AMERICAN BANKRUPTCY INSTITUTE

JOURNAL

Issues and Information for Today's Busy Insolvency Professional

The Sad Tale of Fraudulent Transfers

The Unscrupulous Are Rewarded and the Diligent Are Punished

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In *In re Bayou Group LLC*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), diligent investment professionals became concerned about their own and their clients' investments in hedge funds owned by Bayou Group. When they pursued that concern to the point of resistance and pulled their investments, they were required to not only return the fictitious profits from this Ponzi scheme, but their principal investments as well.[2] By contrast, in *In re Sharp International Corp.*, 403 F.3d 43 (2d Cir. 2005), when bankers concerned with potential fraud by their borrower client investigated and effectively discovered the fraud, then demanded repayment, and after consenting to the client's raising $25 million from new investors with what the bank undoubtedly knew were false financials, the bank was allowed to keep a $12.25 million loan repayment.

Paul Sinclair

One cannot help but ask how *Sharp* can be reconciled with *Bayou*. The answer turns not merely on a presumption of fraud adopted by courts in cases involving Ponzi schemes under §548(a)(1)(A) as applied in Bayou,[3] but moreover to the broad and expansive reading of the term "good faith" in the affirmative defense to a fraudulent-conveyance claim set forth in §548(c), not only as legally defined by *Bayou*, but as applied in the opinion. *Bayou* undoubtedly follows the "modern trend" evidenced by a series of bankruptcy decisions that sharply limit the good-faith defense, but that trend is clearly at odds with decades of tradition interpreting fraudulent transfer law since its inception in the Statute of Elizabeth, 13 Eliz., ch. 5 (1570).

About the Author

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Setting the Stage: The Classic View

Section 548 is derived from the Uniform Fraudulent Conveyance Act (UFCA). The commissioners on Uniform State Laws promulgated the UFCA to facilitate interstate business by providing a uniform statutory scheme. Because of the sometimes varying interpretation of the badges of fraud, the commissioners explicitly sought to bring case law and statutes into greater accord by reducing the role of the debtor's subjective intent and expanding the role of objective factors, which resulted in a definition of constructive fraud focused on objective factors. By this, they sought to eliminate the tendency of courts to invoke extra-statutory presumptions.[4] The objective factors in constructive fraud related to concepts of (1) fair consideration, (2) rendering the debtor insolvent, (3) leaving the debtor with unreasonably small capital and (4) whether the debtor was incurring debts beyond its ability to pay.[5] While good faith was a component of the definition of fair consideration in section 3, it was never an "objective" component.

In a December 1983 *Harvard Law Review* Note, "Good Faith and Fraudulent Conveyances," the author expressed concerns that the developing case law was eroding the preferable traditional "narrow construction" of the good-faith requirement.[6] The seminal case noted is *Tacoma Association of Credit Men v. Lester*, 72 Wash.2d 453, 433 P.2d 901 (1967). In this case, the court ignored the traditional subordination of the good-faith requirement to the consideration requirement, and instead focused its opinion on "good faith," defined as (1) an honest belief in the propriety of the activities in question, (2) no intent to take unconscionable advantage of others and (3) no intent or knowledge that the activities in question will hinder, delay or defraud others.[7]

This emphasis on the transferee's state of mind contravenes both the UFCA's purposes and the limited function of the fraudulent conveyance doctrine in the traditional scheme of debtor-creditor law. By focusing on good faith, courts may rely more on presumptions of intent similar to those that plagued pre-UFCA law.

In *Boston Trading Group, Inc. v. Burnazos*, 835 F.2d 1504 (1st Cir. 1988), Judge Stephen Breyer (now a Supreme Court justice) analyzed

Feature

1 The author gratefully acknowledges the contribution of Michael Foster, an associate at Polsineslli Shughart PC who assisted in the research for this article.
2 For a more detailed explanation of *Bayou, see* "Investors Beware: Bankruptcy Court Decision Takes Narrow View of Good Faith," by Kathy Yeatter, *ABI Journal,* February 2009.
3 *Bayou*, 396 B.R. at 843; *In re Manhattan Investment Fund Ltd.*, 397 B.R. 1, 8 (S.D.N.Y. 2007).
4 Note, "Good Faith and Fraudulent Conveyances," 97 *Harv. L. Rev.* 495, December 1983.
5 Sections 3-6 of the UFCA.
6 97 *Harv. L. Rev.* 495.
7 *Id.* at 458.

fraudulent transfers and good faith. He began by citing the three paradigm examples of fraudulent transfers: (1) a transfer to a friend who will use the property for the debtor's benefit; (2) a transfer to a family member or friend as a matter of preference of not seeing it go to a stranger or enemy; and (3) the transfer of a liquid asset to an illiquid asset, such as a homestead. From these, he distinguished a fourth transfer, preferences, noting that "commentators also state that fraudulent conveyance law does *not* seek to void."[8] In reversing the judgment below as to actual fraud, the opinion stated that to posit a liability on a preference "would tend to deflect fraudulent conveyance law from one of its basic functions (to see that an insolvent debtor's limited funds are used to pay some worthy creditor), while providing it with a new function (determining *which* creditor is the more worthy)."[9]

As to good faith, the court recognized that courts have had difficulty in determining its meaning. Nevertheless:

> Whatever "good faith" may mean, however, we believe it does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies which the debtor obtained at the expense of other creditors. To find lack of "good faith" where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a kind of "preference"—concededly a most undesirable kind of preference, one in which the claims of alternative creditors differ considerably in their moral worth, but a kind of preference nonetheless.[10]

This position was cited repeatedly with approval by the Second Circuit in *HBE Leasing Corporation*.[11] Thus, even before *Sharp*, both the First and Second Circuits had cautioned against an expansive reading of good faith.

In *Bayou*, the debtor brought 131 separate adversary proceedings seeking recovery of both the principal and fictitious profits paid to *Bayou* investors in excess of $125 million.[12] The great majority of what was sought was for return of principal, which investors received through redemption payments.

In fraudulent-transfer litigation, there is a major difference with respect to the return of principal between claims asserted for actual fraud under §548(a)(1)(A) and those asserted for constructive fraud under §548(a)(1)(B). For constructive fraud, the debtor must have received less than a reasonably equivalent value, which is defined to include antecedent debt under §548(d)(2)(A). Because an investor defrauded by a Ponzi scheme has a claim for rescission, the claim for return of principal constitutes antecedent debt offsetting the claim.[13] This is so, notwithstanding negligence or inquiry notice on the part of the investor. *Id.* By contrast, with the actual fraud presumed in a Ponzi case under §548(a)(1)(A)—intent to hinder, delay or defraud—the court in *Bayou* found that the only remaining defense is giving value in good faith under §548(c).

Again, value is not an issue with respect to the extent of the principal returned because value includes antecedent debt. §548(d)(2)(A). For the investors with Bernie Madoff, or the several other Ponzi cases now emerging in 2008's cataclysmic market reversal, a broad and expansive reading of good faith can make the return of $125 million to the investors in *Bayou* look like pocket change. This is even more troublesome because *Bayou*, Madoff and other cases are in New York, which has a six-year statute of limitations for fraudulent transfers.[14]

In Sharp, *Diligence Pays Off*

Even after discovering the potential fraud, the bankers in *Sharp* never advised the new investors putting in $25 million of their discovery. The first cause of action rejected by the court in that case was not fraudulent transfer, but aiding and abetting a breach-of-fiduciary duty. The court found that, absent a duty to act, the only action prescribed by New York law is to not affirmatively assist or help conceal the fraud.[15] The court further found that "a company in a position to thwart or expose a breach of fiduciary duty may protect its interests by doing neither, sitting tight and being quiet... [S]ilence and forbearance did not assist the fraud *affirmatively*." (Emphasis in original).[16] The court noted that the bank had no affirmative duty under New York law to inform *Sharp*, its existing creditors or its prospective creditors of the fraud.[17]

As to the constructive-fraud count, the debtor had the burden to prove under New York's version of the Uniform Fraudulent Transfer Act that the transfer was not in good faith. The court found that the payment merely had the effect of preferring one creditor over another and that the transfer was not made to an insider. As such, the court found:

> The decisive principle is that a mere preference between creditors does not constitute bad faith: [E]ven the preferential repayment of pre-existing debts to some creditors does not constitute a fraudulent conveyance, whether or not it prejudices other creditors, because "[t]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy some of his creditors; it normally does not try to choose among them."... Nor does it matter that the preferred creditor knows that the debtor is insolvent.[18]

The debtor alleged that this transfer was more than a mere preference because the bank knew that the funds used to repay the debt were fraudulently obtained. Again, the *Sharp* court rejected this argument, saying that lack of good faith does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies, which the debtor obtained at the expense of other creditors.[19] The court explicitly held that the bank's knowledge of the fraud, without more, does not allow an inference that the bank received the $12.25 million in bad faith.[20]

As to actual fraud, unlike the adoption of the Ponzi fraud presumption in *Bayou*, the *Sharp* court stoutly refused to collapse the fraudulent taking of money from new investors into the second step of the immediate payment of the bank's loan.[21] In this respect, one could view the Ponzi fraud presumption as just another classic badge of fraud examined by courts in determining whether there is actual fraud. In *Sharp*, in the final year before the bankruptcy filing, its reported revenues were $118.1 million, versus actual revenues of $19 million. Mathematically, this is only a 16 percent Ponzi scheme, because there

8 835 F.2d at 1509 (emphasis in original).
9 *Id.* at 1511 (emphasis in original).
10 *Id.* at 1512 (emphasis in original).
11 48 F.3d 623, 634 (2d Cir. 1995).
12 396 B.R. at 824.
13 *Jobin v. McKay* (*In re M&L Business Machine Company Inc.*), 84 F.3d 1330, 1341-42 (10th Cir. 1996).
14 N.Y. McKinney's CPLR, 213; *Miller v. Polow*, 14 A.D.3d 368 (N.Y. App. Div. 2005).
15 *Sharp*, 403 F.3d at 52.
16 *Id.* (emphasis in original).
17 *Id.*
18 *Id.* at 54.
19 *Id.* at 55.
20 *Id.*
21 *Id.* at 56.

were some actual revenues. Does a Ponzi scheme only exist when 100 percent of the economic activity is fictitious, or 75 percent, or, as here, 84 percent? At what point does the Ponzi scheme exist and the Ponzi fraud presumption adopted in *Bayou* take hold?

Bayou *and the Modern "Consensus"*

In *Bayou*, the court quoted, at length, from the plaintiff's brief and stated that there is no real dispute between the plaintiffs and defendants as to the relevant case law construing the "good faith" defense under §548(c), nor are there materially conflicting views expressed in the reported decisions.[22] Quoting from plaintiff's brief, the court states:

> "Good faith" as used in §548(c) is not defined in the Code. There is no legislative history. It must be determined using an "objective" or "reasonable person" standard. Subjective assertions of good faith are of no moment. Courts look to what the transferee knew or should have known. A transferee cannot be found to have taken a transfer in good faith if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose. A transferee is on inquiry notice if it knew or should have known of information placing it objectively *on alert that there was a problem with the fund*.[23]

Although the court cites a number of cases for this proposition, it principally relies on *Jobin v. McKay, supra*; *In re Manhattan Inv. Fund Ltd., supra*; and *In re Agric. Research and Tech. Group. Inc.*[24]

The court concludes that good faith must be evaluated on a case-by-case basis. Once on inquiry notice, the failure to conduct a diligent investigation is fatal to a good-faith defense. Unless investigation actually discloses no reason to suspect financial embarrassment and concerns are allayed, there is no good faith.[25] This requires more than just asking the transferor, such as Samuel Israel in *Bayou* or Bernie Madoff, about wrongdoing. The transferee is obligated to make independent inquiry and confirmation.[26] Where defendants even undertook inquiry and (1) didn't ask the right questions (*i.e.,* ask the Connecticut Secretary of State who the registered agent was for Bayou Group's CPA firm) or (2) felt that they were being stonewalled upon inquiry and pulled their investments, the court granted summary judgment because of a *failure* to demonstrate food faith.[27] Explicitly, the court ruled that even the "inconclusive diligent investigation" failed the good-faith test.[28] It is this *extraordinary* requirement that a transferee "knew or should have known" and conducted an exhaustive diligent inquiry that is so at odds with traditional, circumscribed concepts of good faith in fraudulent transfer law.

Next, the court points out that "good faith" under §548(c) is different from the traditional notion of good faith as that term is customarily used by laymen. In common parlance, good faith denotes conformity with accepted standards of integrity, trust and good conduct. Whereas, in the court's view, under §548(c), good faith includes freedom from knowledge of circumstances that ought to put the holder on inquiry and an honest intention to abstain from taking any unconscious advantage of another, together with the absence of all information, notice, benefit or belief of facts that render a transaction unconscientious, as defined in *Black's Law Dictionary* (1990).[29]

Nevertheless, while invoking "objective" factors and "diligence," the *Bayou* court refused to disregard the "*objective evidence* of the transferee's *subjective* good faith intent."[30] Consequently, in the *Bayou* court's analysis, a variety of defendants who redeemed their investments for *other* reasons unrelated to any knowledge or inquiry, were deemed to be in good faith. The subjective reasons for redemption that resulted in summary judgments for the defense included: (1) compliance with ERISA; (2) purchasing a home; (3) liquidation after principal beneficiary's death; (4) paying for newborn child and private school tuition; (5) satisfying redemption requests of its own investors and to pay off a loan; and (6) the fact that the Bayou investment did not fit new fund profile.[31]

Sources of the Modern "Consensus"

Despite the admission in *Bayou* and all other cases that the statute does not define "good faith" and there is no legislative history, what is the basis for this broad interpretation's insistence on objectivity and extraordinary due diligence? Looking through the cases cited, *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006), relied on *Jobin v. McKay*. *Jobin* relies on B*lack's Law Dictionary, supra; 4 Collier on Bankruptcy*, ¶548.07; and *In re Agric. Res. and Tech. Grp. Inc., supra.*[32] It also relies on *Brown v. Third Nat. Bank*, 67 F.3d 1348, 1355 (8th Cir. 1995), but this in turn merely relies on *In re Agric. Res. and Tech. Grp. Inc. Black's Law Dictionary* relies on the "developing trend." *Collier* relies on *Southern Indus. Inc. v. Jeremias,* 66 A.D.2d 178, 183, 411 N.Y.S.2d 945, 949 (2d Dept. 1978), which in turn relies on *Tacoma, supra,* the source of the *Harvard* Note complaint.

In re Agric. Res. and Tech. Grp. Inc., relies on *Collier* and admits that no party in the matter had even been fully briefed "good faith."[33] It then looks to *Shauer v. Alterton*, 151 U.S. 607, 621, 14 S.Ct. 442, 446 (1894), a case that involved a transfer of store goods by one brother to another, who continued to sell the goods in the same physical location. In analyzing the 1885 transaction, the *Shauer* case relied for its conclusion on: (1) the language of the statute then effective in the Territory of South Dakota on fraudulent conveyances which, in the instance of this "insider" transaction, incorporates language on the "diligence" of a transferee with notice to put a "prudent man upon inquiry;" and (2) analogizing this transfer of personal goods to notice standards for real property under a "race/notice" statute. Neither of these standards is applicable to the congressional adoption of §548(c) in 1978. *In re Agricultural Research and Technology Group Inc.,* further relies on *In re Polar Chips International Inc.,* 18 B.R. 480 (Bankr. S.D. Fla. 1982), a case without any authority for its view. In sum, there is no basis for this line of cases, other than the felicitous optimism of *Tacoma* that good faith should have a broader meaning.

22 396 B.R. at 844.
23 *Id.* at 844-45.
24 84 F.3d 1330 (10th Cir. 1996), 397 B.R. 1 (S.D.N.Y. 2007), and 916 F.2d 528 (9th Cir. 1990), respectively.
25 396 B.R. at 846, again relying upon *Jobin v. McKay.*
26 *Id.* at 846-47.
27 *Id.* at 865, et seq.
28 *Id.* at 852.
29 *Id.* at 847, n.8.
30 *Id.* at 849 (emphasis in original).
31 *Id.* at 853-54.
32 84 F.3d at 1335.
33 916 F.2d 528, 536 (9th Cir. 1990).

Plain Meaning

So, take the words "good faith" standing alone. Congress would be expected to have used it in the sense it was traditionally interpreted.[34] Further, if Congress had meant the words "knew or should have known" in §548(c), it could have used those words. Instead, it used the words "good faith," which have nothing other than a subjective meaning. "Congress says in [a] statute what it means and means in a statute what is says there." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.,* 530 U.S. 1, 120 S.Ct. 1942 (2000). The plain meaning of words should be conclusive, except in cases where the literal interpretation produces a result demonstrably at odds with the intention of the drafters. *United States v. Ron Pair Ent. Inc.,* 489 U.S. 235, 109 S.Ct. 1026 (1989). Moreover, subjective knowledge, which is present in many of these cases, can negate good faith. The "objective" good faith rejected in *Jobin* is the knowledge of the transferee that he was promised 120 percent per year on two investments and 468 percent on two other investments.[35] Even with a subjective definition, that would negate good faith and require disgorgement of all payments.

Conclusion

The 1983 *Harvard* Note commented: "To allow [avoidance] only when the creditor is unaware of his debtor's predicament is to place a curious premium on incompetency in creditors."[36] A focus on what the transferee knows or should have known, and the imposition of high degrees of diligence and inquiry, is inconsistent with decades of fraudulent-transfer law. The UFCA commissioners never intended to penalize diligence, and *Sharp* is not substantively reconcilable with *Bayou*. Courts should not so cavalierly deny the layman's concept of "good faith" and ignore its plain meaning. An analysis of subjective knowledge is an adequate and consistent barrier to avoid what are historically considered fraudulent transfers. As tens of millions of dollars have been spent litigating *Bayou*, pursuing investors who lacked diligence in Madoff will unnecessarily cost hundreds of millions. ■

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34 Where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 330, 101 S.Ct. 2789, 2794 (1981).

35 84 F.3d at 1338.

36 *See* note 4, 97 *Harv. L. Rev.* at 506-07.

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