Choosing among Innocents: Should Donations to Charities Be Protected from Avoidance as Fraudulent Transfers

Jeffrey Davis
University of Florida Levin College of Law, davis@law.ufl.edu

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CHOOSING AMONG INNOCENTS: SHOULD DONATIONS TO CHARITIES BE PROTECTED FROM AVOIDANCE AS FRAUDULENT TRANSFERS?

Jeffrey Davis*

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Maria was a widow. Her house was paid for and her savings, including her deceased husband’s life insurance, amounted to approximately $100,000. Her income from social security and a small pension was modest, but adequate. Her son, Frankie, was an investment advisor. In 1995, Frankie convinced Maria that she would receive a much better return on her savings if she were to invest her money in stock in Transcontinental Airlines Travel Services, Inc. This company was one of three fraudulent Ponzi¹ schemes operated by Lou Pearlman.²

* Jeffrey Davis, Gerald A. Sohn Research Scholar and Professor of Law, University of Florida Levin College of Law.

1. A Ponzi scheme is one in which investments are solicited from customers who believe their monies are being invested profitably, but investors are paid their profits from new monies received from customers, without any actual investments being made. See Picard v. Katz, 462 B.R. 447, 451 (S.D.N.Y. 2011).

2. For a description of Pearlman’s Ponzi schemes, see Kapila v. Integra Bank (In re
Frankie was one of Pearlman’s broker intermediaries that marketed the stock. Frankie assured his customers that the program was safe, it was FDIC insured, and that he invested the bulk of his personal assets in the program. By 2007, Maria’s periodic statement showed that her account had appreciated to a value of more than $300,000.

Pearlman’s Ponzi schemes collapsed in early 2007 and an involuntary Chapter 11 petition was filed on March 1, 2007. Maria was informed of the bankruptcy and was devastated to learn that her investment did not exist. Transcontinental never had any assets and had never issued any stock. She was further devastated when Frankie committed suicide. With the assistance of Frankie’s best friend James, she learned that she could submit a claim in bankruptcy, limited to her original investment of $100,000.\(^3\) However, it would probably take years to receive anything and any recovery would probably fall far short of what she claimed.

Meanwhile, 130 miles to the southwest, the receiver for the Arthur Nadel Ponzi scheme demanded that the Jewish Family and Children’s Service of Sarasota-Manatee pay back the $227,000 that Nadel had donated previously.\(^4\) The Chief Executive Officer said, “We don’t have it! We spent it long ago. When donations come in, we put them to use helping the homeless. How can you be so heartless, Mr. Receiver?” The Receiver replied,

I am far from heartless. I have hundreds of defrauded investors who have been victimized by this Ponzi scheme. They have lost their life’s savings, their children’s college funds, and their medical emergency funds. They are devastated. Some have even committed suicide. The damage done by this vicious criminal is incalculable. It is my job to restore hope by returning as much as I can to replace what they’ve lost. You paid nothing for that

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\(^3\) The claim for the imaginary return on her investment is not a provable claim. As stated in *In re New Times Securities, Inc.*, 371 F.3d 68, 87-88 (2d Cir. 2004), claims should be valued according to the amount initially paid by the claimants to the debtors for purchase of the investment. As explained by Judge Lifland in *In re Bernard Madoff Investment Securities LLC*, 424 B.R. 122, 137-44 (Bankr. S.D.N.Y. 2010), the claim for the imagined appreciation creates “potential absurdities created by reliance on . . . entirely artificial numbers.” *In re New Times Securities Inc.*, 371 F3d at 88. Equity and practicality also favor this conclusion.

\(^4\) This is the amount claimed by the receiver to have been donated by the Guy-Nadel Foundation, the charitable arm of the Nadel Ponzi operation. Eventually, the receiver agreed to settle the case for $140,000, payable in three installments over two years. John Hielscher, *Charity to Return $140,000 in Donations From Nadel Ponzi Scheme*, HERALD-TRIB., Sept. 23, 2011, http://heraldtribune.com/article/20110923/ARTICLE/110929790?template=printart.
$227,000. The law says you have to give it back.5

“Well, it shouldn’t,” said the Chief Executive Officer.
Well, it does. The centuries-old premise of fraudulent transfer law is that if you are not paying your creditors, you should not be making gifts, and the person receiving the gift should have to give it back so the assets of the donor can be distributed to the donor’s creditors. The innocence of the donee is irrelevant. Even if the “lucky” transferee has innocently spent the money and is no longer in a position to give it back, creditors are entitled to a judgment against the transferee. Having failed to give reasonably equivalent value, the good faith of the transferee is no defense.6

In recent years, the nation has experienced the most severe recession since the Great Depression of the 1930s. A recession is like a low tide. When the water recedes, the crabs, slugs, and urchins appear. Similarly, when the economy recedes, Ponzi schemes appear. People cut back on saving and investing, and many are forced to draw on savings and investments. Deprived of its life’s blood, a positive cash flow, a Ponzi scheme dies. This explains why so many Ponzi schemes have failed recently, including the schemes of Bernard Madoff in New York, Tom Petters in Minneapolis, Robert Allen Stanford in Houston, Scott Rothstein in Miami, Lou Pearlman in Orlando, and Arthur Nadel in Sarasota. Many failed Ponzi schemes fall directly into bankruptcy, but some find their way into state law processes, such as receivership or assignment for the benefit of creditors. Some, but not all Ponzi schemes make a show of their generosity by making large donations to charities. Inevitably, the trustee or receiver for the failed Ponzi scheme seeks to recover the donations from the charities, so that the recovered funds can be distributed to the creditors of the Ponzi scheme, primarily the defrauded savers or investors. But charities do not retain assets for a rainy day. They depend largely on cash flow. The cash comes in and it is put immediately to work. So, when the trustee or receiver demands return of the donations, the donations will have already been spent. Any repayment has to come out of future income, cutting into charitable works.

Recently, a number of state legislatures have been asked to protect charities from these demands under state law, usually the Uniform Fraudulent Transfer Act. For example, as a direct result of the Tom

5. Both state law and bankruptcy law state, in essence, that if a transfer is made either with the actual intent to defraud creditors, or by an insolvent transferor for less than reasonably equivalent value, the transfer is voidable. U.F.T.A. § 4 (1984); 11 U.S.C. § 548(a)(1) (2012).
6. One who has received a fraudulent transfer has a defense under both state and bankruptcy law to the extent that the transferee takes for value and in good faith in exchange for the transfer. 11 U.S.C. § 548(c) (2005); U.F.T.A. § 8(a), (d) (1984).
Petters Ponzi scheme, the state of Minnesota has amended the Minnesota Fraudulent Transfer Act. A number of bills aimed at similar effect were introduced in both the 2012 Florida and Georgia legislative sessions. Neither the Florida nor Georgia bills passed, but they promise to return in 2013. Although the legislation seems to have sailed through the Minnesota legislature, the legislative decision to protect or not protect charitable donations is complex. It inevitably requires a choice among innocents, the defrauded investors whose investments never existed or the would-be beneficiaries of the unprovided for charitable works. How is this choice to be made?

In this Essay, it is my thesis that by looking generally at ways in which the law chooses among innocents, insights may be gained that will be helpful in making the choice at hand. In Part I, I discuss the ways in which the law chooses among innocents, taking examples from numerous areas of American law. Drawing on that discussion, in Part II, I discuss whether charitable donations should be protected from fraudulent transfer avoidance, focusing initially on charitable donations made by Ponzi schemes, and then expanding to donations generally. Although it is a close call, I conclude that charitable donations should be protected. In Part III, I discuss how such protection, if warranted, might be implemented at the state level. Of course, if such protection under state law is warranted, it would also be warranted under federal law, but nobody expects Congress to take up amendments to the Bankruptcy Code any time soon. For the moment, the activity is at the state level, but implicit in this Essay is an argument for amendment of the Bankruptcy Code as well.

I. HOW DOES THE LAW CHOOSE AMONG INNOCENTS?

The job of private civil law is to resolve disputes. Huge legal systems and vast bodies of Property, Contract, Commercial, Corporate, Tort, Family, and other common and statutory law have come into being, aimed at achieving the civilized resolution of private disputes. Of enormous importance is the concept of fault, or relative fault, as a tool for choosing among disputants. But frequently, none of the disputants can truly be said to have been at fault. Ultimately, innocence is a subjective concept. A person is innocent if he or she pursues a course of action or inaction having no idea of the risks, dangers, or consequences that lay ahead. Perhaps the most common way the law resolves a dispute in which such a person is engaged is by imputing something like

fault, by asking what that person, or a reasonable person in the same position, *should have known or foreseen*. Ignorance of risk begets innocence only if it is unforeseeable, which carries strong moralistic overtones. If the risks should have been foreseen, the cloak of innocence is removed and replaced with imputed fault, and the dispute is resolved in favor of the other. The true innocence of the disputant is not changed, but the dispute is resolved, and the civil law has done its job.

What follows is a series of examples of ways in which disputes between innocents have been resolved in a number of areas of Anglo-American law. Of course, no such list can be exhaustive, but perhaps it can be instructive.

**A. Examples Taken From Personal Property Law**

1. Stolen Artworks

Perhaps the best-known and most dramatic examples of disputes between innocents involve the theft of valuable works of art. Frequently, the true owners of these artworks are the collectors victimized by Nazi Germany, but theft victims can also be the artists themselves, as well as museums, churches, and the like. The thieves are always long gone and the artwork will have found its way into the hands of a *bona fide* purchaser. The choice must be made between the innocent owner and the innocent purchaser who has paid fair value without any knowledge that there is a problem with the artwork’s provenance.

At first instance, it would seem the choice is simple enough. It has long been clear that a thief cannot convey good title, and nobody claiming title through a thief can defeat the title of the true owner, including a *bona fide* purchaser. Any other rule would encourage thieves, or purchasers from thieves. What rule of law could be more familiar than the phrase *caveat emptor* or "buyer beware"?

But the choices among these innocents have not been resolved so simply. There is much sympathy for a *bona fide* purchaser in our legal tradition. Some have argued for protection of the art buyer’s reliance interest by using the doctrine of adverse possession, but this idea has proven to lack legs. Most of the sympathy for art buyers has appeared

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11. The adverse possession doctrine, taken from real property law, requires open, notorious, and hostile possession, which are requirements that do not fit chattels well because
in the application of statutes of limitation. When the victimized owner of stolen property locates the artwork in the hands of a bona fide purchaser who refuses to return it, the owner must bring a legal action to recover it, usually an action in conversion or replevin. Where the theft has occurred in the distant past, the possessor will defend on the ground that the statute of limitations has run. The issue is then posed: At what point in time did the cause of action accrue? Courts have taken a number of approaches here. One approach that favors the possessor, borrowed from adverse possession law, holds that the cause of action accrues when the possessor acquires the property. The possessor is favored because unlike adverse possession, in which the statute of limitation may run for decades, here, where the action is in tort, statutes of limitation typically run in a mere two to four years. By then, the owner may not have been able to find the stolen artwork. Another approach that still favors the possessor, but gives the owner at least a fighting chance, is the so-called discovery rule. This is taken from personal injury tort law. The cause of action accrues when "an event or events have occurred that were reasonably likely to put the plaintiff on notice that someone may have caused her injury." The rule favors the possessor unless the victimized owner actually discovers the injury and takes action relatively quickly after the telling events occur. In contrast, New York explicitly follows the "demand and refusal" rule, which decidedly favors the victimized owner. Under that approach, the action against the innocent purchaser does not accrue until there has been a demand for and refusal to surrender the property, rendering the innocent possessor perpetually vulnerable to suit no matter how much time has elapsed between the theft and the demand.

Choice of the demand and refusal rule is rooted in its tendency to deter theft by increasing the risk to buyers of goods whose chain of title may be flawed. However, out of sympathy to buyers, some New York courts have softened the rule by commencing the limitation period from the time the owner first gained the right to make the demand (i.e., time

chattels are moveable and often inconspicuous. Id. at 2441.


13. Id.


of the theft or conversion). In contrast, one attraction of the discovery rule is that it tends to permit a balancing of numerous factors. The party seeking the benefit of the discovery rule has the burden of showing: (1) that she lacked actual knowledge of the basis for her claim and (2) that her lack of knowledge was objectively reasonable. Courts applying the discovery rule have tested the reasonableness of the claimant’s lack of knowledge by asking whether the claimant acted with due diligence in pursuing his or her personal property. In essence, this permits a rough inquiry into relative fault. There is a strong tendency in these stolen art cases to choose among innocents on the basis of whether the possessor could have or should have looked more diligently into the chain of title, and to balance those factors against the victim’s self-protective efforts such as reporting the theft to the authorities or periodically searching for the artwork in the hope it might surface.

In sum, there is much dissatisfaction with the way in which the law chooses between innocent victims of theft and bona fide purchasers of art. Strict application of a rule that favors innocent victims of theft may deter theft or at least reduce the market value of stolen art. But the sympathy for innocent buyers, which leads to ad hoc inquiry into relative fault is extremely arbitrary, unreliable, and ultimately moralistic. A number of commentators have proposed the creation of a worldwide computerized registry for stolen art for two reasons: (1) it will make it easier for prospective buyers to know whether there is a thief in the chain of title of a work of art, thus reducing the market for such works and deterring theft, and (2) the choice among innocents can be made much more mechanically, depending on use or non-use of such a registry, thus reducing litigation. I will have more to say about registration systems below.

2. Other Types of Stolen or Lost Property

The choices here have not been so complicated. For most kinds of stolen goods, the rule that a thief cannot convey good title is applied without much difficulty. In a recent example, an Austin Healy automobile was stolen in 1970. The owner never stopped looking for it, and in 2012 he noticed that the stolen car, identified by VIN number, was being sold on Ebay for $19,700. He notified the police, who dug up the original theft report, grabbed the car, and returned it to him. His

19. Id.
20. Bibas, supra note 9, at 2460.
only expense was the $600 towing charge.\textsuperscript{21} The would-be seller got nothing. Similarly, if goods are lost, the finder does not get good title without showing that the goods were abandoned by the true owner.\textsuperscript{22} Absent abandonment, ownership is ownership.

B. Examples Taken From Negotiable Instruments Law\textsuperscript{23}

A thief steals a sizeable check made out to Payee. Thief forges Payee’s endorsement, deposits the check in Thief's deposit account at Depository Bank, waits a few days, and then withdraws the cash and absconds. Of course, Thief should have to repay the stolen money, but thieves, whether hanged\textsuperscript{24} or not, rarely do. If Payee can be shown to have been at fault, say by mishandling the check, by entrusting it to an unworthy employee, or by failing to discover previous forgeries, the dispute will be resolved against Payee on that basis.\textsuperscript{25} But if Payee was not at fault, the loss will have to be borne by some innocent party. Normally the loss will fall on the first person to take the check from the thief\textsuperscript{26} on the theory, usually fanciful, that the person that deals with the thief is the one with the best chance of preventing the fraud in detecting the forgery by demanding identification.\textsuperscript{27} If the first person to take the forged-endorsement check is Gullible Grocer, perhaps one could say


\textsuperscript{22} “[T]he law of property asks whether the owner has voluntarily, intentionally, and unconditionally relinquished his or her interest the property, so that another in possession may successfully assert a superior interest . . .” 1 AM. JUR. 2D, Abandoned, Lost, and Unclaimed Property § 4 (2012).

\textsuperscript{23} The clearest example in Negotiable Instruments Law of a choosing among innocents lies in the application of the Holder in Due Course doctrine, in which a Holder of a negotiable instrument who has taken the instrument for value without notice of a claim or defense takes free of the claim or defense. U.C.C. §§ 3-302, 3-305 (1991). The innocence of the person asserting the claim carries no weight. But this is an \textit{ex ante} choice, rooted in the policy to encourage free negotiability of such instruments. Parties to negotiable instruments should know of the risk that the instrument will end up in the hands of a holder in due course and proceed cautiously.

\textsuperscript{24} In the seminal case of Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B.1762), the forger of the drawer’s signature on a bill of exchange was hanged, leaving Lord Mansfield to choose between the innocent drawee and the innocent buyer of the bill.

\textsuperscript{25} For example, negligence contributing to a forgery precludes assertion of the forgery. U.C.C. § 3-406 (1991), as does a customer’s failure to discover previous forgeries. U.C.C. § 3-406(c) (1991).

\textsuperscript{26} A person who takes a check bearing a forged endorsement can normally sue upstream on breach of warranty that the transferred check bears no forged endorsements. U.C.C. §§ 3-417(a)(1), 4-208(a)(1), 3-416(a)(1), 4-207(a)(1)-(2) (1991). However, for the first person to take from Thief, there is no upstream warrantor other than the thief, and the loss comes to rest there.

\textsuperscript{27} See Perini Corp. v. First Nat'l Bank of Habersham Cnty., Ga., 553 F.2d 398 (5th Cir. 1977) (discussing these issues).
Grocer should have demanded proof of Thief's identity as Payee. But if Thief merely endorses Payee's name, then his own, Thief will be able to prove his own identity, and it is pure fancy to say Grocer should have discovered the fraud. But today's Grocers rarely will take a three-party check. It is far more likely that the first person to take from Thief is Thief's bank, a Depository Bank, which like Grocer, has no way of discovering that Payee's endorsement above Thief's was forged. Furthermore, now that the handling of checks is automated, banks do not look at signatures any longer; the UCC explicitly absolves banks of this obligation.  

Another example of choosing between the victims of a forger is the case where the forger issues a check by forging the name of the account holder, the Drawer. In this instance, absent actual fault by the account holder, the loss will fall on the account holder's bank, Payor Bank. The traditional rationale for this loss allocation is that the account holder's payor bank should check its customer's signature card before paying the check. But this too is fanciful today because checking signatures have proven to be largely ineffective. As a result, the UCC

28. U.C.C. § 3-103(a)(9) (1991) (stating that in the case of a bank that processes items by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4). For most banks, especially the large ones, general banking usage is not to examine checks. See Espresso Roma Corp v. Bank of Am., N.A., 124 Cal. Rptr. 2d 549 Cal. Dist. Ct. App. (2002).

29. Where an employer has entrusted an employee with responsibility for handling or preparing checks, U.C.C. § 3-405 (1991) places the forged-endorsement loss upon the employer, by making the endorsement effective, regardless of whether the employer is negligent. Here, the risk of infidelity is clearly assumed by the employer, by placing the employee in a position of trust. The employer is also in the best position to insure this risk by employee fidelity bonds. U.C.C. § 3-405, cmt. 1. (1991). Similarly where a crook fools one into issuing a check by impersonating another, or induces the issuance of a check to a fictitious payee, the person fooled gets the loss. U.C.C. § 3-404 (1991). Where one's negligence contributes to a forgery, loss is allocated to the extent of the contribution. U.C.C. § 3-406 (1991). These loss allocations are based on fault, clear risk assumption, or at least, having superior access to insurance.

30. In the seminal case of Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B.) (1762), Price had paid Neal on a bill of exchange drawn on him by a forger. When Price discovered that the bill was forged, he sued to recover the money. Lord Mansfield said it was incumbent on Price to be satisfied that the bill was drawn upon the drawer's hand, and held that even if there was no neglect by Price, there was no reason to throw off the loss on the innocent Neal. If there was any fault or negligence in any one, it certainly was in Price and not Neal.

31. Now that forgers utilize desktop printers, sight review has become obsolete for the large volume of corporate and government checks on which signatures are printed. Even on personal checks in which a signature is written in ink, a sight reviewer, who can normally spend only a few seconds on each check, is no match for a skillful forger. Thus, banks came to the conclusion that sight
does not require banks to check signatures, and banks rarely check on their own.

On what basis has the law made this choice between innocent Payee and Thief's Depository Bank or innocent account holder and his/her payor bank? One might characterize these as examples of imputed fault, but more appropriately, they should be seen as the allocation of a cost of doing business shouldered by the better risk bearer, usually a bank.

C. Examples Taken From Contract Law

Where a contracting party intentionally assumes the risk that an event will or will not occur, and things do not go as hoped, the disappointed party is not an innocent. However, when one goes forward innocently, unaware of the risk that an unfortunate event might occur, there are a number of ways contract law might nevertheless allocate that risk to him or her.

Allocation of risk is a key concept in choosing among innocent contracting parties. In general, when one enters a contract knowing he or she lacks information that a reasonable person would consider material in deciding whether or not to enter the contract, contract law states that he or she has assumed the risk of the disappointing turn of events. In going forward without bothering to allocate known risk by agreement, the risk is intentionally assumed. If not intended, the result is the same under contract law if it should have been foreseen and allocated by agreement. Conversely, the occurrence of a truly big surprise that renders performance impracticably difficult or valueless, will normally serve to excuse. The Suez Canal closes (again), and the steamship company has to go around Africa at its own expense to make the promised delivery, but if the gravel to be taken in constructing a bridge surprisingly turns out to be under water, increasing the cost of extraction by 1200%, the buyer is excused. Other grounds for rescinding, such as mutual mistake of material fact, can affect a choice among innocents. The party excused from performing is saved the cost of performance, whereas the other party to the contract loses what would have been a pretty good deal. Forcing the excused party to render the now much more difficult or much more valuable performance would

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review was not cost effective. Some banks purported to find no greater forgery losses without sight review than with it . . .

32. See U.C.C. § 3-103(a)(9), supra note 28.
34. ld. §§ 261, 265.
be in the nature of a windfall, an undeserved benefit to the party receiving the performance.

On what basis does contract law make these choices? In essence these are fault-based choices. There is fault if a contracting party fails to foresee and allocate the risk of a foreseeable event, but one may be forgiven for failing to allocate the unforeseeable. If parties miscommunicate, and one but not the other has reason to know of the miscommunication, the loss is allocated to the one who knew or should have known of it. However, where no one knew or had reason to know of the misunderstanding, there is no reasonable basis upon which to choose among them, and no enforceable contract remains.37

Rescission of a contract on the basis of infancy or incompetence is clearly policy based. Ignorance of risk is forgiven here, sometimes resulting in a choice among innocents. Suppose a teenager buys a motor scooter for a fair price intending to use it to deliver pizzas. The teenager is in good faith, believing he has the right to purchase, and the seller does not know the teenager is not yet eighteen and the teenager does not lie. If the teenager then crashes the scooter, he can return the damaged scooter and demand his money back. The policy here is that rigid rules provide the greatest protection to infants. A form of fault is imputed to the seller. Seller should have known better than to sell to an infant, even if the teenager looked to be twenty-five years old. Infants and incompetents are viewed as a class in need of protection, both from those who would prey on them, and from themselves. A line must be drawn between adults and minors, and drawing it mechanically minimizes litigation.38 Drawing the competency line cannot be done so mechanically but the policy is the same.

D. Choosing Ex Ante Among Innocents: Certificates of Title and Recording Systems

Two types of systems have been developed in Anglo-American law for the purpose of protecting and choosing between innocents. Because they are movable, state laws generally provide that transfer of an interest in motor vehicles, such as automobiles, motorcycles, boats, and mobile homes must be accomplished by transferring the certificate of title issued by the state for the particular vehicle. The transfer to a buyer is recorded on the certificate of title and the Department of Motor Vehicles then issues a new certificate of title in the name of the new owner. This protects innocent buyers because the certificate proves the

38. See Kiefer v. Fred Howe Motors, Inc., 39 Wis. 2d 20, 158 N.W. 2d 288 (Wis. 1968).
seller is the current owner and the owner cannot sell it more than once. Any innocent but gullible buyer who pays value without going through this process will lose to one who does. The choice between these two innocents is made ex ante and is essentially fault-based. Any ignorant buyer that is unaware of or disregards these protective systems is at fault.

All states provide elaborate systems for recording transfers of interests in real estate and transfers of security interests in personal property. The records are open to the public. Where competing claims to such property arise, state law provides the mechanical rules for resolving these priority disputes. An innocent buyer who does not take advantage of the protections afforded by the real property recording system will lose to a buyer of the same property who does. An innocent buyer out of the ordinary course of business of personal property will lose to a properly perfected secured creditor. Again, these choices are made ex ante and are, in essence, fault based. Innocence borne of unforgivable ignorance is fault.

E. In Sum

Where has the above discussion led? We have seen that in choosing among innocents, the choice is difficult only if both are truly innocent. By that, I mean both persons are free of causative fault and truly subjectively unaware of the risk of the loss that will eventually be suffered. With that as a starting point, we have seen that innocence is lost if that ignorance or lack of awareness of the risk is not forgivable. Ignorance of the risk is forgiven for those who are incompetent or under age. The most common basis for loss of forgiveness arises when one should have known of the risk, which is usually tested by asking whether the average reasonable person in the same position would have known of the risk or would have inquired into the possibility of risk.

39. Moreover, any lien on the motor vehicle must be perfected by notation on the title, so the buyer is protected from buying a vehicle that is subject to a valid lien. See, e.g., Fla. Stat. § 319.27(2) (2011).

40. In the United States, there are three types of recording statutes: race, notice, and race-notice. Powell on Real Property 14-82, § 82.02 (2012).

41. See generally U.C.C. § 9 (2012). This article, adopted in all states, creates this recording system.

42. For example, in a state that has adopted a race recording statute, if seller sells a parcel of real estate to two different buyers, the first to record wins, regardless of knowledge or notice of the claim of the other. Powell on Real Property 14-82, § 82.02 (2012).


44. If one enters the sophisticated world in which society has provided these protective systems, one enters with peril. As my Contracts professor used to say, "If you ain't a whale, don't go where the whales go."
A similar idea is that one’s ignorance is not forgiven if one has facilitated the loss, perhaps innocently, by entrusting an employee or other person with authority or access to the means of inflicting loss. Ignorance of risk is sometimes not forgiven on the basis of status. The person who was in the best position to protect against risk, by purchasing insurance, checking for identification, or checking the signature card—no matter how unrealistic the expectation—may be unforgiven for his or her ignorance of the risk. Sometimes, forgiveness may be lost to the one who, relative to the other, is seen as the better risk bearer, the one better able to spread or absorb the risk. This is the Payor bank rather than the non-negligent depositor. One loses forgiveness for failing to utilize the systems society has explicitly made available for the protection against the loss incurred, such as recording systems and certificates of title or ownership.

Finally, one who is truly innocent sometimes loses to another innocent for failure to take adequate protective steps following the loss, such as failure to report a theft or to diligently search for the stolen item. Public policy also enters the picture, such as the policy to protect infants and incompetents who cannot protect themselves, and the policy to reduce the incentive to purchase stolen goods.

Perhaps, though never explicit, status may play a role in the choosing one innocent or class of innocents, if perceived as more deserving than the other. It would be a mistake here to try to generalize that the beneficiaries of charitable works are somehow more deserving than the defrauded investors. Speaking personally, having mediated over seventy “clawback” disputes arising out of the Pearlman Ponzi scheme, I have seen the devastation to families defrauded by this vicious scheme. Many of the Ponzi victims are not people of means, although some might have thought they were. The harm from the loss of one’s life savings or a child’s college fund is incalculable, and cannot be measured in dollars. The suicides cannot be measured in dollars either.

II. SHOULD CHARITABLE DONATIONS BE PROTECTED FROM FRAUDULENT TRANSFER AVOIDANCE?

Because the demand for the proposed legislation has been driven by the collapse of numerous Ponzi schemes, I focus first on that setting. How might the above discussion assist in choosing between the defrauded investors\textsuperscript{45} in a Ponzi scheme and the eventual beneficiaries

\textsuperscript{45} Of course, the defrauded investors are not the only creditors of a Ponzi scheme. Depending on the nature of the Schemer’s businesses, there may be many other kinds of creditors, such as trade creditors, unpaid employees, tort victims, and the like. However, I focus primarily on the defrauded investors because they normally make up the great bulk of the
of the schemer's charitable donations? First, we must be careful to recognize that the innocents competing with the defrauded investors are not the charitable institutions themselves, nor the employees of the charities that might lose their jobs if the charity has to cut back its operation. The innocents competing with the defrauded investors should be viewed as the would-be recipients of the unprovided charitable works. Because they are faceless, they are at a comparative disadvantage to the defrauded investors. However, they are surely real.

Can we say that one group more than the other should have foreseen the risk that what appeared to be a legitimate organization was actually being run as a Ponzi scheme? Or that one more than the other should have been more skeptical, checking more diligently into the *bona fides* of the investment opportunity or the source of the donation? It is surely fair to say that anyone contemplating an investment has an obligation to assure him or herself of the stability and reliability of the institution. This is usually done by looking into the history and track record of the institution, coupled with the assurance of a trusted advisor that the institution is sound. But Ponzi schemers have proven to be enormously adept at creating the perception of reliability and soundness. The enthusiastic accolades of early investors, who have received excellent returns creates confidence in investors that cannot be said to be irrational or foolish. Many, if not most investors rely on the personal recommendations of family members, friends, and well known brokers. They are shown documentation assuring them that the funds are FDIC or SIPC insured. Unless a Ponzi scheme promises outlandish returns, and sometimes even if they do, it is difficult to conclude that defrauded Ponzi investors as a class have been inattentive or foolhardy. Many of the most notorious Ponzi schemes survived government investigations with flying colors.

What about charities? Can it be said that charities generally look with a healthy skepticism at the fiscal reliability of donors? Probably not. If the check clears, all is well. Should charities be more skeptical? Probably not. After all, if the check clears, the chance of being asked to give the money back is pretty minuscule. If a charity were to demand proof of solvency from donors, it would probably greatly undermine generosity, and the loss in donations would likely greatly outweigh the beneficial effect of protecting against a fraudulent transfer claim. There is little sense in arguing that charities should be more careful about accepting gifts. It is indeed unseemly to look a gift horse in the mouth.

Is either group in a better position than the other to protect against a claimants against the estate. Moreover, because the non-investor creditors are more likely to have actually dealt with the schemer or his/her principals, they may be less innocent than the investors.
Ponzi loss? There is nothing here comparable to a payor bank’s signature card. Can one insure against a Ponzi loss? To my knowledge, there is no such thing as investment insurance other than to invest with an institution that is truly FDIC or SIPC insured. I also do not know of anyone that insures against fraudulent transfer claims. There is nothing comparable to a public record or title certificate system that might have permitted these innocents to protect themselves.

Public policy favors charities in many ways: providing tax deductions for donations, making charities tax exempt, and sometimes protecting charities from liability for the torts of their employees. There is obviously a strong public interest in the continued existence and operation of charities. There is a possibility that forcing a charity to cough up a large donation could drive it into insolvency or dissolution. Personally, I am skeptical of these disaster claims. A trustee or receiver pursuing a large number of fraudulent donation claims will be interested in settling them and will not unreasonably demand more than the charity can, perhaps with difficulty, pay. No trustee or receiver in cases like these would insist on driving the charity into dissolution.

Can either group be characterized as the better risk bearer? Would it be appropriate to expect the defrauded investors to forego the portion of their distribution attributable to clawed-back charitable donations, or should charities be treated the same as all recipients of voidable transfers and forced to give the donations back? Speaking practically, in the context of an insolvency proceeding, a large portion of the assets returned for distribution must be applied to pay the fees of professionals. For example, Bloomberg reported in July, 2012, that the Madoff trustee’s law firm had so far charged $273 Million for liquidating the estate, while returning $330 million to customers. For

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46. Large institutions rely on various hedging strategies, such as purchasing credit default swaps, to reduce investment risk. But these are not insurance, and it would be unrealistic to expect defrauded savers and investors to employ such sophisticated risk-reduction schemes.

47. Even if one invests with a brokerage that is registered with the Securities Exchange Commission and is a member of Securities Investor Protection Corporation, coverage is not assured. The victims of the Stanford Ponzi scheme purchased over $7 billion worth of CDs issued by an Antiguan Bank and marketed by a broker-dealer for SGC. On July 3, 2012, the U.S. District Court for the District of Columbia held the investors were not protected because they were not customers within the meaning of the Securities Investor Protection Act. S.E.C. v. Sec. Investor Prot. Corp., 842 F. Supp. 2d 321 (D.D.C. 2012). The investors had not deposited cash or securities with the broker for the purpose of purchasing securities. Id. at 7-11. At this writing, the S.E.C. was considering whether to appeal.

every dollar returned by a charity, perhaps half will be distributed to the creditors.\textsuperscript{49} Moreover, unless the Ponzi schemers were extremely generous, only a small portion of the money returned to the estate will come from charitable sources.\textsuperscript{50} Accordingly, if charities are forced to give back 100\% of the Ponzi donations received, the distribution of these funds will make up a very small proportion of all funds distributed to the defrauded investors. By thinking of the investors and the charities as risk bearers, the burden on each of the investors of protecting the charities is relatively small, whereas the burden on each of the charities of forcing return may be quite large. Viewed in this light, I believe the defrauded investors are the better risk bearers, which supports the argument for protecting the charities. Choosing against an innocent is always unsettling, but if choosing cannot be avoided, one must do the best one can. In my opinion, loss suffered by the charitable beneficiaries is greater, perhaps only slightly, than the benefit of protecting investors. Accordingly, states should protect these charitable donations if it can be done sensibly.

Should the protection of donations be limited to donations from Ponzi schemes? No. The vast majority of donations to charities come from ordinary people and businesses. Whereas these donations are rarely voidable, voidability is certainly possible. If a donation is made

\textsuperscript{49} For example, of the Nadel Receiver’s $227,000 claims against the Jewish Family and Children’s Service of Sarasota-Manatee, the receiver settled the claim for $140,000. Hielscher, \textit{supra} note 4.

\textsuperscript{50} For example, Lou Pearlman never gave a dime to charity. Arthur Nadel was one of the more generous Ponzi schemers. Of the $397 million Nadel reportedly took (Steven Secklow, \textit{In Echoes of Madoff, Ponzi Cases Proliferate}, \textit{WALL ST. J.}, Jan. 28, 2009) in the Nadel Receiver from 2000 to 2008, he had made a total of $2,484,589 in charitable contributions to various non-profit (e.g., Sarasota Opera, $353,000) and charitable (e.g., Catholic Charities, $40,000) organizations. Receiver’s Eleventh Interim Report, 42-43 (5/31/2012). The receiver’s interim reports may be accessed at: S.E.C. v. Arthur Nadel, Case No. 8:09-cv-0087-T-26TBM (M.D. FLA. May 31, 2012), \textit{available at} www.nadelreceivership.com. Nadel Receivership Website, http://www.nadelreceivership.com/. So, even for one of the more generous Ponzi schemers, only 0.6\% of the money taken in was donated to non-profits and charities. Furthermore, because the reach back period in Florida is limited to four years, much of those donations are not recoverable. It cannot yet be determined what percentage of eventual distributions will come from charitable sources, but the percentage is certain to be quite small.

\textsuperscript{51} Numerous individuals and businesses make large donations to charities, but they do not ordinarily meet financial collapse soon after doing so. Most insolvency-bound individuals and businesses will have struggled economically in the few years prior to insolvency and will not have been making large charitable donations during that period. Ponzi schemes, in contrast, tend to collapse quickly, making it much more likely that the receiver can find charitable donations that have been made in the few years prior to collapse, donations recent enough that the statute of limitations has not run. Since the period of voidability under state law can go back
by an ordinary person or entity that is insolvent, should this charitable donation not be protected from avoidance as well? Does the calculation change? Is the choice still among innocents? Surely the creditors of an insolvent individual or business are no more deserving than the defrauded investors in a Ponzi scheme. If the defrauded investors can better bear the loss, so too can the creditors of an insolvent individual or business. If charitable donations are to be protected, the identity of the donor should not matter.

III. How To Do It

If one assumes for the moment that states should protect charitable donations from fraudulent transfer avoidance, doing so sensibly will be a challenge. As mentioned above, the problem is significant primarily in the case of failed Ponzi schemes. The first concern of a drafter seeking to amend state fraudulent transfer law is to avoid creating a forum shopping incentive. The Bankruptcy Code provides only very narrow protection to charities. Protected transfers are those that are constructively fraudulent, made in the two years prior to bankruptcy by natural persons, and that do not exceed 15% of the individual's annual income, or more if consistent with prior practice. This protection is applicable to a qualified religious or charitable entity or organization as defined in Internal Revenue Code § 170(c)(1) or (c)(2). The obvious intent of Congress was to protect tithes received from individuals by churches, but it is also applicable to charities and certain other not-for-profit organizations. Because Ponzi schemes and businesses are not natural persons, donations received by charities from

as much as four years under U.F.T.A. § 4, it is quite possible that a once generous donor could fall into insolvency in that period of time. The recent recession has demonstrated that certain kinds of assets can deteriorate in value quite rapidly.

52. If the donor actually intends to defraud his or her creditors, sympathy for the creditors increases. This explains why donations in excess of 15% of annual income under the Bankruptcy Code, are protected only on a showing that it is consistent with prior practice. See 11 U.S.C. § 548(a)(2) (2012).

53. This phrase is commonly used jargon for transfers that are not made with actual intent to defraud creditors, yet are made under 11 U.S.C. § 548(a)(1)(b) (2005) in exchange for less than reasonably equivalent value and the debtor was insolvent or about to become unable to pay its debts as they mature, or made the transfer to or for the benefit of an insider, or incurred an obligation to or for the benefit of an insider under an employment contract and not in the ordinary course of business.


Ponzi schemes and businesses receive no protection at all in bankruptcy. Accordingly, if a Ponzi scheme or business finds its way into state court receivership, and if the scheme had made a number of significant charitable donations within the two years prior to insolvency, the situation fairly begs for an involuntary petition in bankruptcy.\textsuperscript{56} Ultimately, it is the creditors that decide upon the forum, and if the federal forum will provide a significantly greater return to creditors than the state forum, the federal forum it will be. For that reason, there is little to be gained in providing broad state protection for transfers to charities made within the two years prior to insolvency. The state protections for donations in the two years prior to insolvency should parallel those of the Bankruptcy Code, protecting only transfers made by individuals that do not exceed 15\% of the individual's gross annual income for that year, or more if consistent with the individual's practices in making charitable contributions. The Minnesota legislature understood this,\textsuperscript{57} although it ventured slightly beyond those bounds.\textsuperscript{58}

\textsuperscript{56} 11 U.S.C. § 303(h) (2005) permits creditors to bring an involuntary petition where the debtor is generally not paying its debts.

\textsuperscript{57} The amended Minnesota statute modifies the definition of “Transfer,” MINN. STATS. § 513.41(12) (2010), as follows: “Transfer” means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an encumbrance.

Transfer does not include a contribution of money or an asset made to a qualified charitable or religious organization or entity unless the contribution was made within two years of commencement of an action under sections 513.41 to 513.51 against the qualified charitable or religious organization or entity and:

(i) the debtor made the charitable contribution with the actual intent to hinder, delay or defraud any creditor of the debtor, or
(ii) the debtor;
(A) was insolvent at the time of the contribution or would be rendered insolvent by reason of the contribution;
(B) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction;
or
(c) intended to incur, or the charitable or religious organization or entity believed or had reason to believe that the debtor would incur, debts beyond the debtor's ability to pay as the debts become due.

A transfer of a charitable contribution to a qualified charitable or religious organization or entity is not considered a transfer covered under item (ii) if the amount of the contribution did not exceed 15 percent of the gross annual income of the debtor for the year in which the transfer of the contribution was made; or the contribution exceeded that amount but the transfer was consistent with practices of the debtor in making charitable contributions.

Transfer does include a return on investment made by a qualified charitable or religious organization or entity. “Qualified charitable or religious organization
One could argue that a little additional state protection in the two years prior to insolvency would be harmless. Under some circumstances, creditors may decide to leave the case in state court despite the additional protections, especially if there were no significant charitable donations during the two years prior to insolvency. For example, in the Pearlman Ponzi scheme, Lou Pearlman, never gave a dime to a charity. Even if there had been some charitable donations, the efficiency and reduced cost of the state proceeding might outweigh the benefits of an involuntary petition, or there may be other legal advantages to the state procedure.\textsuperscript{59}

The problem with broad state protection of charitable donations within the two years prior to insolvency is that it would be misleading. To the unwashed, the statute would give the false impression that such recent donations are protected. One must ask whether this misleading statute creates a danger of harm to one who relies upon it. A well drafted statute should not intentionally mislead. Perhaps there is a way to include a warning in the statute itself. A phrase like “unless the case is involuntarily removed to bankruptcy court” would be slightly odd. Some sort of preamble might also work. On the other hand, protecting a few, small near-term transfers in the odd case where an involuntary petition is not worth the trouble may not, of itself, be worth the trouble.

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or entity” means an organization or entity described in U.S.C. title 26, § 170(c)(1)(2), or (3).

MINN. STAT. § 513.41(12)(c) (2010). As amended, the statute guards against forum shopping incentives by withholding protection for transfers made to charitable organizations within the two years prior to an avoidance action, while protecting such transfers only if less than 15% of gross annual income, or more if consistent with prior practice.

58. One Minnesota deviation from the bankruptcy code protection is that the protection is not limited to transfers by individuals, so transfers in the two years prior to bankruptcy under the 15% ceiling by a corporation would be protected under Minnesota law, but not under the Bankruptcy Code. Bearing in mind that the annual income to a Ponzi scheme could be enormous, so could 15% of annual income be enormous. Such a corporate donation would cry out for a change of venue via involuntary bankruptcy petition. In contrast, if the donation were made by the individual schemer, it would be protected under both Minnesota law and the Bankruptcy Code. Another deviation from the Bankruptcy Code protections is the broader Minnesota definition of Qualified Charitable or Religious Organization, as described in I.R.C. § 170(c)(1)-(3) (2010). This third subsection, (c)(3), was added to the Minnesota definition. It is not to be found in that of the Bankruptcy Code. I discuss the consequence of this expansion infra note 61.

59. For example, the Florida Assignment for the Benefit of Creditors statute clearly permits the creditors to go after third parties who have aided and abetted the Ponzi schemer, without concern for the in pari delicto doctrine. FLA. STAT. § 727.108(1)(b) (2007). Case law under the Bankruptcy Code protects these third parties. See Jeffrey Davis, Ending the Nonsense, The In Pari Delicto Doctrine has Nothing to Do With What is Section 541 Property of the Bankruptcy Estate, 21 EMORY BANKR. DEV. J. 519, 522-34 (2005). If there is a prospect of significant return on this ground, the creditors may choose to remain in state court.
There is much to be said for minimizing the difference between state and federal law here.

The protection should not apply if the transfer is not received in good faith. The chief Bankruptcy Code protection of transferees generally is that a transferee may retain a transfer that it takes for value and in good faith. Of course, charities do not give value in exchange for gifts, which is why donations from Ponzi schemes are normally voidable. If charitable donations are to be protected despite the failure to give value, the charity should still be required to be in good faith, meaning that the managers of the charity may not be insiders and that the managers must have no knowledge or reason to know that the donor is insolvent or in financial difficulty.

Who should be protected? Under the Bankruptcy Code, the protected entity is a “qualified religious or charitable entity or organization,” which means an entity or organization described in section 170(c)(1) or (c)(2) of the Internal Revenue Code of 1986. The category is quite broad, including organizations operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition. In my view, the category needs to be pared down to “[a]n organization operated exclusively for religious or charitable purposes.” Presumably, organizations operated for scientific, literary, or educational purposes or to foster amateur sports provide some societal benefit, but those benefits should not compete for the funds that would otherwise be returned to the defrauded victims of a Ponzi scheme.

What about the fact that all charities are not fiscally equal? Larger charities, such as United Way or the Red Cross, or even smaller

61. The Minnesota amendment falls far short in this regard. The only reference to what the charity knows or should have known is found in amended MINN. STAT. § 513.41(12)(ii)(c) (2012), making voidable a contribution if it was made within the 2 years prior to the avoidance action and “the debtor intended to incur, or the charitable or religious organization . . . believed or had reason to believe that the debtor would incur debts, beyond the debtor’s ability to pay as the debts become due.” Accordingly, all transfers made more than two years before the avoidance action would be protected, including transfers made with actual intent to hinder, delay, or defraud creditors, regardless of what the charity knew or had reason to know. So, a charity that actually colludes with the schemer will be permitted to keep the donation as long as the schemer can avoid collapse for the next two years. In my view, this degree of protection is excessive.
63. Curiously, the Minnesota amendments enlarged the definition of charity to include organizations described in I.R.C. § 170(c)(3), a post or organization of war veterans. While the local VFW Lodge (Veterans of Foreign Wars) might purport to engage in activities beneficial to society, such as marching in elaborate costumes in the New Year’s Day parade, what they mostly do is get together to socialize, and, yes, tell war stories. This is not charity. If required to return a Ponzi schemer’s gift, harm to innocents will be minimal.
charities that are well managed are able to write a large check without endangering their existence. In contrast, the Girls’ Club of Tampa Bay might truly struggle to return a large gift. Should that matter? In my view, it should not. Although some have tried, the task of sensibly distinguishing between those charities that can afford to write a check and those that cannot is probably impossible, and might even disadvantage efficient management. Furthermore, it is important to remember that the innocents to be protected are the beneficiaries of charitable works, not the charity itself. The beneficiaries are equally deserving regardless of the size of the charity.

How should transfers that pre-date the two-year period prior to insolvency be treated? Because the Bankruptcy Code §§ 548 & 550 permit avoidance only of transfers made within the two-year period, for there is no forum-shopping problem for earlier transfers. Broad protection of these earlier donations will be effective. This is meaningful not only for donations received from donors who descend into state insolvency proceedings, but also for donors that descend into bankruptcy because of Bankruptcy Code § 544(b), which permits the trustee in bankruptcy to avoid transfers that are voidable under applicable law by a creditor holding an allowed unsecured claim. In this context, “applicable law” means the state fraudulent transfer law. Since the statutes of limitations under state law typically go back farther than two years in the past, usually four or six years, the trustee can go back that far in time to avoid charitable donations under state law. Accordingly, in order to provide the maximum protection to charitable donations, state fraudulent transfer law should protect such donations made more than two years prior to insolvency. The protection should apply to donations made by any entity, not just individuals, as long as the donation is received in good faith.

The question arises: how far back is the look-back period? How far

64. For example, one Florida legislator introduced a Committee Substitute for H.B. 451, 2012 Leg., 114th Reg. Sess. (Fla. 2012) that would have provided a partial defense to an avoidance claim. Only a percentage of the transfer would have been voidable, that being the percentage of overall expenses represented by the administrative and non-charitable expenses for the year. The voidable amount of the transfer could be increased up to the amount of the actual increase of the charity’s net worth for the year. The more efficient the charity, the more effective it is, unless its efficiency contributed to an increase in net worth. Presumably, the legislative goal here is to encourage charities to keep non-charitable expenses down and either avoid increased donations or get the charitable expenditures quickly out the door. In my view, this would create conflicting incentives, which would be largely ignored until litigation is on the horizon. It would then create incentives to game the system as well as adding complication to any litigation.

65. Trustees and receivers have a strong incentive to settle disputes, not to destroy charitable organizations. If charities are not to be protected, I believe the danger that they will be destroyed is minimal.
back in time can the avoidance power reach? If the debtor is in
bankruptcy, the Code is clear. The avoidance period begins two years
prior to the filing of bankruptcy and is extinguished on the date of filing
bankruptcy. Under the Uniform Fraudulent Transfer Act, the claim for
relief must be brought within 4 years (or in some states 6 years) after
the transfer was made. However, if the transfer was made with the
actual intent to hinder, delay, or defraud any creditor, the cause of
action may be brought later as long as “within one year after the transfer
. . . was or could reasonably have been discovered by the claimant.”
Recent cases have routinely held that transfers by a Ponzi schemer are
made with such actual intent. Based on this language, the Minnesota
trustee in the Petters case, Doug Kelley, took the position that the
limitations period did not begin to run until discovery by the trustee that
the transfer was fraudulent. Thus, in demanding return of approximately
$500-$600 million, he claimed there was virtually no time limit on how
far back he could look to avoid transfers by Petters’ entities. At least 21
of the defendants sued by the trustee were nonprofits, some
charitable (e.g., Make-a-Wish Foundation) and some not (e.g.,
Minnesota Public Radio). The 2012 amendments to the Minnesota
Fraudulent Transfer Act were applied to pre-amendment transfers in
order to protect these non-profits from the trustee’s claims, which
helps explain how this non-uniform amendment to the Act made it so
rapidly through the Minnesota legislature.

The Petters Trustee complained that the “unintended consequence” of
the amendment, if signed into law, would be to possibly bar him from
collecting more than $200 million. Whether the trustee’s timing
argument would have been successful is uncertain. To avoid the

68. In re Evergreen Sec., Ltd., 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003); In re World
Vision Entm’t, Inc. 275 B.R. 641, 656 (Bankr. M.D. Fla. 2002); In re McCarn’s Allstate Fin.,
69. Statement of Robert McCollum giving background to the proposed amendment to the
Minnesota Fraudulent Transfer Act.
70. Id.
71. The effective date of the Minnesota bill was “the day following final enactment and
applies to a cause of action existing on or arising on, or arising after, that date.” Under
Minnesota law, when the legislature changes the law while a case is pending, but prior to
rendition of judgment, the court may not perpetuate the old law but must apply the new. There is
no vested right in an existing law until final judgment has been entered therein. Holen v.
72. Jacqueline Palank, Minnesota Lawmakers Seek to Protect Nonprofits From
bankruptcy/2012/04/03/minnesota-lawmakers-protect-nonprofits-clawbacks.
73. There are no cases applying the language in U.F.T.A. § 9(a) (1984) permitting suit by
a trustee after the statute of limitation has run on the theory that suit was brought within one
uncertainty, the protection of charitable donations should apply to all donations made more than two years prior to initiation of an insolvency proceeding.\textsuperscript{74}

The amended statute should make clear that return on investment by charities should be denied protection. In these Ponzi cases, most of the assets trustees seek are the "false profits" received by investors. Initially, a Ponzi scheme must make good its promise of attractive returns. This is the key to recruiting future investors. So in its early stages, numerous investors will receive payouts in excess of their initial investment. The trustee cannot recover all the funds paid out to investors because the investors have the defense, available under both state and federal law, that to the extent they have paid money in, they are entitled to the defense that "a transferee that takes for value and in good faith ... may retain any interest transferred ..."\textsuperscript{75} However, to the extent that the investor has received payments in excess of those invested, no value has been given and there is no defense.\textsuperscript{76} Such payments received must be returned to the estate.

If, as is sometimes the case, a religious or charitable organization has invested funds in what turned out to be a Ponzi scheme, the funds received are returns on investment, not charitable donations. Whereas charities should not be expected to investigate the financial soundness of a donor, when a charity enters the investment world, it is entitled to no such solicitousness. As a defrauded investor, a charity has no better claim to its share of the recovered property than any of the other defrauded investors.

\textbf{IV. IS IT WORTH THE CANDLE?}

As long as the Bankruptcy Code remains as is, it serves as a severe limitation on the amount of protection states can afford charitable donations. Regardless of whether the Ponzi scheme descends into a state year after the transfer "was or could reasonably have been discovered by the claimant." Because under 11 U.S.C. § 544(b) (2005) the trustee seeks to avoid a transfer that is "voidable under applicable law by a creditor holding an unsecured claim," the argument that no such claimant could have discovered the transfer until the trustee was appointed is highly questionable.

\textsuperscript{74} Another timing complication arises when state insolvency proceedings are initiated and thereafter an involuntary bankruptcy petition is filed. The effect of this delay is that the two-year reach back from the point of bankruptcy filing will occur less than two years before the initiation. This will not harm charities. Obviously, once the state proceeding is initiated and control over the Ponzi scheme is wrested from the schemer, there will be no more donations, thus no voidable transfers in the period between initiation of the proceeding and filing.


\textsuperscript{76} The argument that promised but unpaid return on investment on value has been clearly discredited. Picard v. Katz, 462 B.R. 447, 455-56 (S.D.N.Y. 2011).
insolvency proceeding or bankruptcy, most donations made within the
two years before insolvency will be avoided.\textsuperscript{77} In essence, Minnesota
did all it could do to protect charities. Only donations made prior to that
two-year period can be meaningfully protected. It’s not perfect, but it is
better than nothing. In states that adopt these protections, future trustees
or receivers for failed Ponzi schemes will not bother to look for
charitable donations more than two years old. This will at least give
charities the comfort of knowing that donations in the distant past,
which surely will have been spent, are safe. It will also protect
donations received from individuals long before the individual’s
fortunes turned for the worse.

Finally, it may affect a desirable balance between the innocents. The
donations made within the recent two years will go to the defrauded
investors and the older donations will not. In this fortuitous way, the
burden upon the innocents will be shared. This is admittedly pretty
rough justice, but in choosing between innocents, an all-or-nothing
choice seems worse.

\textsuperscript{77} Technically, donations made by the individual schemer could be protected up to 15%
of gross annual income, but Ponzi schemers rarely act individually. They normally act through
one of their many, often interchangeable, entities.