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

APPEARANCES:

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

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

Presently before the Court is a motion ("Motion") filed on May 4, 1998, on behalf of the Official Early Investors Committee ("EIC") pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), incorporated by reference in Rule 7012 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), requesting the dismissal of the fraudulent transfer and fraudulent conveyance counts ("Fraudulent Transfer Counts") in complaints filed by Richard C. Breeden, as chapter 11 trustee ("Trustee") of the substantively consolidated estates of The Bennett Funding Group, Inc. ("BFG"), Bennett Receivables Corporation ("BRC"), Bennett Receivables Corporation II ("BRC-II"), Bennett Management & Development Corporation ("BMDC"), The Processing Center, Inc. ("TPC"), Resort Service Company, Inc. ("RSC"), American Marine International, Ltd. ("AMI") and Aloha Capital Corporation ("Aloha") (the "Debtors") in late March 1998 against certain investors.[1] The Trustee filed his Response and Objection to the Motion on June 8, 1998. On June 9, 1998, the Official Committee of Unsecured Creditors ("Unsecured Creditors Committee") filed its statement indicating support of "a

[1] Although the complaints were filed in late March 1998, alleging causes of action against approximately 10,000 investors, they have not been served on any of the defendants. At the request of the Trustee, the Court has extended the time for service of the complaints beyond the 120 day period after filing pursuant to Fed.R.Bankr.P. 7004(a), which incorporates Fed.R.Civ.P. 4. Attached to the Motion is a sample complaint. *See* Exhibit A of the Motion.

dismissal of the affirmative profit or interest recoveries against investors/creditors."[2]

The Court heard oral argument of the Motion on June 11, 1998, and reserved on its decision with respect to the relief sought.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction of the adversary proceedings commenced by the Trustee which seek, *inter alia*, to avoid certain transfers under §§ 548 and 544 of the Bankruptcy Code (11 U.S.C. §§ 101-1330) ("Code") pursuant to 28 U.S.C. § 1334, 157(a), (b)(1), (b)(2)(H) and (O).

FACTS

On March 29, 1996, BFG, BRC, BRC-II and BMDC filed voluntary petitions seeking relief under chapter 11 of the Bankruptcy Code . The Trustee was appointed trustee for each of them on April 18, 1996. On April 19, 1996, AMI and RSC filed petitions for relief under chapter 11, and on April 25, 1996, an involuntary chapter 11 case was filed against Aloha. TPC filed a voluntary chapter 11 petition on April 26, 1996, and on May 10, 1996, the Court entered an order for relief against Aloha. The Trustee's appointment for AMI, RSC, TPC and Aloha was

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[2] In addition, there are responses filed by the law firms of Harter, Secrest & Emory, Green & Seifter and Bond, Schoeneck & King, LLP, generally in support of the EIC's motion with the proviso that the same relief be granted to various banks represented by said firms with respect to adversary proceedings now pending before this Court for which complaints have been served.

approved by the Court on May 15, 1996. By Order dated July 25, 1997, the Court substantively consolidated the Debtors' estates.

Prior to filing, one or more of the Debtors were involved in the originating, purchasing and selling of commercial leases of copy machines and other office equipment. For purposes of financing their operations, the Debtors compiled the leases into portfolios which were then assigned/transferred to potential lenders and investors. The Trustee asserts that between 1990 and 1996 "[t]he Debtors financed their capital and cash flow needs through a Ponzi scheme accomplished by, among other means, (i) obtaining investments and loans by pledging the same lease multiple times to investors and pledging that same lease to a financial institution and (ii) pledging to investors fictitious leases." *See* Complaint at ¶ 9. He also contends that "[t]he lease stream payments (to the extent they existed at all) were inadequate to pay the obligations due to investors and financial institutions to whom such payments were pledged multiple times." *See id.* at ¶ 10. Accordingly, it is the Trustee's position that "the Debtors satisfied their obligations to current investors and financial institutions by using funds raised from new investors or leases pledged to others." *See id.* at ¶ 11. Furthermore, funds received by the Debtors from a variety of sources, including the lessees, were commingled into a single account, referred to in this case as the "Honeypot" and later used, *inter alia*, to make payments to the investors. *See id.* at 12.

On December 19, 1997, the Trustee filed an objection to the claims of approximately 9,000 creditors ("Claims Objection"). As part of the Claims Objection, the Trustee moved for the reduction of the claims of certain investors by the amount of interest paid to them by one or more of the Debtors in the six year period prior to the Debtors' bankruptcy filings under a "Ponzi interest theory" ("Claims Adjustment Motion"). The Claims Adjustment Motion was heard on

January 30, 1998, and while portions of the Claims Objection have been granted, that portion involving the Ponzi interest theory, namely, the Claims Adjustment Motion, has been adjourned and remains unresolved to date.

On January 30, 1998, the Trustee filed a motion pursuant to Code § 554(a) seeking to abandon all preference claims against certain investors under Code § 547 ("Preference Abandonment Motion"). On February 12, 1998, the Trustee filed a second motion pursuant to Code § 554(a) seeking to abandon fraudulent transfer claims against certain investors pursuant to Code § 544, § 548 and the New York Debtor and Creditor Law ("NYDCL") ("Fraudulent Transfer Abandonment Motion").

The Preference Abandonment Motion was originally scheduled to be heard at the Court's motion term in Utica, New York, on January 30, 1998, but was consensually adjourned by the parties to February 12, 1998. In the interim, on February 11, 1998, the Office of the U.S. Trustee appointed the EIC to represent the "early investors," including those individuals who, as of March 29, 1996, "had a claim against the Debtor, as listed in Exhibit A attached to the Claims Objection, which exceeded the amount of interest paid to such creditor during the six year period prior to the commencement of the Debtor's bankruptcy case" (hereinafter the "Current Investors" for purposes of this Decision).[3] *See* Motion at ¶ 1. The EIC does not represent any

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[3] For purposes of this discussion, the Current Investors are those individuals who fit within "Type C" of the four basic fact patterns to which the Trustee alleges constructive fraudulent transfer law applies in a Ponzi scheme. For example, an individual who invested $100 and prior to the petition date had received $70 of principal and $10 of interest from the Debtor would be deemed to be a "Type C" investor under the Trustee's analysis. *See* Trustee's Response at 13. Based on the Motion, it is not clear whether the EIC is seeking relief on behalf of the "Type B" investor who, for example, may have invested $100 and received $80 of principal and $20 of interest prepetition because such individual would not have a claim against one or more of the Debtors which exceeds the amount of interest paid to him/her.

investors who received an amount in excess of their original principal investment back from one or more of the Debtors.

Following oral argument on the Preference Abandonment Motion on February 12th, Trustee's counsel requested that it be adjourned to February 26, 1998, in order for the Court to consider it along with the Fraudulent Transfer Abandonment Motion which had been filed that day. Trustee's counsel indicated that a nexus existed between the two motions which made it appropriate that the two be addressed together. Following the hearing on February 26, 1998, the Court issued a Memorandum-Decision denying the Trustee's Preference Abandonment Motion based on a finding that the Trustee had failed to establish that abandonment of the preference claims would be of inconsequential value and benefit to the estate. *See In re Bennett Funding Group, Inc.*, Case No. 96-61376, slip op. at 14 (Bankr. N.D.N.Y. March 6, 1998) ("March 6th Decision"). The Court also denied the Trustee's Fraudulent Transfer Abandonment Motion based on the representation by Trustee's counsel that in the event that the Trustee decided to commence adversary proceedings against the same investors pursuant to Code § 547, the expense to the estate would be minimal if the Trustee also determined that it was appropriate to seek affirmative relief from them pursuant to Code §§ 544 and 548." *See id.* at 16. The Court made no finding with respect to whether the Trustee had a valid claim against the investors pursuant to Code §§ 544 and 548 and left it to the Trustee's judgment to decide whether it was appropriate to seek affirmative relief under the circumstances of this case.

By way of Order to Show Cause, the Unsecured Creditors Committee sought reconsideration of that portion of the Court's March 6th Decision which denied the Trustee's Fraudulent Transfer Abandonment Motion. Following oral argument on March 17, 1998, the

Court concluded that it could not find "any compelling basis to grant Mr. Stolz's motion for reconsideration to the extent that I will give to the trustee as Mr. Steinberg styles it, a comfort order which allows him to abandon the 548(a) causes of action against the investors to the extent that he may seek affirmative relief on those causes of action."[4] *See* Transcript ("Tr.") of March 17, 1998 Hearing at 64.

As noted previously, the Trustee filed complaints against approximately 10,000 investors prior to March 29, 1998, but has not served them. The sample complaint attached to the Motion seeks (1) to recover alleged fraudulent transfers made to the Current Investors pursuant to Code § 548(a)(2); (2) to recover alleged fraudulent conveyances made to the Current Investors pursuant to §§ 272-275 of the NYDCL and Code § 544(b), and (3) to recover alleged preferences pursuant to Code § 547. The first two causes of action ("Fraudulent Transfer Counts") are premised on allegations of constructive fraud based on a Ponzi interest theory.[5] The Trustee is not alleging actual fraud on the part of the Current Investors.[6] It is the first two causes of action which the

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[4] The Court also expressed concerns about the Trustee's unwillingness to seek abandonment of similar claims against the Banks. The Court noted, "It may turn out that I'm incorrect. It may turn out that the trustee can distinguish under 548(c) the conduct of the banks from the conduct or lack thereof of the investors. But we don't know that on these papers." *See* Tr. at 64.

[5] Although a determination of whether a Ponzi scheme exists depends on a number of factors, the basic premise is the existence of "an investment scheme by which returns to investors are not financed through the success of the underlying business venture, but rather are taken from moneys received from other investors." *Tropin v. Weisser (In re Premium Sales)*, Case No. 93-12253-BKC-AJC, Adv. P. No. 95-0176-BKC-AJC and Adv. P. No. 95-0226-BKC-AJC, slip op. at 15 (Bankr. S.D.Fla. June 23, 1997) (citations omitted). Under this theory, an investor is entitled to restitution on out-of-pocket losses, and, accordingly, all amounts paid to an investor, whether denominated as principal or interest, must be applied as a credit to the claim he/she has against one or more of the Debtors.

[6] At the hearing on the Reconsideration Motion, the Trustee indicated that he did not intend to pursue the Current Investors for <u>all</u> payments (both principal and interest) received by

EIC now seeks to have dismissed pursuant to Fed.R.Civ.P. 12(b)(6) for failure to state a claim.

ARGUMENTS

In its Motion, the EIC asserts that the Trustee previously conceded that he has no constructive fraudulent conveyance cause of action against the Current Investors to the extent that payments to an investor were less than the amount invested. The EIC asserts that the Current Investors, as defined in the Motion, hold claims in excess of the amount paid to them by the Debtors. The EIC contends that the Trustee admitted that even if he were able to establish a fraudulent conveyance cause of action, the Current Investors would be able to establish a defense under Code § 548(c) and equivalent state law. Furthermore, it is the EIC's position that the dismissal of the Fraudulent Transfer Counts in the Complaint will not affect the Trustee's ability to seek the same relief in the Claims Adjustment Motion under the Ponzi interest theory.

The EIC also makes the argument that even if the Trustee did not make the above admissions, the Trustee must demonstrate that the Debtors received less then reasonably equivalent value or less than fair consideration in order to recover the payments of interest. The EIC argues that satisfaction of an antecedent debt constitutes "value" and "fair consideration." The EIC contends that "[t]he sole area of dispute is whether the Trustee is entitled to an adjustment on the claim of the Current Investors based on the Ponzi interest theory - - under no circumstances is the Trustee entitled to an affirmative recovery of a transfer where the Current Investor transferred to the Debtors more than it was repaid." *See* Motion at ¶ 24. It is the EIC's

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them pursuant to Code § 548(a)(1).

position that whether an adjustment in the claims of the Current Investors is appropriate based on the Ponzi interest theory is a matter more appropriately addressed in the Claims Adjustment Motion. The EIC also asserts that § 502(d) is inapplicable if the Current Investors have a complete defense to the Fraudulent Transfer Counts.

In response, the Trustee indicates he has not conceded that there are no constructive fraudulent conveyance claims against the Current Investors and that any such claims of the Trustee are subject to a defense. *See* Trustee's Response at 5. He points out that he previously indicated that many, if not all of the Current Investors, might be able to establish a defense under Code § 548(c) and equivalent state law. The Trustee also indicates that he has not conceded that the issue should proceed by way of the Claims Adjustment Motion. The Trustee asserts that whether the Debtors operated a Ponzi scheme is a question of fact that cannot be decided on a motion to dismiss as the Trustee should have an opportunity to prove his case in that regard.

With respect to the element of reasonably equivalent value, the Trustee asserts that the proposition that because the Current Investors paid more to one or more of the Debtors than the Current Investors were paid in return that one or more of the Debtors received reasonably equivalent value or fair consideration in return for the payments is "fallacious"! *See* Trustee's Response at 12. The Trustee asserts that in a Ponzi scheme a "lender" is entitled to a claim for principal only or restitution in an amount equal to the amount "loaned."[7] According to the Trustee, payments to a Current Investor would constitute reasonably equivalent value only to the extent that they reduced the principal of his/her claim against one or more of the Debtors. *See*

[7] It is unclear why, in his response, the Trustee refers to "lenders" rather than "investors" in his discussion of a Ponzi scheme. *See* Trustee's Response at 11, 13-15.

id. at 15.

The EIC indicates in connection with the Motion herein that "the Trustee can argue that reasonably equivalent value or fair consideration is only given if there is a commensurate reduction in the principal claims filed by the Current Investors against the Debtor. That is the battleground for the [Claims] Objection and the Committee is prepared to meet that issue head on in that proceeding. There is no need to conduct two parallel proceedings on the same issue."[8] *See* Motion at ¶ 23.

The Trustee indicates that he cannot agree to dismiss the Fraudulent Transfer Counts against the Current Investors unless the Court determines:

> (i) reduction of the claim by crediting against the claim all payments made prepetition constitutes reasonably equivalent value and fair consideration for purposes of section 548(a)(2) and the NYDCL, provided that there is not a negative remaining balance (footnote omitted);
>
> (ii) reduction of the claim can properly be accomplished through the claims objection process and need not be done in an adversary proceeding; and
>
> (iii) the Consolidated Estate is not required to seek affirmative recovery of the constructive fraud claims on a dollar-for-dollar

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[8] The Court recognizes that the Trustee was under certain time constraints set forth in Code § 546(a) to commence avoidance actions prior to March 29, 1998. The Trustee filed his Claims Objection on December 19, 1997, approximately three months before said deadline for filing complaints. Both the Trustee and the EIC acknowledge that approximately 1500 objections were filed in response to the Trustee's Claims Objection, most of which concerned the Claims Adjustment Motion. Although portions of the Claims Objection have been resolved, there had been no ruling on the Claims Adjustment Motion by the Court prior to the statutory deadline for filing the complaints. However, according to the Trustee, on or about June 1, 1998, he was served with the EIC's memorandum of law in support of a motion for summary judgment, dismissing in part the Trustee's Claims Objection with respect to "certain lenders." *See* Trustee's Response at Footnote 1. The motion for summary judgment was most recently scheduled to be heard on July 30, 1998, and has been consensually adjourned indefinitely.

> basis through the lawsuits and/or by offset of the claims for interest against distribution amounts under section 502(d).

("Rulings"). *See id.* at 16. In reply, the EIC states, "The Trustee has no affirmative recovery remedy in situations where a creditor's claim exceeds the interest paid to it." *See* EIC's Reply to the Trustee's Response, filed June 10, 1998, at ¶ 10.

DISCUSSION

As the Court has previously indicated, the complex nature of this case requires that the Court be flexible in its approach provided what it does is within the parameters set for it by the Code and the Rules. In this case, the EIC's Motion is brought pursuant to Fed.R.Civ.P.12(b)(6). Upon examination of Fed.R.Civ.P. 12, it is clear that a necessary predicate to seeking relief thereunder is the service of a complaint on the defendant/movant. Fed.R.Civ.P. 12 addresses when a motion to dismiss is to be presented and begins with the phrase, "If a complaint is duly served . . . ." Although the EIC has provided the Court with a sample complaint, both the EIC and the Trustee acknowledge that there has as yet been no service of any complaints on the Current Investors, as defined herein. Therefore, it is evident that there has been no affirmative recovery actually sought against any of the Current Investors. The Court is being asked to decide the merits of a potential controversy; however, the Court has no authority to render such an advisory opinion. *See Matter of FedPak Systems, Inc.*, 80 F.3d 207, 211-12 (7th Cir. 1996) (indicating that "A bankruptcy court, like any other federal court, lacks the constitutional power to render advisory opinions or to decide abstract, academic or hypothetical questions."). Until the complaints have actually been served, and the Court is not suggesting that they should be at

this time solely for the purpose of "ripening" this motion, it would be inappropriate for the Court to dismiss any of the causes of action set forth therein.

The EIC has suggested that parallel proceedings are unnecessary. The Trustee "acknowledges that only one remedy will ultimately be available . . . ." *See* Trustee's Response at 17. The Trustee indicates that he is amenable to withdrawing the Fraudulent Transfer Counts in his complaints provided that the Court make the Rulings noted above. The Court, however, believes that it may be inappropriate to consider the requested Rulings until it determines whether, as alleged by the Trustee, one or more of the Debtors operated a Ponzi scheme between 1990 and 1996. This issue permeates almost every aspect of the litigation presently pending in this case and impacts on not only the Current Investors, but also various financial institutions, brokers and investors who are not represented by either of the Committees having completed their transactions with the Debtors prior to the bankruptcy proceedings. Based on the number of objections filed to the Claims Adjustment Motion, which is to a large extent based on the Ponzi scheme and Ponzi interest theories of the Trustee, it may be that the Court will have an opportunity to address these issues on the EIC's motion for summary judgment.[9] However, with respect to the current Motion, there are no legally-protected interests that have been "invaded" because as yet no complaints have been served on the Current Investors.

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[9] Although it is not known whether the EIC is seeking a declaratory judgment, the Court would note that the Declaratory Judgment Act (28 U.S.C. § 2201) authorizes a court to render declaratory relief in the case where there is an "'invasion of a legally-protected interest' that is 'concrete and particularized' *and* 'actual or imminent, not conjectural or hypothetical.'" *FedPak* Systems, 80 F.3d at 212, quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560, 112 S.Ct. 2130, 2136, 119 L.Ed.2d 351 (1992). "A bankruptcy court may grant a declaratory judgment whenever a real threat of litigation exists." *In re Leslie Fay Companies, Inc.*, 216 B.R. 117, 134 (Bankr. S.D.N.Y. 1997) (citations omitted).

Based on the foregoing, it is hereby

ORDERED that the EIC's Motion requesting dismissal of the first two causes of action of the complaints filed by the Trustee is denied without prejudice.

Dated at Utica, New York

this 6th day of August 1998

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge