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Limiting the Scope of the Value Defense under 11 U.S.C. § 548(c) in Avoidance Litigation

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Introduction

Today, most people are aware of, or have at least heard of, the notorious Bernard Madoff Ponzi scheme. Other than the scheme originally perpetrated by Charles Ponzi in the 1920s, the man whom the scheme was named after, the elaborate Madoff Ponzi scheme has become one of the most infamous fraudulent schemes of our time.[1] Bernard Madoff operated this scam using newly deposited customer funds to support the business and make "profit" payments to older customers who then withdrew these "profits," which were in excess of the principal amounts they invested.[2] Essentially, there were no actual profits being made; rather, initial investments made by new customers were being used to distribute recorded fictitious profits among the company's older customers.[3] This is the fundamental way in which typical Ponzi schemes are operated.

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[1] *See* Amy J. Sepinwall, *Righting Others' Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds*, 78 BROOK. L. REV. *1, *9 (2012) (hereinafter, "Sepinwall, *Righting Others' Wrongs*") (stating that the Madoff Ponzi Scheme is the "largest fraud in recorded history").

[2] J. Scott Colesanti, *Another Madoff Masquerade?: Questioning "Securities Fraud" in the Crime and its Cleanup*, 56 ST. LOUIS U. L.J. 521, 536 (2012) (hereinafter, "Colesanti, *Another Madoff Masquerade?*").

[3] *Id.*

Although Madoff has since been arrested and convicted in 2008, clawback suits (or avoidance actions) to redress the injuries of his victims remain.[4] There have been numerous avoidance actions in which a trustee has been appointed by the courts to initiate clawback suits against the net winners, seeking to recover the fictitious profits they received and to distribute them in order to restore customers' net equity claims. However, the Madoff scandal is not the only one of its kind. The courts continue to address these clawback suits with respect to Madoff's Ponzi scheme as well as other suits to redress the harm caused by other, more recent, and similar Ponzi schemes.

In the case of Bernard Madoff's Ponzi scheme, Irving Picard has been appointed as the trustee responsible for recovering the money from the fraudulent transfers and distributing it among the victims of the scheme.[5] The overwhelming majority of "net winners" involved specifically in the Madoff avoidance actions are entities or individuals who innocently benefitted from the scheme, meaning that it is not alleged that they knew or should have known of the fraudulent scheme.[6] These innocent beneficiaries are also known as "good-faith" transferees in the context of fraudulent transfer litigation. This memorandum will address issues relating to Ponzi scheme clawback suits against good-faith defendants.

In fraudulent transfer litigation under Section 548 of the United States Bankruptcy Code (the "Bankruptcy Code"), where a trustee seeks to recover fictitious profits from good-faith defendants who received them as part of a Ponzi scheme, the defendants will typically try to offset their profits with claims of giving value in an effort to retain them. For instance, good-faith defendants have put forth a value defense, arguing that their receipt of the fictitious profits qualifies as satisfying the debtor's antecedent debt owed to them, which gave value to the debtor

[4] Sepinwall, *Righting Others' Wrongs*, 78 BROOK. L. REV. at *12–13.
[5] *Id.* at *1–2.
[6] *Id.* at *2.

in exchange for the fictitious profits. The value defense is codified in Section 548(c) of the Bankruptcy Code and will be discussed further in Part I of this memorandum. Generally speaking, the satisfaction of a debtor's present or antecedent debt constitutes value under Section 548(d)(2)(A) of the Bankruptcy Code.

However, the prevailing view among New York courts is that transferees do not give value in exchange for any fictitious profits or fraudulent transfers they receive, even if they act in good faith. Recently, the Bankruptcy Court for the Southern District of New York held that good-faith transferees do not give value beyond their principal deposits and the payment of fictitious profits do not provide value under section 548(c) of the Bankruptcy Code.[7] In reaching its holding, the Court highlighted several issues that courts have faced in avoidance litigation; more specifically, regarding what constitutes "value" under these circumstances.

This memorandum will analyze the scope of the "value" affirmative defense pursuant to 11 U.S.C. § 548(c) in avoidance actions under 11 U.S.C. § 548. Part I will examine the ways in which courts determine "value." Part II will examine whether recipients of fictitious profits give value beyond their principal investments.

I. Determining "Value" Pursuant to 11 U.S.C. § 548(c)

The term "value" is defined under the Bankruptcy Code as property, or the satisfaction or securing of a debtor's present or antecedent debt.[8] "Value" does not include "an unperformed promise to furnish support to the debtor or to a relative of the debtor."[9] Additionally, under 11 U.S.C. § 548(c), transferees can assert a value defense in avoidance actions to the extent that the transferee received the transfer for value in which he or she gave value to the debtor in exchange

[7] *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec., LLC* (hereinafter referred to as "*SIPC*"), Adv. Proc. Nos. 08–01789(SMB), 10–04311(SMB), 2016 WL 1695296, at *10–11 (Bankr. S.D.N.Y. Apr. 25, 2016).
[8] 11 U.S.C. § 548(d)(2)(A).
[9] *Id.*

for the transfer(s) in question. As stated in *In re Adler, Coleman Clearing Corp.*, "[a]s a threshold matter, [§548(c)] by its very terms provides that in order to invoke this defense, the transferee must satisfy three standards: take (1) for value *and* (2) in good faith, and (3) claim the applicable right to the interest only to the extent the transferee gave value to the debtor in exchange."[10] If a court determines that the transferee does not satisfy any one of these three elements, section 548(c) will not apply.[11] If it is determined that the transferee received the transfer(s) in question for value and in good faith, then the trustee cannot recover the transfer(s); meaning the transferee may retain the avoidable transfers they received.[12] The burden is on the transferee to plead and prove each element of this defense.[13]

Moreover, the Bankruptcy Court for the Southern District of New York has concluded that the court's inquiry must be focused on the specific transaction(s) the trustee is attempting to avoid, as opposed to the overall value of the transaction(s) to the welfare of the debtor's business.[14] This is a case-by-case analysis conducted by the courts.[15] In addition, the debtor must receive a fair equivalent or an "amount not disproportionately small as compared with the value of the property or obligation" the debtor has given to the transferee for value to be present during the exchange.[16] When determining if the exchange was parallel, a court must compare what was given and received by the debtor.[17] Therefore, the proper analysis for determining value must include an examination of the specific transaction between the debtor and the

[10] 263 B.R. 406, 471 (S.D.N.Y. 2001).
[11] *Id.*
[12] 11 U.S.C. § 548(c).
[13] *In re Bayou Group, LLC*, 362 B.R. 624, 631 (Bankr. S.D.N.Y. 2007).
[14] *In re Churchill Mortg. Inv. Corp.*, 256 B.R. 664, 678 (Bankr. S.D.N.Y. 2000).
[15] *Id.*
[16] *Id.* (citing *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 993 (2d Cir. 1981) (reasoning that if the exchange is equal, then the creditors have no reason to complain because they have not suffered any loss).
[17] *Id.* (citing *In re Guerrera*, 225 B.R. 32, 36 (Bankr. D. Conn. 1998)).

transferee that is in question, and a measurement of what the debtor gave to the transferee and what the debtor received in return.[18]

II. Recipients of Fictitious Profits Do Not Give Value Beyond their Principal Investments

Furthermore, the prevailing view among the New York Bankruptcy and District Courts is that the value that investors in a Ponzi scheme give to a debtor in exchange for the transfers they receive is limited to the amount of their principal investments.[19] In other words, pursuant to § 548(c), only a transferee's principal investment constitutes value.[20] According to the court in *In re Bayou*, the plaintiffs' assertion that nearly every court has held that payments received by investors in excess of their principal investments are voidable as fraudulent transfers is correct.[21] As the District Court for the Southern District of New York stated in *Picard v. Greiff*, "in this context, the transfers must be assessed on the basis of what they really were; and they really were artificial transfers designed to further the fraud, rather than any true return on investments."[22] In addition, the majority of courts have rejected the argument that the payment of the fictitious profits to the transferees provided value under Section 548(c) because it purportedly satisfied an antecedent debt or obligation.[23]

However, the Bankruptcy Court for the Southern District of New York in *In re Churchill,* determined that the trustee could not recover the debtor's payments of commissions to the brokers because the commissions satisfied the antecedent debts that the debtor owed to the brokers for their services.[24] Therefore, the Court found that the brokers gave value to the debtor

[18] *Id.* at 679.
[19] *SIPC*, Adv. Proc. Nos. 08–01789(SMB), 10–04311(SMB), 2016 WL 1695296, at *10.
[20] *In re BLMIS*, 499 B.R. 416, 424 (S.D.N.Y. 2013) (hereinafter referred to as the "*Antecedent Debt Decision*").
[21] 362 B.R. at 636.
[22] 476 B.R. 715, 725 (S.D.N.Y. 2012) (referring to the receipt of avoidable transfers in the Ponzi scheme context).
[23] *SIPC*, Adv. Proc. Nos. 08–01789(SMB), 10–04311(SMB), 2016 WL 1695296, at *11.
[24] 256 B.R. at 680.

when receiving the commissions in question.[25] In this case, the brokers, who were also known as the defendants, were employees of the 15 debtors who rendered an array of financial services while operating "under the umbrella of 'The Churchill Group'" (hereinafter referred to as "Churchill").[26] As employees of Churchill, the brokers provided services to the debtors including, originating mortgages and/or soliciting investors for them.[27] The trustee sought to recover a sum of $5 million of which the brokers received as payment for these services they provided to the debtors during the years 1991 through 1997, claiming that the payment of these commissions did not provide value because they merely perpetuated the debtors' Ponzi scheme.[28] Ultimately, the Court held that the brokers produced the services they were hired to do, which gave value, placing a contractual obligation on behalf of Churchill to pay the commissions sought by the trustee.[29] The Court further reasoned that the transaction between the debtors and the brokers was equivalent in value, and that allowing the trustee to recover the commissions would be in contrast with the equitable principles underlying fraudulent conveyance law.[30]

Although the court in *In re Churchill* found in favor of the defendants, this case is distinguishable from other fraudulent transfer cases where the defendants argued that the avoidable transfers received satisfied an antecedent debt or obligation, as illustrated in the case *In re Bayou*.[31] The Court in *In re Bayou* notes that *In re Churchill* remains as a correct statement

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[25] *Id.*
[26] *Id.* at 667–668 (explaining that Gerald P. Hirsch also falls under the umbrella because he principally operated and controlled these debtors).
[27] *Id.* at 667 (stating that the brokers were, in fact, hired for the purpose of providing these services to the debtors).
[28] *Id.* at 667, 674 (noting that it is assumed that the brokers were unaware of the Ponzi scheme and acted lawfully when rendering their services).
[29] *Id.* at 680 (determining that the brokers lawfully earned what they were paid).
[30] *Id.* at 681–682 (stating that the power to avoid transfers in which a transferee received more than what he gave to the debtor is an equitable remedy created to correct the disparity in this transaction by requiring the transferee to pay back the excess in value he received).
[31] 362 B.R. at 637.

of the law regarding constructive fraudulent conveyances; however, its outcome was a result of the Court's determination that the payment of the commissions were not, in fact, constructively fraudulent because the services rendered by the defendants provided equivalent value in exchange for the commissions.[32] In contrast, the payment of the fictitious profits to the investors, or defendants in *In re Bayou*, were paid using fictitious account balances misrepresented by the fraudulent financial statements that were used to foster the debtor's Ponzi scheme.[33] Thus, the payment of fictitious profits in this case was inherently fraudulent, and a fair value was not exchanged during the transaction at issue.[34] Moreover, the Court upheld the rule that transfers received in excess of principal amounts invested are voidable as fraudulent transfers.[35]

In an effort to conceal their Ponzi scheme, the debtors, also known as the "Bayou Hedge Funds," paid their investors fraudulent and inflated amounts of money that exceeded the actual amount in the investors' account balances.[36] In actuality, the debtors had falsified the financial statements to cover up the fact that they had experienced a substantial loss of the investors' principal deposits and had not made any profits.[37] The defendants asserted that they provided value to the debtors when receiving the payments in return of their principal investments because it satisfied the antecedent debt owed to them.[38] In addition, they argued that the fictitious profits were payments on antecedent debts because they maintained either a contractual interest or a statutory prejudgment interest on their investments.[39] However, the Court determined that the defendants had no contractual right to interest and that there was no present or antecedent debt

[32] *Id.* (stating that the commissions paid constituted fair compensation for the services rendered).
[33] *Id.* at 638.
[34] *Id.* at 637–638.
[35] *Id.* at 636.
[36] *Id.* at 629.
[37] *Id.*
[38] *Id.* at 634.
[39] *Id.* at 635.

that existed for prejudgment interest when they received the payments.[40] Ultimately, the Court rejected the defendants' value defense and denied the defendants' motions to dismiss.[41]

In addition, the District Court for the Southern District of New York in the *Antecedent Debt Decision* further rejected the defendants' claims that the transfers in excess of their principal investments provided value to the debtor, Bernard L. Madoff Investment Securities, LLC ("BLMIS"), by satisfying the antecedent debt owed to them because they held state and federal claims against BLMIS.[42] The Court reasoned that transferees who were already repaid the full amount of their principal deposits do not have a freestanding interest claim, so their federal and state law claims to interest would not allow them to retain any of the amounts in excess they received.[43] The defendants argued that "value" should not be restricted to the amount of principal invested because it is too limited.[44] However, the Court determined that transferees cannot use federal and state law claims to increase the amount of which they are entitled to; and they are only entitled to their principal investments.[45] Therefore, recipients of fictitious profits in excess of their principal deposits do not provide value and cannot claim that the payment of those fictitious profits provided value under the theory that they satisfied the antecedent debts they were owed due to claims that they held an interest on those excess profits.

Furthermore, the most recent case to address the scope of the value defense is *SIPC v. BLMIS* in which the Bankruptcy Court for the Southern District of New York held that innocent transferees involved in a Ponzi scheme must return all fictitious profits they received in excess of

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[40] *Id.*
[41] *Id.* at 639.
[42] 499 B.R. at 422.
[43] *Id.* at 422.
[44] *Id.* at 425.
[45] *Id.* at 425–426 (noting that this supports the underlying policy of the Securities Investor Protection Act to allow each customer to recover from the customer property and pro rata distributions based on each of their net-equity claims instead of allowing those who benefitted from the debtor's wrongdoing to retain amounts they received).

their principal deposits.[46] In this case, Irving Picard, as the trustee for the liquidation of BLMIS under 15 U.S.C. § 78eee(b)(3), sought to recover the fictitious profits from several recipients, including Andrew Cohen, under Section 548 of the Bankruptcy Code due to the insolvency of the BLMIS estate since December 11, 2002.[47] Andrew Cohen withdrew approximately $4 million from his account at BLMIS between January 18, 1996 and December 11, 2008.[48] Of that withdrawal, approximately $1.1 million was fictitious profit from BLMIS' operation of its Ponzi scheme.[49] In an effort to retain these fictitious profits, Cohen asserted that he was a good faith transferee and that he gave "value," under § 548(c) of the Bankruptcy Code, to BLMIS in exchange for the avoidable transfers.[50] Specifically, Cohen asserted that the payment of fictitious profit gave value, for purposes of the affirmative defense, by satisfying the antecedent debts that BLMIS owed to Cohen.[51] Additionally, Cohen argued that the previous *Antecedent Debt Decision* was wrongly decided because the Court had misinterpreted the Securities Investor Protection Act by limiting value to the amount of principal investment, which in turn, expanded the Trustee's avoidance powers under the Bankruptcy Code.[52] However, the Bankruptcy Court rejected both this argument and Cohen's antecedent debt/value defense, following the same pattern as the previous New York Courts, making this the fifth rejection of this defense.[53] Ultimately, the Bankruptcy Court reiterated the two rules: (1) transferees do not give value beyond their principal deposits and (2) it cannot be argued that the payment of fictitious profits

[46] Adv. Proc. Nos. 08–01789(SMB), 10–04311(SMB), 2016 WL 1695296, at *14.
[47] *Id.* at *4.
[48] *Id.* at *2.
[49] *Id.* at *2–3.
[50] *Id.* at *5.
[51] *Id.*
[52] *Id.* at *11.
[53] *Id.* at *5, *10–11.

provided value under Section 548(c) of the Bankruptcy Code because it satisfied an antecedent debt or obligation.[54]

Conclusion

In light of the major Ponzi schemes that have occurred in New York, defendants to the avoidance actions have increasingly asserted the value defense under Section 548(c) in an effort to retain the fictitious profits they received. As a result, New York courts have faced the issue of determining what constitutes "value" under these circumstances. Essentially, the prevailing view of New York courts is to limit the scope of the value defense under section 548(c) in avoidance actions by concluding that value given by recipients of fictitious profits is limited to the amount of principal they have invested.[55] Additionally, recipients of fictitious profits cannot argue that the payment of those profits provided value because it satisfied an antecedent debt or obligation.[56] Accordingly, good-faith recipients of fictitious profits from Ponzi schemes may be required to turnover their profits because they did not give value for any transfers they received in excess of their principal deposits.

[54] *Id.* at *10–11.
[55] *See SIPC*, Adv. Proc. Nos. 08–01789(SMB), 10–04311(SMB), 2016 WL 1695296, at *10.
[56] *See id.* at *11.