UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.	CASE NO. 96-61376 Chapter 11
Debtors	Substantively Consolidated

RICHARD C. BREEDEN, Trustee of
THE BENNETT FUNDING GROUP, INC.

Plaintiff

vs. ADV. PRO. NO. 98-40892A

STEPHEN A. THOMAS

Defendant

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

In this adversary proceeding, Chapter 11 Trustee Richard C. Breeden (hereafter, "Trustee") seeks to avoid and recover as fraudulent transfers certain pre-petition payments made to Stephen A. Thomas ("Defendant") by Debtors Bennett Receivables Corporation ("BRC") and Bennett Receivables Corporation II ("BRC II").[1] On November 30, 1998, Defendant filed a motion for summary judgment pursuant to Rule 7056 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P.") and Rule 56 of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."),[2] and on January 5, 1999, the Court issued an order modifying a stay under which it had previously placed this and various related adversary proceedings for the limited purpose of allowing Defendant's summary judgment motion to go forward.

[1] By an order of this Court dated July 25, 1997, the estates of BRC and BRC II were substantively consolidated with those of The Bennett Funding Group, Inc. ("BFG") and five other related corporate entities (collectively, the "Bennett" companies or the "Debtors").

[2] The Trustee argues that the present motion is procedurally improper because of Defendant's failure to comply with Local Bankruptcy Rule 7056-1 (improperly cited as Local Rule 193.1(i) in the Trustee's responding papers), which requires each party to a summary judgment motion to annex to their papers a short and concise statement of facts which the party contends are undisputed or disputed. The Court notes, however, that the Trustee has also failed to comply with these requirements, and it will accordingly overlook this mutual violation of the Local Rules.

The Court heard oral argument on Defendant's summary judgment motion on January 14, 1999, at which time it reserved decision and authorized the parties to submit memoranda of law. The Court additionally authorized the submission of memoranda in support of Defendant's motion by the law firms of Hancock & Estabrook, L.L.P. and Bond, Schoeneck & King, L.L.P., which represent various interested parties who are presently defendants in other adversary proceedings commenced by the Trustee. Defendant's motion for summary judgment was then submitted for decision on February 12, 1999.[3]

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334 and 157(a), (b)(1), and (b)(2)(H).

STATEMENT OF FACTS

[3] From the evidentiary materials submitted by Defendant, it appears that each of Defendant's investments may have been purportedly insured by Assicurazioni Generali, S.p.A. ("Generali") or its affiliates. If the evidence of this purported insurance proves satisfactory to the Trustee or the Court, the Trustee will be required to seek a unilateral discontinuance of the present adversary proceeding under the terms of a recently-approved settlement between the Trustee and Generali. *See In re The Bennett Funding Group*, Case No. 96-61376 (Bankr. N.D.N.Y. April 9, 1999). The Court notes, however, that this adversary has already been extensively litigated as a de facto test case for hundreds if not thousands of similarly-situated Bennett investors, not all of whom will be offered discontinuances pursuant to the Generali settlement. In the interests of judicial efficiency, the Court will therefore exercise its discretion to proceed with this Decision, in spite of the fact that there is a high probability that the adversary proceeding at issue will be voluntarily discontinued in the near future.

On February 25, 1994, Defendant, a resident of Vermont, purchased a short-term promissory note in the amount of $10,000.00 from BRC, a wholly-owned subsidiary of The Bennett Funding Group, Inc. with its principal place of business in Syracuse, New York. This note carried a stated annual interest rate of 6.00% and a maturity date of June 24, 1994, at which time BRC would be obligated to repay Defendant in a single lump sum of $10,197.26. Upon maturity, Defendant opted to "roll over" his investment by accepting a new short-term promissory note for $10,197.26 in lieu of immediate payment. The second short-term note obligated BRC to pay Defendant $10,413.36 on October 21, 1994, for a stated annual interest rate of 6.50%; at maturity, the second note was rolled over into a third note, under which BRC promised to pay Defendant $69.42 of interest per month (equal to a rate of 8% annually) until January 1, 1996, at which time the principal amount of the note would become due.

Defendant purchased an additional $10,000.00 short-term note from BRC II on May, 9, 1994. Like the first BRC note, the BRC II note carried an interest rate of 6% and matured after 120 days. Upon maturity, the $10,197.26 due to Defendant was rolled over into a 12-month, 7.50% promissory note from BRC II, which provided for monthly interest payments of $63.73 and a return of principal on January 1, 1996. On that date, Defendant accepted payment on both of his outstanding notes and thereafter entered into no further transactions with any of the Bennett companies.

While neither Defendant nor the Trustee provide a detailed mathematical analysis of these transactions, it appears that Defendant thus made an original investment of $20,000 with the Debtors and ultimately received a total return of $22,208.42, having rolled over one of his notes twice and the other one once.[4] At all times, the effective rate of interest paid to Defendant ranged from six to eight percent, a rate of return considered non-usurious under the laws of both New York and Vermont. *See* N.Y. GENERAL OBLIGATIONS LAW §5-501 (McKinney 1989); VT. STAT. ANN. tit. 9 § 41a(a) (1998).

On March 29, 1996, BRC and BRC II filed for bankruptcy, and on February 9, 1998, the Trustee filed an adversary complaint in the present proceeding (the "Adversary Complaint"), asserting that all payments made to Defendant are avoidable as fraudulent transfers pursuant to §§ 548(a) and 550 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"), as well as §§ 271-281 of the New York Debtor & Creditor Law (McKinney 1990) ("NYD&CL"), which is made applicable to this proceeding by the strong-arm powers of Code § 544(b). In his prayer for relief, the Trustee seeks to avoid payments in the total amount of $52,783.21, of which $1,975.33 is designated as an "excess amount" above principal. Although these figures are not entirely consistent with the data reported in Defendant's affidavit and supporting documents, it may be surmised that the Trustee obtained these numbers by treating each of the rollover transactions as a repayment in full followed by an immediate reinvestment of the entire amount repaid.[5] However, while it appears from Defendant's undisputed affidavit that BRC and BRC II made payment on the promissory notes within 90 days of March 29, 1996, the Trustee does not seek to avoid the payments as preferential transfers pursuant to Code § 547.

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[4] The record before the Court does not indicate whether any funds actually changed hands pursuant to the rollover transactions.

[5] According to this method of accounting, however, the total number of "payments" received by Defendant from the Debtors should be $53,016.30, rather than the $52,783.21 recited in the Adversary Complaint. By contrast, the Adversary Complaint's stated "investment amount" of $50.807.88 is in accord with the data reported by Defendant.

The Trustee's fraudulent conveyance cause of action is based largely on the allegation that, during the entire period of Defendant's transactions with BRC and BRC II, the Debtors "conducted a Ponzi scheme at the direction of certain of their insiders." (Adv. Comp. at ¶ 9).[6] In response to Defendant's motion for summary judgment and in support of his Ponzi scheme allegation, the Trustee has submitted extensive documentary information detailing various acts of alleged fraud committed by officers of the Bennett companies. These submissions do not, however, relate directly to the specific instruments purchased by Defendant and pursuant to which the payments at issue were made.

In the affidavit accompanying his motion for summary judgment, Defendant states that he entered into his transactions with the Debtors in good faith and without knowledge or suspicion of the Debtors' alleged fraud. Defendant further states that other non-Bennett, non-fraudulent investment opportunities were available to him at that time, which offered comparable rates of return to those promised by the BRC and BRC II notes. Because none of the statements regarding Defendant's good faith are controverted by the Trustee's responding papers, they will be deemed admitted. *See Ehre v. People of the State of New York (In re Adirondack Railway Corporation)*, 28 B.R. 251, 253 (Bankr. N.D.N.Y. 1983) (Marketos, J.).

DISCUSSION

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[6] Under the standard definition of the term, a Ponzi scheme is a financial fraud in which a purported investment venture uses the capital it receives from a new round of investors to pay off its obligations to a previous round of investors, all the while conducting little or no actual business activity. In order to give the appearance of profit, Ponzi schemes must draw in a continually-expanding number of new investors; when the pool of new investors dries up, the Ponzi scheme inevitably collapses. *See Martino v. Edison Worldwide Capital (In re Randy)*, 189 B.R. 425, 437 n.17 (Bankr. N.D. Ill. 1995) and cases cited therein.

Under Fed.R.Civ.P. 56(c), which is incorporated by reference into Fed.R.Bankr.P. 7056, a properly-supported motion for summary judgment shall be granted if the non-moving party "fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 2552, 91 L.Ed.2d 265 (1986). Although the Court's power to dispose of a proceeding through summary judgment is one that must be exercised "with the precision of a scalpel," *see Donahue v. Windsor Locks Board of Fire Commissioners*, 834 F.2d 54, 55 (2d Cir.1987), a mere scintilla of evidence in support of the non-movant's position will be insufficient to defeat the motion; instead, the non-movant (in this case, the Trustee) must establish that a fact-finder could reasonably find in favor of either party at trial. *See Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 252, 106 S.Ct. 2505, 2512, 91 L.Ed.2d 202 (1986).

<u>1. NYD&CL Causes of Action</u>

Pursuant to Code § 544(b), the Trustee may avoid any transfer of an interest in property that would be voidable by at least one unsecured creditor under applicable state law. Both parties to this motion agree that the applicable state law is that of New York, whose version of the Uniform Fraudulent Conveyance Act ("UFCA") is codified as NYD&CL §§ 271-281. That statute essentially provides two separate mechanisms by which a creditor may avoid a transfer as fraudulent. Under NYD&CL § 276, a transfer is avoidable if it is made "with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors." While § 276 places in issue only the state of mind of the transferor (and not on the actions or intent of the transferee), that section must be understood in conjunction with NYD&CL

§ 278, which provides that recovery may not be had against a transferee who both lacked knowledge of the fraud and provided "fair consideration" in exchange for the transfer.

This last term is specially defined by NYD&CL § 272, which provides that "fair consideration" is given for a transfer of property when "as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied." New York courts have held that the "good faith" of this section entails a duty to "deal honestly, fairly, and openly" in the transaction, as well as the absence of any intent to defraud or take unconscionable advantage of others. *See Southern Industries, Inc. v. Jeremias*, 66 A.D.2d 178, 183, 411 N.Y.S.2d 945, 949 (N.Y. App. Div. 2d Dept. 1978). This "good faith," moreover, must be present on both sides of a transaction; consequently, a transfer from a bad-faith transferor to a good-faith transferee will never be treated as a transfer for fair consideration under New York law. *See Breeden v. Gloucester Bank & Trust Co. (In re The Bennett Funding Group, Inc.)*, Adv. No. 98-70037A, Slip. Op. at 31 (Bankr. N.D.N.Y. Feb. 9, 1999); *Julien J. Studley, Inc. v. Lefrak*, 66 A.D.2d 208, 213, 412, N.Y.S.2d 901, 905 (N.Y. App. Div. 2d Dept. 1979), *aff'd* 48 N.Y.2d 954, 401 N.E.2d 187, 425 N.Y.S.2d 65 (1979).

An alternate cause of action is provided by NYD&CL §§ 273-275, which allow transfers to be avoided under theories of constructive (as opposed to actual) fraud. Under these sections, a creditor may avoid a transaction as constructively fraudulent if it is proved: (1) that the transfer was made for less than fair consideration, as defined above; and (2) that at the time of the transaction, the transferor was either insolvent, a defendant in an action for money damages, engaged in a business with unreasonably small capital, or about to incur debts beyond his ability to repay. *See Marine Midland Bank v. Murkoff*, 120 A.D.2d 122, 124, 508 N.Y.S.2d 17, 19 (N.Y.

App. Div. 2d Dept. 1986).

Under either theory of action, of course, the Trustee must first prove that an actionable conveyance took place. While there can be no dispute that the January 1, 1996 cash payment to Defendant was a conveyance, it is less clear whether the Trustee may also treat the three rollover transactions as conveyances for purposes of the UFCA. While neither party has addressed this issue in any great depth, the Trustee's complaint apparently seeks to treat these transactions in their literal form, that is, as the satisfaction of one obligation owed to Defendant and the simultaneous loan of additional funds from Defendant to the Debtors. Under this analysis, each of the rollover transactions resulted in a payment to Defendant of approximately $10,000, and the Trustee accordingly seeks a total recovery from Defendant in excess of $50,000, an amount more than double the sum of Defendant's initial investments and apparent profit.

Analyzing another unconventional transaction under the UFCA, the District Court for the Southern District of New York has held that "[i]n evaluating the applicability of fraudulent conveyance laws designed to protect creditors' rights, it is essential to view the transaction or transactions in question from the perspective of creditors." *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 998 (S.D.N.Y. 1991). In *Crowthers McCall*, the court faced the issue of whether a transaction in which a predecessor of the debtor served as the "mere conduit" for a transfer of funds would be considered a conveyance to that corporation for purposes of the UFCA. Noting that the putative transferee was never intended to receive the substantive benefits of the transfer, the *Crowthers McCall* court refused to treat the transaction as a conveyance to the conduit, reasoning that it would not "turn a blind eye" to the true nature of the transaction and that an opposite finding would "harm creditors in exactly the way fraudulent conveyance laws are designed to prevent." *Id*.

While the facts of *Crowthers McCall* are obviously distinguishable from the case at bar, the Court believes that the legal principles underlying its holding are directly applicable to the rollover transactions. Although from a purely formalistic standpoint, the parties may have created a fresh debtor-creditor relationship each time one promissory note was exchanged for another, the uncontroverted evidence of Defendant's affidavit makes it clear that these rollovers must be viewed as part of a single, continuous transaction. Both BRC and BRC II offered terms on their short term promissory notes that would vary depending on whether or not the note represented a rollover from an earlier investment. Notes that were issued as rollover investments would pay a higher rate of interest than those that were not; the amount of the premium would moreover increase depending on the number of times the notes had been rolled over. From the standpoint of the creditors, there can be no reason to treat a short-term note that was repeatedly rolled over any differently from a long-term note issued for the same effective term and rate of interest. Lastly, the Court notes that it would be grossly inequitable to expose Defendant to over $50,000 in potential liability when the amount of capital he risked and the amount of purported profit paid to him barely exceed $20,000 combined. For these reasons, the Court finds that the three rollover transactions were not conveyances for which monetary recovery may be had pursuant to Code § 544(b) and NYD&CL §§ 271-281.

Turning to the remaining elements of the Trustee's UFCA causes of action, the Court finds that for purposes of NYD&CL § 276, a material question of fact exists with respect to the

Debtors' intent to defraud their creditors by means of the payments to Defendant.[7] While the evidence submitted by the Trustee does not relate specifically to the transactions with Defendant or to the BRC/BRC II short term promissory note programs, a finder of fact could reasonably conclude based on this evidence that a Ponzi scheme pervaded the Debtors' entire business operation, that Defendant was paid with funds misappropriated from other investors, and that the purpose of such payments was to induce other investors to entrust their money to the Debtors. Should the Trustee succeed in proving these facts at trial, it would follow as a matter of course that the payments were made with actual fraudulent intent. In the words of one of the leading cases on the subject,

> A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent in the eyes of the law, *cf.* Restatement (Second) of Torts § 8A (1963 & 1964), and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.

Merrill v. Abbott (In re Independent Clearing House Co.), 77 B.R. 843, 860 (D.Utah 1987).

Defendant does not dispute the reasoning of the *Independent Clearing House* court, but rather argues that its holding is inapplicable to the present case, since Defendant was not promised any extraordinary rate of return for his investment. As Defendant correctly notes, the vast majority of reported Ponzi scheme cases involve investors who are promised profits far too

[7] The fraudulent intent that must be proved under this section, of course, is that of the Debtors (the transferor), not the Defendant (the transferee). *See HBE Leasing Corp. v. Frank*, 61 F.3d 1054, 1059 (2d Cir. 1995).

good to be believed, and in any case far greater than the roughly market-rate return received by Defendant. *See Compton v. Bonham (In re Bonham)*, 224 B.R. 114, 116 (Bankr. D. Alaska 1998). No court, however, has ever incorporated a minimum rate of return into its definition of a Ponzi scheme, and this Court is reluctant to do so today. The fraudulent nature of a Ponzi scheme is not in the fact that it offers unrealistic profits-- for many frauds that are not Ponzi schemes assuredly do the same-- but, rather, as *Independent Clearing House* pointed out, in the fact that it creates a spiraling cycle of fraud in which one victim is robbed to pay off another. The reasonableness of the promised interest rate may well be probative evidence against the existence of the Ponzi scheme if and when that issue is litigated at trial, but the Court simply cannot conclude at this point that the evidence presented is "so one-sided that one party must prevail as a matter of law," *cf. Anderson*, 477 U.S. at 252. Accordingly, Defendant's motion for summary judgment will be denied on the Trustee's NYD&CL § 276 cause of action with respect to the transfers of January 1, 1996.

The preceding analysis also disposes of Defendant's motion with respect to the Trustee's NYD&CL §§ 273-275 causes of action. As noted above, the good faith of the transferor as well as the transferee is an indispensable condition of fair consideration as defined by NYD&CL § 272, *see Julien J. Studley*, 66 A.D.2d at 213, and it can hardly be disputed that one who intends to defraud is not dealing in good faith. For the reasons stated above, the Court finds that the evidence presented by the Trustee raises a material question of fact with regard to the good faith of the transferor-Debtors at the time of the payments of January 1, 1996, and hence also with regard to whether the payments were received for fair consideration. In addition, as Defendant apparently concedes, there remain unresolved material questions of fact concerning the Debtors' solvency, capital reserves, and belief as to their ability to pay future creditors at the time of the transfers. *See* NYD&CL §§ 273, 274, 275. Defendant is accordingly not entitled to summary judgment on the constructive fraud causes of action of the UFCA. Likewise, Defendant is not entitled to summary judgment on any of the UFCA causes of action by reason of the affirmative defense of NYD&CL § 278, a defense which is only available to transferees who provided fair consideration for the transfer in the sense of NYD&CL § 272. *See City of New York v. Johnson*, 137 F.2d 163, 164 (2d Cir. 1943).

2. Code § 548(a)

The Trustee's complaint alternately seeks to avoid and recover the payments to Defendant pursuant to federal law and Code § 548(a)(1).[8] The elements of the fraudulent conveyance causes of action set out in Code § 548 are largely modeled on those of the UFCA, and the two statutes

[8] Code § 548(a)(1) provides that:

> 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
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> (B)(i) received less than a reasonably equivalent value in exchange for such obligation; and
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> (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; and
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> (II) was engaged in a business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

have often been interpreted similarly. *United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1298 (3d Cir. 1986). In particular, there is no substantive difference between Code § 548 and the UFCA in their definitions of a transfer and of an actual fraudulent transfer. For the reasons stated in the discussion of the UFCA causes of action above, the Court concludes that the rollover transactions were not transfers for purposes of Code § 548 and that a question of fact exists with regard to whether the transfers were made with fraudulent intent for purposes of Code § 548(a)(1)(A).

One important substantive difference between the two statutes, however, is that Code § 548 employs the concept of "reasonably equivalent value" in place of the UFCA's "fair consideration." This difference of language is of considerable significance to the present case: while "fair consideration," as discussed above, requires a showing of both equivalent economic value <u>and</u> good faith, "reasonably equivalent value" requires only economic equivalency. *See Pereira v. Checkmate Communications Co. (In re Checkmate Stereo and Electronics, Ltd.)*, 9 B.R. 585, 591 (Bankr. E.D.N.Y. 1981), *aff'd* 21 B.R. 402 (Bankr. E.D.N.Y. 1982). As a result, while proof of the Debtors' bad faith would be fatal to Defendant's efforts to establish fair consideration under NYD&CL § 272, it would not prevent him from establishing reasonably equivalent value under Code § 548.

The distinction is also important because of Code § 548(c), which provides that a good-faith transferee of any transfer avoided under Code § 548 "has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer."[9] By the plain terms of the statute, Defendant will be beyond the reach of the Trustee's Code § 548 avoidance power if he is able to carry his burden of proof under this section, even if the substantive requirements of Code § 548(a) are otherwise met. *See Stratton v. Equitable Bank, N.A.*, 104 B.R. 713, 728 (D. Md. 1989), *aff'd* 912 F.2d 464 (4th Cir. 1990). Because Defendant's good faith is undisputed, the determinative issue under this section, as both parties appear to recognize, is whether (and to what extent) Defendant gave value in exchange for the payments which the Trustee now seeks to avoid.

In arguing that he provided equivalent value for the payments as a matter of law, Defendant relies primarily on Code § 548(d)(2), which defines "value" to include, *inter alia*, the "satisfaction or securing of a present or antecedent debt of the debtor." Under Defendant's analysis, the promissory notes created a contractual obligation running from the Debtors to Defendant, the satisfaction of which provided the value necessary to make the transaction non-voidable under Code § 548(c). Implicit in this argument, of course, is the assumption that the promissory notes were valid and enforceable against the Debtors as of January 1, 1996. As the Trustee correctly points out, however, the well-founded allegation of a Ponzi scheme places the enforceability of the notes squarely in dispute. *See Sender v. Buchanan (In re Hedged-*

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[9] In his Answer to the Adversary Complaint, filed on December 3, 1998, Defendant does not specifically raise the defense of Code § 548(c). Instead, the answer simply alleges that (1) Defendant was paid a legal market rate of interest; (2) the transactions between Defendant and the Debtors were ordinary commercial loans; (3) the Debtors operated legitimate businesses at the time of the transactions; and (4) although defendant has been repaid in excess of his original principal investment. "the Ponzi scheme theory does not automatically apply when the interest paid does not exceed the maximum legal rate of interest." Taken together, and in light of the notice-pleading requirements of Fed.R.Civ.P. 8, the Court finds that these factual allegations state the essential elements of a Code § 548(c) defense, even though they are not expressly labeled as such. Accordingly, the Court rejects the Trustee's suggestion that Defendant's Code § 548(c) defense or any subspecies of it has been waived.

Investments Associates, Inc.), 84 F.3d 1286, 1290 (10th Cir. 1996) (holding a contract in furtherance of a Ponzi scheme unenforceable as a matter of public policy); *Independent Clearing House*, 77 B.R. at 858 (same); *Randy*, 189 B.R. at 441 (same).[10]

This does not, however, end the inquiry over whether the payments necessarily satisfied an antecedent debt owed to Defendant. Under the Bankruptcy Code, the term "debt" is defined broadly to include not merely valid contractual obligations, but any "liability on a claim." "Claim," in turn, is defined as any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *See* Code §101(5), (12). It is clear that if the Debtors truly were operating a Ponzi scheme, they would have faced contingent liability to Defendant (on theories ranging from fraud to restitution) from the moment they were entrusted with his money. *See McLemore v. Third National Bank in Nashville (In re Montgomery)*, 123 B.R. 801, 808 (Bankr. M.D. Tenn. 1991), *aff'd* 136 B.R. 727 (M.D. Tenn. 1992), *aff'd* 983 F.2d 1389 (6th Cir. 1993). This type of liability falls within the Code's broad definition of a "debt," and as such, the Debtors' payments to Defendant— which incidentally served to satisfy Defendant's unasserted, undiscovered, and possibly unimagined tort rights— operated as the satisfaction of an antecedent debt, and hence as an exchange for value under Code § 548(c). *See Independent Clearing House*,

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[10] The Court rejects Defendant's suggestion that an opposite conclusion is mandated by the District Court decision of *McNellis v. Raymond*, 329 F.Supp. 1038 (N.D.N.Y. 1971), which determined that a usurious loan contract would be void with respect to interest paid above the legal maximum, but would otherwise be enforceable. The holding of *McNellis* is based on an interpretation of New York's usury statute, and has no immediate applicability to other types of voidable contracts. While the vast majority of contracts in furtherance of a Pozni scheme are presumably usurious as well as illegal, the illegality of a Ponzi contract derives from the fraud perpetrated on the other investors, not from the interest rate imposed on the Ponzi operator.

77 B.R. at 857 (holding that operator of Ponzi scheme received value for payments made to investor which reduced restitution claim), *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 595 (9th Cir. 1991) (same); *Scholes v. Lehmann,* 56 F.3d 750, 757 (7th Cir. 1995) (same).[11]

Having determined that the payments to Defendant were made in good faith and in satisfaction of an antecedent debt, the Court next considers the Trustee's contention that Defendant's Code § 548(c) defense is at most limited to the $20,000 amount of his principal investment, but that under no circumstances did Defendant provide value for the approximately $2,208.42 of the payments which represented his alleged "profit." The Trustee notes the vast majority of courts that have recognized Code § 548(c) defenses for Ponzi scheme investors have refused to extend the defense beyond the amount of the investor-defendant's original undertaking. *See Jobin v. Ripley (In re M&L Business Machine Co., Inc.)*, 198 B.R. 800, 809 (D. Colo. 1996); *Randy*, 189 B.R. at 442; *Sender v. Hannahs (In re Hedged Investments Associates, Inc.)*, 176 B.R. 214, 215 (D. Colo. 1994); *Independent Clearing House*, 77 B.R. at 857. According to the Trustee, these cases have recognized a sharp distinction between payments that are merely a return of principal, for which a valid Code § 548(c) defense might be available, and those that represent the investor's profit, which are always avoidable. *Cf. Independent Clearing House*, 77 B.R. at 870 (stating that "[t]he law allowing a Trustee to avoid payments of fictitious

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[11] It is quite possible, of course, that there was neither an enforceable contract nor a Ponzi scheme, in which case the above analysis might not hold. However, in his responding papers to the Defendant's summary judgment motion, the Trustee cited only the alleged Ponzi scheme as a basis for the non-enforceability of the promissory note. Accordingly, the Court will assume at this point that the note was either enforceable, or not enforceable solely by reason of the Ponzi scheme.

Ponzi scheme profits as fraudulent conveyances embodies the principal [sic] that no one should profit from a fraudulent scheme at the expense of others. Were the defendants allowed to keep payments in excess of their undertakings, they would be profiting at the expense of those who entered the scheme later and received little or nothing.")

Defendant offers a slightly more nuanced, and in the view of the Court, a better interpretation of the authorities cited above. According to Defendant, the critical question is not whether some payment represented "profit"or "return of principal"— a distinction that will not always be as clear-cut as the Trustee seems to envision—[12] but rather whether the additional payment served to further reduce some antecedent liability in the sense of Code § 548(d)(2). As explained by the Seventh Circuit:

> Phillips [a Ponzi scheme investor] is entitled to his profit only if the payment of that profit to him, which reduced the net assets of the estate now administered by the receiver, was offset by an equivalent benefit to the estate. *In re Independent Clearing House*, 77 B.R. 843, 857-59 (D.Utah 1987). It was not. . . . The paying out of profits to Phillips not offset by further investments by him conferred no benefit on the corporations, but merely depleted their resources faster.

Scholes, 56 F.3d at 757 (interpreting parallel provision of Illinois law).

In the normal case, this choice of rationales will be unimportant. As a matter of general American law, the damages which may be sought by a fraud victim are usually limited to out-of-

[12] Consider the case of a hypothetical innocent investor who deposits $1,000 into a Ponzi scheme and is repaid, one year later, with $1,010. Though under the Trustee's analysis, this hypothetical investor will have received $10 of profit, it is hard to conclude that he is a net winner under this transaction. By spending $1,000 on the Ponzi scheme, the investor gave up the chance to place his money in other investments, many of which presumably would have offered him a better return than the 1% actually received. In borderline cases, the legal (and equitable) question of whether an investor benefitted from or was victimized by a Ponzi fraud will often depend on whether the fact-finder chooses to take into account such factors as lost opportunity costs and transaction costs, thus making the entire analysis more complicated that the simple comparison of figures on a balance sheet.

pocket monetary losses; under this framework, the benefit to the Ponzi debtor would be exhausted as soon as the payments made back to the investor exceeded the debtor's original capital outlay. *See* 22 AM. JUR. 2D, DAMAGES § 181. Defendant argues, however, that this principle is superseded in the present case by § 5001 of the New York Civil Practice Law and Rules (McKinney's 1992 & 1999 supp.) ("CPLR"), which provides for prejudgment interest on damages arising out of "an act or omission depriving or otherwise interfering with title to, or possession or enjoyment of, property."[13] Pursuant to CPLR § 5004, the default rate of prejudgment interest under this section is nine percent per annum, a rate in excess of the highest interest rate ever paid to Defendant by the Debtors.

While the literal language of CPLR § 5001 does not appear to encompass fraud claims, New York and federal courts have consistently applied this section to causes of action similar to the hypothetical tort claim which Defendant might have asserted against the Debtors. *See Farrell*

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[13] In full, CPLR § 5001 provides:

> **(a) Actions in which recoverable.** Interest shall be recovered upon a sum awarded because of a breach of performance of a contract, or because of an act or omission depriving or otherwise interfering with title to, or possession or enjoyment of, property, except that in an action of an equitable nature, interest and the rate and date from which it shall be computed shall be in the court's discretion.
> **(b) Date from which computed.** Interest shall be computed from the earliest ascertainable date the cause of action existed, except that interest upon damages incurred thereafter shall be computed from the date incurred. Where such damages were incurred at various times, interest shall be computed upon each item from the date it was incurred or upon all of the damages from a single reasonable intermediate date.
> **(c) Specifying date; computing interest.** The date from which interest is to be computed shall be specified in the verdict, report, or decision. If a jury is discharged without specifying the date, the court upon motion shall fix the date, except that where the date is certain and not in dispute, the date may be fixed by the clerk of the court upon affidavit. The amount of interest shall be computed by the clerk of the court, to the date the verdict was rendered or the report or decision was made, and included in the total sum awarded.

v. Comstock Group, Inc., 211 A.D.2d 493, 621 N.Y.S.2d 325 (N.Y. App. Div. 1st Dept. 1995) (fraudulent inducement); *Action S.A. v. March Rich & Co., Inc.*, 951 F.2d 504 (2d Cir. 1991) (common law fraud and breach of fiduciary duties); *Mallis v. Bankers Trust Co.*, 717 F.2d 683 (2d Cir. 1983) (securities fraud); *Quintel Corp. v. Citibank, N.A.,* 606 F.Supp. 898 (S.D.N.Y. 1985) (securities fraud and breach of fiduciary duties); *Freschi v. Grand Coal Venture*, 588 F.Supp. 1257 (S.D.N.Y. 1984), *rev'd on other grounds*, 767 F.2d 1041 (2d Cir. 1985) (securities fraud).

As noted above, the validity of the Code § 548(c) defense hinges on the question of whether, on January 1, 1996, Defendant held a colorable claim against the Debtors in an amount of at least $22,208.42. Had the Debtors failed to make payment on that date, and the contract was found to be unenforceable because of the Debtors' fraud, CPLR §§ 5001 and 5004 would have entitled Defendant to damages equal to $20,000 plus nine percent interest dating back to the moment when the Debtors were entrusted with Defendant's money. As a result, it is clear that a payment of only $20,000 would not have made Defendant whole and would not have extinguished the Debtors' potential liability. It thus follows that those payments that were in excess of Defendant's original investment amount, but less than the equivalent of nine percent interest, served to reduce the antecedent liability of the Debtors and thus constituted "value" by the plain language of Code § 548(d)(1). Accordingly, the Court concludes that Defendant is entitled to the protection of Code § 548(c) for the full amount of the transfers made to him.

In his responding papers, the Trustee has offered three general objections to the preceding analysis of Code § 548. In pertinent part, the Trustee argues that (1) the proper measure of the Debtors' prepetition liability to Defendant is not New York law, but rather federal law; (2)

alternately, that Defendant's restitution claim should be measured under Vermont rather than New York law; and (3) that under principles of equity, Defendant should not be allowed to retain more than his original investment. For the following reasons, the Court concludes that all three of these objections are without legal merit.

The Trustee's first argument appears to be premised on the idea that, for purposes of measuring "value" under Code § 548(c), the "debt" which was discharged by the payments to Defendant is not Defendant's hypothetical prepetition fraud suit against the Debtors, but rather his equally-hypothetical postpetition proof of claim against the bankruptcy estate. If the fraudulent conveyance provisions of the Bankruptcy Code authorized the courts to make this type of post-hoc analysis, a reasonable argument could perhaps be made for the Trustee's method of valuation. Under Code § 548, however, value must be determined as of the date of the transfer, and not in light of subsequent events. *See Cooper v. Ashley Communications (In re Morris Communications NC, Inc.)*, 914 F.2d 458, 466 (4th Cir. 1990); *Breeden v. L.I. Bridge Fund, L.L.C. (In re The Bennett Funding Group)*, Adv. No. 96-70280 (Bankr. N.D.N.Y. Feb. 22, 1999). Because BRC and BRC II had not yet filed for bankruptcy on January 1, 1996, Defendant's rights against them would have been governed by state law, not the Bankruptcy Code, and the benefit which the Debtors obtained by the release of these rights must be valued accordingly.[14]

In the alternative, the Trustee has argued for the application of Vermont rather than New

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[14] Alternately, the Court notes that even if Defendant's prepetition rights against the Debtors were analyzed as a bankruptcy claim under Code §§ 501 and 502, it does not follow that the Defendant's state law rights to prepetition interest would be disallowed. *See In re United States Lines*, 199 B.R. 476, 482 (Bankr. S.D.N.Y. 1996) (noting that "the Bankruptcy Code contemplates the allowance of claims for prepetition interest"); *In re Pettibone Corp.*, 134 B.R. 349, 351 (Bankr. N.D.Ill. 1991).

York law for purposes of measuring Defendant's right to prepetition interest. While the Trustee has cited to no authority indicating that Vermont law differs in any way from New York law on this point, the Court believes that an analysis of Vermont law is in any case unnecessary, as both the contract and the tort rights of Defendant against the Debtors are properly determined under the laws of New York.

Under the doctrine announced in *Klaxon v. Stentor Electric Manufacturing*, 313 U.S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477 (1941), a federal court must apply the choice of law rules of the forum in which it sits. New York law, in turn, recognizes two separate methods of determining the applicable law for a cause of action arising out of a multistate transaction. Under the "center of gravity" approach, which is the accepted method of analysis for contract cases, the court applies the law of the state having the most significant relationship to the parties and the transaction. Under the "interest analysis" approach, which is mainly used for tort cases, the Court analyzes the substantive policies underlying an area of regulation and determines if a conflict between two competing state interests truly exists; where a true conflict does arise, the law of the forum state will usually govern. *See Hassett v. Far West Federal Savings and Loan Association (In re O.P.M. Leasing Services, Inc.)*, 40 B.R. 380, 392 (Bankr. S.D.N.Y. 1984).

On the facts of the present case, either method of analysis yields the conclusion that New York law should apply to the transactions between Defendant and the Debtors. From the undisputed evidence submitted by the parties, it appears that the Debtors' entire business operation was directed from Syracuse, New York. The short-term promissory notes at issue were executed in New York, contained a New York choice-of-law clause, and were accompanied by purported certificates of insurance which listed as loss payee a New York-based affiliate of BRC and BRC II. Moreover, the acts of fraud alleged by the Trustee appear to have taken place primarily in New York. By contrast, apart from being Defendant's state of residence, Vermont has no apparent connection with the transaction or the fraud. As such, the center of gravity approach clearly favors the application of New York law.

Likewise, New York law must be applied under an interest analysis method. Under this approach, it appears that both states have a legitimate policy interest in the transaction at issue: Vermont certainly has an interest in protecting its own citizens from fraud, but New York also has a legitimate interest in policing tortious conduct within its own borders. *See In the Matter of Allstate Insurance Co. v. Stolarz*, 81 N.Y.2d 219, 225, 613 N.E.2d 936, 939; 597 N.Y.S.2d 904, 907 (1993). Having identified a true conflict, a New York court employing the interest analysis method in a tort case would then break the deadlock by applying the law of either the forum state or the state in which the tort was committed, both of which are New York in the present case. *See Cooney v. Osgood Machinery*, 81 N.Y.2d 66, 73, 612 N.E.2d 277, 281, 595 N.Y.S.2d 919, 923 (1993). Accordingly, the Court concludes that either choice of law analysis results in the application of New York law.

Lastly, the Trustee argues that it is simply inequitable to allow Defendant to keep his payments when other equally innocent investors lost most or all of their money. The force of this argument is blunted, of course, by the Court's holdings under NYD&CL §§ 271-281; even if the Code § 548 causes of action are dismissed, Defendant will still be potentially liable to the Trustee under the state law causes of action. Even were this not the case, however, the payments to Defendant cannot be avoided under Code § 548 without doing violence to the language and structure of the Bankruptcy Code. As the *Independent Clearing House* bankruptcy court noted under similar circumstances:

> It is undoubtedly true that the bankruptcy court is a court of equity and proceedings in bankruptcy are governed by equitable principles. [citations omitted] A trustee's powers, however, are statutory and limited. The Bankruptcy Code places restrictions upon the trustee's powers to nullify transactions between a debtor and its creditors. . . . A court of equity may not create totally new substantive rights under the guise of doing equity.

Merrill v. Abbott (In re Independent Clearing House Company), 41 B.R. 985, 1005 (Bankr. D. Utah 1984).

Based on the foregoing, Defendant's Motion for Summary Judgment pursuant to Fed.R.Bankr.P. 7056 and Fed.R.Civ.P. 56 is hereby

GRANTED with respect to the Trustee's Code § 548 causes of action, and

DENIED with respect to the Trustee's Code § 544(b) and NYD&CL §§ 271-281 causes of action, except that summary judgment is granted to Defendant with respect to all amounts sought to be avoided in excess of the payments made to Defendant on or around January 1, 1996.

Dated at Utica, New York

this 29th day of April 1999

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge