<u>CRIMINAL FRAUD AND CLAWBACK ACTIONS</u>

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A bankruptcy trustee's primary role is to collect and administer assets belonging to the bankruptcy estate and to distribute those funds to creditors on account of their claims. In the context a of criminal fraud scheme that ultimately leads to a chapter 7 liquidation proceeding, the trustee collects a great deal of estate funds through various clawback actions. Often, the criminal fraud that underlies the bankruptcy proceeding also helps the trustee to establish the elements necessary in order to recover funds under these causes of action.

There are two primary clawback actions a bankruptcy trustee utilizes to recover funds for the bankruptcy estate: (1) fraudulent transfers; and (2) preferences. In the most basic sense, fraudulent transfer actions enable a trustee to recover transfers the debtor made without consideration, and preference actions enable a trustee to recover payments to preferred creditors made on the eve of the bankruptcy filing. The trustee uses these causes of action to avoid (i.e., undo) specific transfers and recover the funds for the bankruptcy estate. Trustees can use both the Bankruptcy Code and state law to pursue fraudulent transfers.

Ponzi schemes in the financial services industry have resulted in numerous fraudulent conveyance actions by appointed trustees. Madoff is the most notable, but collapsed companies of all levels have spawned these "clawback" actions.

In addition to the individuals that perpetrated the Ponzi scheme, individuals connected to the scheme (e.g., brokers, investors, etc.) are also subject to clawback actions. Whether cognizant of the illegal scheme or not, a trustee can and will pursue brokers for salaries and commissions, investors for "illusory" profits, and criminal counsel for attorney's fees paid for pre-petition representation, using clawback actions to recoup as much value as possible for the bankruptcy estate. There are, however, different defenses available to defendants faced with clawback actions by a bankruptcy trustee, defenses that can limit or even eliminate exposure to liability for past dealings with a Ponzi scheme operator in bankruptcy.

<u>FRAUDULENT TRANSFERS</u>

There are two different types of fraudulent transfer claims: (1) actual fraud; and (2) constructive fraud. Bankruptcy Code fraudulent transfers have a two-year statute of limitations, while the New York fraudulent transfer statute of limitations is six years. For an actual fraudulent transfer claim, the debtor must have made a transfer or incurred an obligation with actual intent to hinder, delay, or defraud a creditor. In other words, the debtor is trying to conceal assets. A constructive fraudulent transfer, on the other hand, needs no "wrongful" intent. It only requires: (1) that the debtor received less than reasonably equivalent value or fair consideration in the exchange; and (2) was insolvent on the date the transfer was made or such obligation was incurred, or became insolvent as a result of the transfer or obligation.

In the case of a debtor previously engaged in a Ponzi scheme, the existence of the Ponzi scheme is sufficient to establish that the debtor made transfers with actual fraudulent intent, obviating the need for the trustee to establish the more fact-intensive elements of a constructive fraudulent

transfer claim. *See Silverman v. Meister Seelig & Fein, LLP (In re Agape World Inc.)*, 467 B.R. 556 (Bankr. E.D.N.Y. 2012); *Gowan v. The Patriot Group, LLC (In re Dreier LLP)*, 452 B.R. 391, 424 (Bankr. S.D.N.Y. 2011). There is, however, a limited defense available to transferee defendants (i.e., those who received the payment from the debtor) faced with fraudulent transfer actions arising out of these Ponzi schemes. Unless the transfer is otherwise avoidable under other legal bases, a transferee that received the conveyance for value and in good faith may retain the interest transferred. Interestingly, the fact that the debtor was operating a criminally fraudulent scheme does not necessarily prevent defendants without knowledge of the debtor's illegal conduct from availing themselves of the good faith defense. *See Balabar-Strauss v. Sixty-Five Brokers (In re Churchill Mortg. Inv. Corp.)*, 256 B.R. 664, 677–80 (Bankr. S.D.N.Y. 2000), *aff'd sub nom. Balaber-Strauss v. Lawrence*, 264 B.R. 303, 307–08 (S.D.N.Y 2001).

PREFERENCES

The elements of a preference claim under Bankruptcy Code section 547 are:

1) A transfer made by the debtor;
2) To or for the benefit of a creditor;
3) For or on account of antecedent debt;
4) Made while the debtor was insolvent;
5) Made within 90 days of the bankruptcy filing date (or 1 year for insiders); and
6) That enables the creditor to receive more than it would receive if:
   a) The case were under chapter 7;
   b) The transfer had not been made; and
   c) The creditor received payment of its debt pursuant to the bankruptcy case.

The primary goal of preference actions is to prohibit "preferred" creditors from receiving payments prior to bankruptcy when other creditors are not being paid. A general concept of bankruptcy is that all creditors should share equally in the estate of a debtor, and to allow certain creditors to retain these preferential payments would defeat that purpose. Unlike fraudulent conveyances that have both bankruptcy and state law bases, preferential transfers are unique to the Bankruptcy Code.

A recurring issue in preference litigation is establishing the debtor's insolvency at the time the transfer was made. There is a presumption under the Bankruptcy Code that the debtor was insolvent during the 90-day period preceding the bankruptcy filing, but that presumption is rebuttable. *See Lawson v. Ford Motor Co. (In re Roblin Industries, Inc.)*, 78 F.3d 30, 34 (2d. Cir. 1996). There is, however, an additional way for the trustee to establish insolvency in a common criminal fraud scenario—using the Ponzi scheme presumption.

As noted above, Ponzi schemes are presumptively insolvent, meaning the trustee need not allege specific facts establishing the debtor's insolvency so long as the Ponzi scheme is adequately established. *See Picard v. Madoff (In re Bernard L. Madoff Inv. Sec. LLC)*, 458 B.R. 87, 118 (Bankr. S.D.N.Y. 2011). Obviously, a conviction or similarly definitive determination of guilt is the ideal evidence for establishing that a Ponzi scheme did, in fact, exist. However, proof of conviction is not necessary for use of the insolvency presumption, so long as the trustee can establish the essential elements of a Ponzi scheme: (1) deposits were made by investors; (2) the

debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operation of the debtor produced little or no profits or earnings; and (4) the source of payments to existing investors was from cash infused by new investors. *See Forman v. Salzano (In re Norvergence, Inc.)*, 405 B.R. 709, 732–33 (Bankr. D.N.J. 2009).

Defendants facing preference claims do have several statutory defenses. Specifically, the trustee may not avoid a transfer to the extent the transfer involved a contemporaneous exchange and new value (e.g., C.O.D. transactions, services or goods provided after payment made, etc.) or was a payment made in the ordinary course of business for a debt incurred in the ordinary course of business. Again, similar to fraudulent transfer actions, the existence of the Ponzi scheme does not necessarily eliminate a defendant's ability to use the various defenses. However, the defenses may be severely limited or unavailable to investors that receive the payments. *See Jacobs v. Matrix Capital Bank (In re AppOnline.com)*, 315 B.R. 259, 282–83 (Bankr. E.D.N.Y. 2004).