more than 10,000 individual investors sued in the Bennett Funding Group, Inc. Chapter 11 Bankruptcy.[1] The Bennett Funding bankruptcy is one of the largest bankruptcies involving a pyramid or "Ponzi scheme" in recent history.[2] In a Ponzi scheme, an investment program is devised where "the returns paid to investors are comprised of nothing more than the principal investments of other investors."[3] Eventually this investment scheme breaks down leaving many investors, who expected profits, with a loss of principal. Once a Ponzi-style enterprise collapses and becomes a debtor under the Bankruptcy Code, the trustee of the estate has the responsibility of collecting whatever assets remain and paying investors and other creditors of the estate.[4] Often there are very few assets left in the estate as many have been paid as returns to investors involved in the scheme. The trustee appointed to a Ponzi scheme estate has the ability to bring a claim against a former investor to recover the payments under the fraudulent transfer and preference provisions of the Bankruptcy Code.[5] In March 1998, the appointed trustee of Bennett Funding's bankruptcy filed over 10,000 lawsuits to recover $100 million in alleged fraudulent transfers.[6] Three years later lawsuits were still pending against former investors.[7]

---

1 Charley Hannagan, *Logjam of Lawsuits, No Bennett Refunds Two Years After Initial Charges, Investors Still Wait For Justice*, SYRACUSE HERALD AMERICAN, Mar. 29, 1998, at E1.

2 The term "Ponzi scheme" has been applied to a number of financial frauds that follow a pattern similar to the famous swindle operating during the 1920s by Charles Ponzi. The details are described in Cunningham v. Brown, 265 U.S. 1 (1924).

3 Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (Spring 1998).

4 *Id.* at 158.

5 *Id.*

6 *Id.* at 159.

7 *See* Order Granting Trustee's Motion for an Order (A) Authorizing the Consolidated Estate to Enter Into Settlements of Fraudulent Conveyance/Transfer and Preference Claims

While the U.S. Bankruptcy Code provides for recovery of fraudulent transfers under either a theory of constructive or actual fraud, a number of serious concerns arise when an investor, who acted in good faith and without any knowledge of fraud, is sued for return of his or her principal or interest paid or both. Although these lawsuits serve as a means to redistribute assets to creditors, they have a punitive effect on good faith investors. In many cases, by the time the trustee brings an action, the investor has already spent his or her return from the investment since the actions are brought more than four years after the investor received the return. Because of the fraudulent activity of the bankrupt corporation, the good faith investor has to defend him or herself in court and return these "payments" to the estate.

The Bennett investors, including a number of banks, invested in Bennett Funding on the advice of brokers or financial advisors who were unaware of a Ponzi scheme due to the low rate of return and Bennett's profitable appearance.[8] Typically, a Ponzi scheme attracts its investors by offering an exorbitant rate of return.[9] However, the Bennett investors received a conservative rate of return that ranged from 8 % to 12 % per annum.[10] At the time these lawsuits were filed in New York State, the maximum rate of interest allowed by banking law was 16% per year.[11] Therefore, there was very little evidence to provide notice that Bennett was conducting a Ponzi scheme. Most investors have long spent the returns from the early 1990s on retirement expenses, college funds or other daily living expenses.

Part I of this Note briefly examines the two theories of fraudulent conveyance recovery available to a bankruptcy trustee. Part II provides the historical background of the Bennett Funding litigation and the stalemate that ensued. Part III examines the trustee's expansive power to

with Certain Former Investor Defendants and (B) Establishing Time to Answer for Non-Accepting Former Investor Defendants, *In re* The Bennett Funding Group, Inc., No. 96-61376 (Bankr. N.D.N.Y. Jan. 30, 2001) [hereinafter Order Granting Trustee's Motion].

8 *See* Breeden v. Thomas (*In re* The Bennett Funding Group, Inc.), No. 98-61376, 1999 Bankr. LEXIS 1843, at *18 (Bankr. N.D.N.Y. Apr. 29, 1999); Breeden v. Gloucester Bank & Trust Co. (*In re* The Bennett Funding Group, Inc.), No. 96-61376, slip op. at 6 (Bankr. N.D.N.Y Feb. 9, 1999).

9 *See* Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281 (10th Cir. 1996) (167% interest rate where legal interest rate was 8% per annum unless otherwise contracted); DiCello v. Jenkins (*In re* Int'l Loan Network, Inc.), 160 B.R. 1 (Bankr. D.C 1993) (625% interest rate paid where legal interest rate was 24% per annum); Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843 (D.Utah 1987) (100.8% APR interest rate where legal interest rate was 10% per annum unless otherwise contracted).

10 *See* Statement Pursuant to Federal Rules of Bankruptcy Procedure 7056 and Local Bankruptcy Rule 7056-1 (Of Material Facts As To Which the Official Early Investors Committee Contends) There Is No Genuine Issue To Be Tried, May 27, 1998, ¶ 14.

11 *See* N.Y. GEN. OBLIG. LAW § 5-501 (McKinney 1999); N.Y. BANKING LAW § 14-a (McKinney 1999).

recover fraudulent transfers through the development in two cases brought under each theory of recovery. Finally, Part IV discusses the unjust and punitive effects that the current fraudulent conveyance laws can have on individuals involved in a Ponzi scheme bankruptcy. Part IV also proposes a modification to the law to prevent such unfairness and inequity in the future. This Note concludes that reform is necessary under current debtor-creditor and bankruptcy laws in order to address both the needs of creditors and good faith investors in a Ponzi scheme bankruptcy.

I. THE U.S. BANKRUPTCY CODE AND THE UNIFORM FRAUDULENT CONVEYANCE ACT

The trustee has two theories of recovery that he or she may exercise to recover funds from a Ponzi scheme investor: constructive fraud or actual fraud. A Ponzi scheme investor receives two types of payment on hir or her investment: (1) a return of principal investment, and (2) the ficticious profits on those investments.[12] If the trustee pursues a constructive fraud theory, demonstrating that at the time of the transfer to the investor the debtor lacked sufficient funds, the investor can retain any repayment of principal.[13] However, if a trustee pursues an actual fraud theory establishing proof of a Ponzi scheme, the estate may recover all sums paid to an investor.[14]

There are three sources that govern fraudulent transfer law: (1) § 548[15] and § 544[16] of the Bankruptcy Code (2) the Uniform Fraudulent

---

[12] *See* McDermott, *supra* note 3, at 164.

[13] *See id.* at 164-65.

[14] *See id.* at 173.

[15] Fraudulent transfers and obligations

(a)(1) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(A) made such transfer or incurred such obligation 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 or such obligation was incurred, indebted; or

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C § 548 (1994).

[16] Trustee as lien creditor and as successor to certain creditors and purchasers

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or

Conveyance Act (UFCA) and (3) the Uniform Fraudulent Transfer Act (UFTA).[17] Today, almost every state has adopted either the UFCA or the UFTA and there are very few differences between the two.[18] The Bankruptcy Code allows the trustee to bring a claim under § 548 or § 544 and the appropriate state law, either the UFCA or UFTA.[19] To establish a constructive fraud claim, the trustee must first show that the debtor had an interest in the property or funds transferred to the investor. In addition the trustee must prove two additional elements:

> (1) that the transfers were made for less than reasonably equivalent value or fair consideration; and
> (2) that the transfers left the debtor with insufficient funds, under one of the three possible scenarios:
> (a) the debtor was insolvent when the transfers were made,
> (b) the debtor was engaged in a business for which the property retained after the transfers was an unreasonably small capital, or
> (c) the debtor intended or believed that it would incur debts beyond its ability to pay as those debts matured.[20]

If a trustee pursues a claim under actual fraud against an investor, he or she must prove that the debtor (1) had an interest in the funds transferred, and (2) "that the transfer was made with actual intent to hinder, delay or defraud the debtor's creditors."[21] As noted above, under an actual fraud theory, unless the investor can satisfy the requirements of a good faith defense the trustee can recover all an investor's returns without regard for whether these amounts are styled as fictitious profits or repayment of principal.[22]

In New York, which codified a version of the UFCA as NYD&CL §§ 271-281, a trustee can proceed under either an actual or constructive

---

> may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable . . .
>
> (b)(1) Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C § 544 (1998).

[17] *See* McDermott, *supra* note 3, at 159.

[18] *Id.*

[19] Section 544(b) of the Bankruptcy Code specifically allows a trustee to take advantage of state law: "[T]he trustee may avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable state law by a creditor holding an unsecured claim . . . ." 11 U.S.C. § 544(b)(1) (1998).

[20] McDermott, *supra* note 3, at 160.

[21] *See id.*

[22] *See id.* at 160-61.

fraud theory to recover fraudulent transfers pursuant to §§ 273-276.[23] While the NYD&CL echoes most of the requirements listed above, § 276, which looks at the transferor's state of mind, requires that it work in conjunction with NYD&CL § 278 to prevent recovery against a transferee who lacked both knowledge of fraud and who provided "fair consideration" in exchange for the transfer.[24]

NYD&CL § 278 provides for a "good faith" affirmative defense for either a constructive or actual fraudulent conveyance claim.[25] However, § 278 splits the burden of proof between the plaintiff and the defendant. Although the plaintiff must carry the burden of proving the defendant's knowledge of fraud, the defendant must prove that there was fair consideration present during the transaction.[26]

II. BACKGROUND TO THE BENNETT FUNDING GROUP LITIGATION

The Bennett Funding Group, Inc., located in Syracuse, New York, was in the business of leasing office equipment and selling various interests in those leases to investors.[27] By early 1996, Bennett had sold over $2 billion in products to thousands of individuals and over 200 financial institutions.[28] Later that same year the Securities and Exchange Commission filed suit, alleging investment fraud.[29] Because of the suit, Bennett and its subsidiaries filed for Chapter 11 bankruptcy on March 29, 1996.[30] The bankruptcy court appointed Richard C. Breeden trustee. He revealed that Bennett owed $215 million to financial institutions and at least $674 million to 11,500 individual investors.[31] Bennett used an ac-

---

23 N.Y. DEBT. & CRED. LAW § 276 (McKinney 1999) ("Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.").

24 1. Where a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has derived title immediately or mediately from such a purchaser,

> a. Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or
>
> b. Disregard the conveyance and attach or levy execution upon the property conveyed.
>
> 2. A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment.

N.Y. DEBT. & CRED. LAW § 278 (McKinney 1999).

25 *Id.*

26 *Id.*

27 McDermott, *supra* note 3, at 157.

28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.*

count consisting of commingled proceeds from individual and institutional investors to create the appearance of investment returns, resulting in a collective debt of over $1 billion, most of which will never be recovered by creditors.[32]

The trustee alleged that the investment scheme pervading The Bennett Funding Group was a massive pyramid or "Ponzi scheme."[33] As noted above, this scheme involves investors receiving profits from the investment capital paid by newly attracted investors.[34] Typically, the debtor guarantees the investors large profits from their principal investments. To allow people at the top to receive a return requires that more people join in the scheme. Eventually the scheme collapses, leaving many investors without profits or repayment of their principal. In order to recover these assets the trustee appointed to a Ponzi scheme estate may bring a claim against those investors who received returns from their investments.[35] The trustee can distribute the recovered funds to other investors, creditors, and non-investor creditors of the estate.

In March 1998, Bennett's trustee commenced over 10,000 lawsuits, 3000 of which were against former investors, in an attempt to recover over $100 million of allegedly fraudulent conveyances.[36] However, since the commencement of these lawsuits very little has happened. Almost three years later, claims were still pending against former investors.[37] In November 1998, the trustee presented former investors with a settlement offer.[38] However, perhaps due to the unfavorable terms of the settlement,[39] former investors did not accept it and the actions continued.

Many attorneys involved in this matter believe the lawsuits filed against former investors were an attempt by the trustee to gain leverage and obtain a large settlement with an insurance group that insured a number of investments made with Bennett. The Assicurazioni Generali Insurance Company (hereinafter "Generali Insurance") provided insurance to individual investors as well as financial institutions on their invest-

---

[32] *Id.* at 157-58.

[33] *See Thomas*, 1999 Bankr. LEXIS 1843, at *7.

[34] *See id.* at *6 n.6.

[35] McDermott, *supra* note 3, at 158.

[36] *See, e.g.*, Motion of Richard C. Breeden, as Trustee Pursuant to Federal Bankruptcy Procedure 9019 for an Order Authorizing the Consolidated Estate to Enter into Settlements of Fraudulent Conveyance/Transfer and Preference Claims with Certain Former Investor Defendants, *In re* The Bennett Funding Group, Inc., No. 96-61376 (Bankr. N.D.N.Y. Nov. 13, 1998) [hereinafter Trustee's Motion]. *See generally* McDermott, *supra* note 3, at 158-59.

[37] *See* Order Granting Trustee's Motion, *supra* note 7, at 2.

[38] Trustee's Motion, *supra* note 36.

[39] *See id.* (requiring former investors to pay 30% of amount owed after reducing the total amount by $1000); *see* Order Granting Trustee's Motion, *supra* note 7.

ments.[40] Generali Insurance afforded the trustee the deep pockets that he required to recover millions of dollars for the estate.

In April 1999, at the expense of the individual investors, the Trustee and Generali Insurance reached a settlement agreement.[41] The terms of the settlement provided that Generali Insurance would pay the estate $125 million.[42] It is estimated that the Generali Insurance settlement will provide more money to the estate than will all the lawsuits filed against former investors. While the trustee was quick to reach a settlement with Generali Insurance, he took very little action to bring an end to the cases pending against individual former investors. As of April 2002, cases are still pending against former investors.

III. *GLOUCESTER* AND *THOMAS*

In order to evaluate the trustee's power to recover alleged fraudulent transactions, it is helpful to examine the two categories of cases that were part of the Bennett litigation. One category of lawsuits included claims against banks and other financial institutions that loaned funds to Bennett's leasing operation. The second type of lawsuits included those suits against individual investors or "former investors" who invested in the leases themselves.[43] In section A, the *Gloucester* case examines the trustee's constructive fraud claim against a financial institution and section B explores, through the *Thomas* case, an actual fraud claim brought against a former investor. While both of these cases demonstrate the trustee's expansive power in recovering fraudulent conveyances, they also illustrate the few options available to a defendant named in the Bennett litigation.

A. *BREEDEN V. GLOUCESTER BANK & TRUST CO.*

Gloucester Bank & Trust Company (herinafter "Gloucester") allegedly helped finance the Bennett leasing operation by providing loans to them.[44] Bennett did attempt to repay their loan obligation to Gloucester. However, the trustee viewed the transfer of funds to Gloucester as a fraudulent conveyance and therefore, recoverable.[45] The trustee filed a complaint in the Federal Bankruptcy Court for the Northern District of New York against Gloucester and other financial institutions under § 548(a)(1)(A), (a)(1)(B), § 544(b) and §§ 271-281 of the New York

40 *See Thomas*, 1999 Bankr. LEXIS 1843, at *3 n.3.

41 *See In re* The Bennett Funding Group, Inc., No.96-61376, 1999 Bankr. LEXIS 1860 (Bankr. N.D.N.Y. Apr. 9, 1999).

42 *See id.* at *13.

43 *See Gloucester Bank & Trust Co.*, No. 96-61376, slip op. at 21. (Bankr. N.D.N.Y. Feb. 9, 1999).

44 *Id.* at 7.

45 *Id.* at 3.

State Debtor and Creditor Law ("NYD&CL").[46] In response to the claim, Gloucester filed a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) in conjunction with Rule 7012(b) of the Federal Rules of Bankruptcy Procedure.[47]

On August 1, 1996, Gloucester filed a lawsuit against the Bennett Estate asserting a secured interest in the loan transactions.[48] In mid-August, Gloucester also sought to lift the automatic stay on certain lease proceeds to which it claimed an interest and enjoin the trustee from disposing of the proceeds.[49] In his amended answer of September 25, 1996, the trustee responded and asserted fifteen counterclaims against the bank.[50] In 1997 and early 1998, after a number of banks settled with the trustee, he asserted new fraudulent transfer claims against Gloucester and other banks that had commenced adversary proceedings against him.[51] One of the four causes of actions was to avoid all loan payments made by Bennett to Gloucester within one year of the filing of the bankruptcy petition as fraudulent transfers under § 548(a) of the Code.[52] The other relevant cause of action attempted to recover loan payments made within six years of the petition under § 544(b) of the Code and the fraudulent conveyance provision of NYD&CL §§ 271-281.[53] On April 9, 1998, Gloucester moved to dismiss the trustee's complaint.[54]

Eventually, the court granted Gloucester's motion to dismiss those causes of action based on § 548.[55] However, the court denied the motion to dismiss the causes of action brought under § 544(b) and §§ 271-281 of the NYD&CL.[56] The New York State version of the UFCA provides the trustee with four separate causes of action against constructively fraudulent conveyances, each requiring the plaintiff to establish that the transfers were made "without fair consideration."[57] Section 272 of the NYD&CL defines what constitutes fair consideration:

> Fair consideration is given for property, or obligation: (1) When in exchange for such property, or obligation as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied or (2) When such property, or obligation is received in good faith to

46 *Id.* at 8.
47 *Id.* at 3-4.
48 *Id.* at 6.
49 *Id.* at 6.
50 *Id.*
51 *Id.* at 8.
52 *Id.*
53 *Id.*
54 *Id.*
55 *Id.* at 21.
56 *Id.*
57 *Id.* at 19.

> secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property or obligation obtained.[58]

The court in *Gloucester*, relying on prior case law, interpreted the "good faith" component of § 272 to exist only when both the transferee and the transferor acted in good faith.[59]

Although the trustee carries the burden of establishing lack of fair consideration in a constructive fraud action brought under NYD&CL, the trustee's burden is disjunctive.[60] Under this disjunctive burden the trustee can successfully disprove fair consideration by establishing either a lack of fair economic value or by proving a lack of good faith on the part of transferor or transferee.[61] In the *Gloucester* case, as well as in a majority of the former investor cases, the trustee did not claim that the bank had acted in bad faith.[62] However, since Bennett had acted with subjective bad faith throughout all of its transactions with Gloucester, the court concluded that if the trustee could establish these facts at trial as a matter of law the Gloucester and Bennett transactions could not have been made for fair consideration under § 272 of the NYD&CL.[63]

The constructive fraud cause of action, as with the actual fraud claims, does contain an affirmative defense. NYD&CL § 278 provides a two-prong test that splits the burden between the plaintiff and the defendant.[64] The plaintiff carries the burden of proof on the issue of the defendant's knowledge of fraud. On the other hand, the defendant must establish that there was fair consideration present during the transactions.[65] The trustee in his complaint against Gloucester never alleged actual or constructive knowledge of Bennett's fraud.[66] However, the court held that Gloucester might not be able to prove fair consideration, as defined under § 272 and therefore might not be protected by § 278.[67] The court denied Gloucester's motion to dismiss the causes of action alleging constructive fraudulent conveyances.[68]

In the early part of 2000, Gloucester and a number of other banks consolidated their claims and appealed this decision to the Bankruptcy Appellate Panel for the Second Circuit. The Appellate Panel narrowly

58 N.Y. DEBT. & CRED. LAW § 272 (McKinney 1999).
59 *See Gloucester Bank & Trust Co.*, No. 96-61376, slip op. at 18.
60 *Id.* at 19.
61 *Id.*
62 *See id.* at 20.
63 *Id.* at 19-20.
64 *Id.* at 20.
65 *Id.*
66 *Id.* at 20.
67 *Id.*
68 *See id.* at 21.

reversed the lower court ruling. The details and ramifications of this appeal are discussed in section C.

B. *BREEDEN V. THOMAS*

In *Thomas*, an individual investor, in an effort to avoid litigation moved to dismiss the causes of action filed against him by the trustee for investments that he made a number of years earlier.[69] The decision in *Gloucester* played a significant role in the success of Thomas and other former investors. However, unlike *Gloucester*, the trustee proceeded against Thomas and other former investors under a theory of actual fraud. The trustee, while filing a constructive fraud claim against former investors, has a better likelihood of success under actual fraud because, if a Ponzi scheme exists, the transactions made to former investors were intended to hinder, delay, or defraud creditors. In addition, actual fraud, if proven, may entitle the trustee to recover not only the fictitious profits, but the principal invested as well.[70]

This hypothetical introduction is based, in part, upon Stephen Thomas. He invested $20,000 in Bennett over a two year period, earning upon maturity a return of about $2,200; the interest rate this investment earned ranged from 6% to 8%.[71] The trustee, pursuant to §544(b) of the Code, filed causes of action under §§ 271-281 of the NYD&CL.[72] While the trustee did pursue a claim of constructive fraudulent conveyance through §§ 273-275 of NYD&CL, it is less significant because of the amount of funds invested and the nature of the investment. In *Thomas*, the court dealt at length with the actual fraud claim brought under §276 of NYD&CL.[73]

NYD&CL §276 allows for recovery of transfers if they were made with actual intent to "hinder, delay, or defraud either present or future creditors."[74] Under § 276, the court may only examine the state of mind of the transferor, not the actions or intent of the transferee.[75] The Bankruptcy court determined that, in order to fully understand actual fraudulent conveyances, § 276 must be read in conjunction with § 278.[76] However, §278 provides that recovery may not be had against a transferee who lacked knowledge of the fraud and who provided fair consideration in exchange for the transfer. As noted above, fair consideration is defined in terms of § 272, which the court interpreted in *Gloucester* to

69 *See Thomas*, 1999 Bankr. LEXIS 1843, at *2-4.
70 *See* McDermott, *supra* note 3, at 160-61.
71 *Thomas*, 1999 Bankr. LEXIS 1843, at *4.
72 *Id.* at *6.
73 *See id.* at *10-20.
74 N.Y. DEBT. & CRED. LAW § 276 (McKinney 1999).
75 *See id.*
76 *See Thomas*, 1999 Bankr. LEXIS 1843, at *11.

require the good faith of both the transferor and the transferee.[77] Thus, under this interpretation, the transfer from a bad faith transferor to an unsuspecting good faith transferee will never be treated as a transfer made with fair consideration.[78]

This interpretation led the court to deny Thomas's motion to dismiss because the trustee provided enough evidence to establish that a Ponzi scheme did exist.[79] The court also denied Thomas's summary judgment motion pursuant to the affirmative defense laid out in § 278; this defense is only available to a transferee that provided "fair consideration" for the transfers in the sense of § 272.[80]

This ruling leaves Thomas and other former investors with very limited options. Thomas, in order to establish that there was "fair consideration" must go to trial and attempt to prove that a Ponzi scheme did not exist. While this option may appear to be viable, it may prove futile for a number of reasons.

First, to litigate the issue of whether a Ponzi scheme did exist will be difficult given the substantial evidence that some type of illegal investment scheme was being conducted on behalf of Bennett. Second, to litigate this issue and bring it to trial will undoubtedly cost thousands of dollars. Thomas, like other former investors, is being sued for the return of profits, which in this case constitute $2,200. From an economic standpoint this option is clearly not logical. The court's ruling forces Thomas to either litigate or pay the amount that the Trustee is attempting to recover. Since the ruling, Thomas and other former investors have attempted to reach some settlement agreement with the trustee.[81] In late January 2001, the trustee proposed another settlement offer to former investors. However, the settlement offer still requires former investors to pay a significant percentage on their return or file an answer with the court to avoid a default judgment.[82]

C. THE *GLOUCESTER* APPEAL AND THE NARROW RESULT IT BRINGS TO FINANCIAL INSTITUTIONS

On May 25, 2000, the United States Bankruptcy Appellate Panel for the Second Circuit ("BAP") narrowly reversed the *Gloucester* decision

---

77 *See Gloucester Bank & Trust Co.*, No. 96-61376, slip op. at 19.

78 *See Thomas*, 1999 Bankr. LEXIS 1843, at *11-12.

79 *See id.* at *18.

80 *Id.* at *20.

81 Interview with Laura Harris, Attorney for Stephen Thomas and other former investors, in Syracuse, N.Y. (July 18, 2000).

82 *See* Trustee's Settlement Package Sent to Former Investor, February 2001, *Thomas*, 1999 Bankr. LEXIS 1843 (No. 98-61376) (requiring former investors to repay either 25% or 50% of amount owed after reducing the total amount by $1000) [hereinafter Trustee's Settlement Package].

as it applied to the constructive fraudulent conveyance causes of actions.[83] Gloucester Bank, and a number of other banks consolidated their claims and appealed the *Gloucester* decision. The issue presented on appeal was whether the lower court properly interpreted the "good faith" component in § 272 by allowing the trustee to successfully disprove fair consideration by establishing a lack of good faith on behalf of the transferee or the transferor.[84] The lower court had held that, under NYD&CL § 272, a lack of good faith could be proven if the transferor alone was acting without good faith.[85]

The BAP believed that the lower court interpreted § 272 inconsistently as it relates to constructive fraud. While the BAP acknowledged that a number of states that have adopted the UFCA are split as to whether the good faith of the transferor is needed to meet the good faith component of fair consideration for constructive fraudulent conveyances,[86] the United States Court of Appeals for the Second Circuit ("Second Circuit") previously resolved this issue under NY State law. In HBE Leasing Corp. v. Frank ("HBE 1") and later in HBE Leasing Corp. v. Frank ("HBE 2"), the Second Circuit interpreted § 272 to require only the good faith of the transferee in order to satisfy the good faith component of fair consideration.[87] Therefore, the BAP concluded that for constructive fraud causes of action in the Second Circuit, only the good faith of the transferee is needed.[88]

On August 14, 2000, the court granted Gloucester's motion to dismiss the constructive fraudulent conveyance cause of actions filed against them.[89] However, the Bankruptcy court reserved the decision concerning motions to dismiss the fraudulent conveyances claims based upon actual fraud under NYD&CL.[90] For Gloucester and other financial institutions, this was the end of a costly legal maneuver filed against them over four years ago. The court will likely dismiss the actual fraud causes of action because the transactions between Bennett and the banks were for repayment on loans, not investments into the leasing scheme.[91]

---

[83] *See* Breeden v. Sprague Nat'l Bank (*In re* The Bennett Funding Group, Inc.), No. 96-61376, slip op. at 4 (B.A.P. 2d Cir. May 25, 2000).

[84] *See id.* at 3-4.

[85] *Id.* at 4.

[86] New Jersey, Massachusetts, and New Hampshire believe that only the transferee's good faith is important, while Minnesota, Nebraska, Arizona, Wisconsin, and Pennsylvania consider the transferor's good faith. *Id.* at 13.

[87] *Id.* at 7-8.

[88] *Id.* at 14-15.

[89] *See generally* Motion to Dismiss Trustee's Fraudulent Conveyance Claims Against the Bank at 4, HSBC Bank USA v. Bennett Funding Group, Inc. (*In re* The Bennett Funding Group, Inc.), No. 96-61376 (Bankr. N.D.N.Y. Aug. 24, 2000).

[90] *See id.*

[91] *See Sprague Nat'l Bank*, No. 96-61376, at 5.

Therefore, it is hard to establish a theory of actual fraud. While the May and August 2000 decisions resolved the confusion surrounding the interpretation of § 272, as it pertains to constructive fraud cases, these decisions do very little to end the lawsuits pending against former investors brought under an actual fraud theory.

IV. MODIFICATION OF CURRENT DEBTOR-CREDITOR LAWS

A. SUMMARY

These two cases demonstrate the strong-arm power of the trustee under § 544(b) and NYD&CL §§ 271-281 to recover transfers made. Both of these cases turned on the interpretation of the good faith component in § 272. The lower court's interpretation required both parties to act with good faith in order to have fair consideration. The problem with this interpretation is that it creates a situation where, if one party acts with good faith and performs the requisite due diligence, the good faith actor is at the mercy of the other party's bad intentions. Arizona, Minnesota, Nebraska, Pennsylvania, and Wisconsin, states that have also adopted UFCA, still require consideration of the good faith of the transferor.[92] This standard places a tremendous burden on the good faith transferee.

For example, suppose you went to lease a car at a local car dealership and paid the amount the dealer was asking. Unknown to you, the dealer had already leased the car to another individual, but still leased it to you. In a number of UFCA states and under the lower court's interpretation of § 272, the lessee would be unable to claim that the deal was made with fair consideration even though you paid fair market value for the vehicle and did not know of the fraud.

In the Bennett Funding Litigation, the Financial Institutions and former investors performed the required investigation before making the transactions. Nothing put bank officials, financial planners, stockbrokers or individuals on notice of a Ponzi scheme. Therefore, the lower court's opinion prevented either party from effectively using the affirmative defense under § 278 because the transferor's bad faith prevented fair consideration from being present in the transactions. While the BAP decision does reverse the lower opinion as it applies to constructive fraudulent conveyance, it still exposes Thomas and other former investors to further litigation over the "profit" or interest that was paid to them. In order for former investors to protect the funds paid to them, they would have to prove at trial that a Ponzi scheme did not pervade the Bennett Funding Group.

---

92 *Id.* at 13.

B. ADVOCATING REFORM TO OUR CURRENT DEBTOR-CREDITOR LAWS

The troubling aspect of the Bennett case is the impact that it had on thousands of individuals, as well as financial planners, businesses, and financial institutions. For most individuals the amount that the trustee was attempting to recover ranged from a couple hundred to a few thousand dollars. In an attempt to recover and distribute the assets of the estate, the trustee brought thousands of lawsuits against innocent, unsuspecting individuals. While the trustee may recover fraudulent transactions, there must be changes in the current Debtor-Creditor laws and Bankruptcy laws to protect individuals who act in good faith. Although the good faith defense is available in both a constructive and actual fraud case, the investor, in limited circumstances, may be permitted to keep funds that constitute repayment of principal, but must repay interest or profits paid. The law needs to react differently in certain Ponzi scheme bankruptcies.

The purpose of the fraudulent conveyance recovery laws is to recover either property transferred to an individual in order to liquidate one's assets before a bankruptcy or the return paid by the debtor to investors in a "too good to be true" profit scheme.[93] In a typical Ponzi scheme, where the rate of return on one's investment ranges between 150% and 400%, there is little doubt that fraudulent activity is known to both parties involved.[94] Thus, our current debtor-creditor laws properly address this situation by allowing for recovery of the fraudulent transactions.

The law fails to act appropriately when an individual is part of a Ponzi scheme that fails to alert investors to its existence. For example, the Bennett scheme was not the typical "too good to be true" investment. Even the trustee of the Bennett Estate did not allege that Thomas and other former investors had acted in bad faith.[95] However, the law still affords the trustee a means to recover these transactions.[96] For many investors, these transactions were made with Bennett four to eight years before the lawsuits were filed against them in 1998.[97] Investors have likely already spent what minimal returns they did realize on everyday living expenses, retirement expenses or college funds.

---

93 *See* McDermott, *supra* note 3, at 186-88.

94 *See id.* at 178-81.

95 *See Thomas*, 1999 Bankr. LEXIS 1843, at *9 (Trustee did not dispute the fact that Thomas acted in good faith).

96 *See* McDermott, *supra* note 3, at 188.

97 *See Thomas*, 1999 Bankr. LEXIS 1843, at *3 (investments began in February 1994 and suit brought in March 1998); Trustee's Settlement Package, *supra* note 82 (claiming recovery of portion of interest earned on all investments made during a six year period from March 29, 1990 up to and including March 29, 1996). Taking into account the added two years before suits were actually filed (March 1998) results in an eight year time period.

Although these individual investors did nothing wrong under the law, or in the view of the trustee, they were still the target of these lawsuits. Former investors, who acted in good faith, were and still are being punished for the misconduct of Bennett Funding. These individuals, many of whom are elderly, are forced to defend themselves in court to prevent being ordered to pay the trustee "profits" of their conservative investments that are no longer available.

As noted above, a majority of states have either adopted the UFCA or UFTA, which provides the trustee of a bankruptcy estate with similar powers to recover fraudulent transfers. The current laws potentially force thousands of individuals who make good faith investments and perform due diligence to be defendants in a lawsuit if that company acted with bad faith. The requirement that good faith be present on both sides of the transaction creates a situation that would require a heightened or super due diligence standard that is unreasonable in today's economy.

C. PROPOSED MODIFICATION TO THE CURRENT LAWS

The Bennett Funding litigation demonstrates the rigidity of current debtor-creditor and bankruptcy laws. While the trustee and the courts commended the defendants for their good faith, they still remain the target of pending litigation two years after their filing. Under current laws, good faith investors in a Ponzi scheme are without recourse to have their cases disposed of on the pleadings or through pretrial motions. Courts are unwilling to decide as a matter of law that a Ponzi scheme exists. Therefore, good faith investors must either engage in costly litigation or pay the trustee the interest paid to them.

As previously discussed, a typical Ponzi scheme bankruptcy involves an exorbitant rate of return that puts both parties on notice of the illegal conduct.[98] In these extreme cases the law properly reacts by allowing the trustee to recover fraudulent transfers. However, in a situation like Bennett, where financial advisors, institutions, and individual investors were unaware of the fraudulent activity of the debtor, an exception must be created for investors who act in good faith, perform the required due diligence and receive a legal rate of return on their investments. These investors should be protected from the inequitable results of current debtor-creditor laws.

One way to provide for this narrow exception is the creation of a minimum rate of return in the court's definition of a Ponzi scheme. A minimum rate of return standard would allow courts to decide on the pleadings or through a pre-trial motion if a Ponzi scheme actually existed. In a fraudulent transfer case the issue would become whether fair

98 *See supra* Introduction.

consideration or a reasonably equivalent value was paid for the transfer of interest paid on a loan between the transferor and transferee. If fair consideration is lacking, the trustee is entitled to recover the interest. In a number of cases that have dealt specifically with the issue of fair consideration, courts have concluded that interest paid within the maximum legal rate of interest constitutes fair consideration.[99] Thus, interest paid to lenders in excess of principal was recoverable by the trustee if the return exceeded the legal rate of interest. In the Bennett matter the rate of interest paid to investors ranged from 7% to 12%, which was well below the 16% maximum rate of interest allowed in New York state.

In the majority of Ponzi scheme cases, courts apply the same principles regarding fair consideration in allowing the trustee to recover fraudulent transactions.[100] An exorbitant rate of return paid to investors is lacking fair consideration and is recoverable by the trustee. When the profits are "too good to be true," the courts prevent an investor from retaining the funds. In typical Ponzi scheme cases, courts base their finding of a fraudulent conveyance on the fact that the return paid to investors was well above the legal rate of return within that state.[101] However, in the Bennett case, the return paid to former investors was not above the legal rate, but the result was the same. These former investors are the subject of a lawsuit attempting to force them to return interest paid to them that falls well within the legal rate of interest of New York state.

To eliminate such inequity, courts must establish a minimum rate of return to fall within the definition of a Ponzi scheme. Such a minimum rate of return standard might read:

> A court may find a Ponzi Scheme exists when the rate of return paid to a lender exceeds the legal rate of interest, within the given state. The bankruptcy trustee may recover these transactions because they were made without fair consideration. If a transaction fell within the legal rate of interest of the state, the court may presume that the transferee acted with good faith provided the transferee performed the required due diligence before investing. The trustee may rebut this presumption by a showing of bad faith on behalf of the transferee. Absent

---

99 *See, e.g.*, Menter v. Ames, 445 F.2d 1404, 1405 (2d Cir. 1971) (citing McNellis v. Raymond, 329 F. Supp. 1038, 1046-47 (N.D.N.Y 1971)); Larrimer v. Feeney, 411 Pa. 604, 609 (1963) (payment in excess of legal rate not fair consideration).

100 *See, e.g.*, Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281, 1284-86 (10th Cir. 1996); DiCello v. Jenkins (*In re* Int'l Loan Network, Inc.), 160 B.R. 1, 23-62 (Bankr. D.C 1993); Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 855-77 (D.Utah 1987).

101 *See, e.g.*, *Buchanan*, 84 F.3d. 1281; *Jenkins*, 160 B.R. 1; *Abbott*, 77 B.R. 845.

> such a showing, the court may grant defendant's motion for summary judgement.

Such a proposed modification may prevent future injustice against good faith investors.

A counter-argument to this proposal is that the Ponzi scheme's fraudulent aspect is not the unrealistic profits paid to investors, but the cycle of fraud that robs one victim to pay another. While the necessity of redistribution of assets to other creditors in a bankruptcy is a valid argument, the current law has a punitive effect on good faith investors in a Ponzi scheme. The current law punishes individuals that act in good faith by forcing them to defend themselves in court at the expense of the debtor's fraud. If a trustee can demonstrate that a Ponzi scheme existed, there are few options available to defendants named in these recovery actions. Even if the case does not go beyond granting a motion to dismiss on jurisdictional grounds, good faith investors still must retain an attorney to file a motion or answer to avoid having a default judgment filed against them. The fraudulent conveyance laws impose legal expenses upon an individual who is in the position least likely to bear such costs.

The current debtor-creditor laws further punish good faith investors through the broad and expansive power of the trustee to bring claims against these individuals after a significant lapse of time following a transaction. In Bennett, the illegal investment scheme operated for more than six years before discovery of its existence. It seems inequitable to force individuals, who received interest payments three to six years prior to the scheme's collapse, to repay this money when they had no reason to suspect they invested in a Ponzi scheme. The state is in a better position to absorb these losses than those individuals who were victims of the transferor's fraudulent activities.

Another potential argument against a minimum rate of interest is that it prevents the trustee from recovering all possible assets that are a part of the bankruptcy estate, thereby limiting the amount of assets to be redistributed to creditors. While the minimum rate of interest standard would exclude investors who acted in good faith and received a rate of return within the legal rate of interest within that state, there will still be investors, however, who did not act with good faith or who received a return above the legal rate. In addition, there may be more sophisticated investors who did not perform the requisite due diligence. In Bennett, it is estimated that the trustee's recovery efforts against former investors will produce little to no recovery of assets for the estate. As previously discussed, there is speculation that lawsuits filed against former investors, by the trustee, were an attempt to gain leverage to force a settlement with the insurance company.[102] The insurance company provided the deep pockets for the estate in its recovery of assets. The trustee should be precluded from recovering transfers paid to investors who received a legal rate of interest and acted in good faith.

CONCLUSION

The creation of a minimum rate of return in a Ponzi scheme bankruptcy would provide protection to those investors who act in good faith. This minimum rate of return standard would allow those defendants, who meet their burden of proof, to dispose of these lawsuits at the pleading stage, thereby avoiding the costly dilemma in which many of the former investors in Bennett Funding litigation find themselves today.

The Bennett Funding litigation provides a backdrop to fully examine the current state of debtor-creditor and bankruptcy laws. Bennett reveals the punitive effects of current law on individuals who acted in good faith and performed the requisite diligence, but still fail to recognize the existence of a Ponzi scheme. The lack of a minimum return rate, coupled with some states' requirement of good faith on behalf of both the transferor and transferee, creates a situation where lenders will be forced to commence arduous and costly investigations even when an investment opportunity does not look too good to be true. It is time to reform current debtor-creditor and bankruptcy laws to create a minimum return rate standard that protects good faith investors from the strong-arm power of the bankruptcy trustee.

---

102 *See supra* Part II.