AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

# Red Flags of Fraud: Background for Due Diligence

**Written by:**
*Paul Sinclair*
*Polsinelli Shughart PC; Kansas City, Mo.*
*psinclair@polsinelli.com*

*Brendan McPherson*
*Polsinelli Shughart PC; Kansas City, Mo.*
*bmcpherson@polsinelli.com*

In Ponzi schemes and other fraudulent-transfer cases, a key defense is "good faith." Courts deny that defense where they find that defendants had knowledge of a "red flag" putting them on inquiry notice that there was a potential problem in the investment requiring further investigation. This article explores what courts find to be the "red flags" triggering such notice.

## Background

Paul Sinclair

When defending an action brought to recover a fraudulent transfer, such as in a typical Ponzi scheme case, a principal defense is that under § 548(c) of the Bankruptcy Code, the defendant took the transfer "for value and in good faith." The defense is available to the extent the transferee gave value in exchange for such transfer. Under § 548(d)(2)(A), "value" may include antecedent debt.

While a recipient of "false profits" from a Ponzi scheme generally must return those false profits as not given for value, a more difficult question is posed by whether the recipients (*i.e.*, the "victims") must also return transfers of their invested principal. It is in this fight over return of principal that the good-faith defense under § 548 becomes the central question. Value is not an issue, because the transferees would be entitled to rescind their investments in the scheme for fraud, thus demonstrating antecedent debt for the "value" element.

**About the Authors**

*About the Authors: Paul Sinclair is a shareholder in Polsinelli Shughart PC in Kansas City, Mo., and has spent much of his career litigating piercing the corporate veil, successor liability, preferences and fraudulent transfers. Brendan McPherson is an associate in the same office and has litigated preferences and fraudulent transfers, representing the rights of creditors in real estate matters.*

This leaves the exploration of the meaning of good faith.

The Code does not define "good faith" as used in § 548(c), but a number of federal courts have ruled that it must be determined according to an "objective" or "reasonable person" standard, and not on the subjective knowledge or belief of the transferee.[1] While as commonly used the term "good faith" refers to conformity with accepted standards of integrity, trust and good conduct, those courts have adopted a broader meaning[2] that a transferee cannot have good faith if it was on "inquiry notice," and once on notice, if it conducted a diligent inquiry of the transferor.[3] While such inquiry notice may occur prior to the investment, that it is "too good to be true," frequently this inquiry arises at the time of redemption. The issue is not whether the defendant was guilty of any sort of bad faith in receiving the money, but rather the test is whether the defendant requested redemption after learning of a "*red flag*" which, under an "objective" standard, should have put the defendant on "inquiry notice" of some infirmity in the [scheme] or the integrity of its management.[4]

**Feature**

## Red Flags in Bayou III

Brendan McPherson

A leading case dissecting the issue of red flags is the initial recent bankruptcy court opinion in *Bayou III*, a ruling covering a significant number of defendants on cross-motions for summary judgment on the issue of good faith.[5] The court granted summary judgment for several defendants finding good faith, granted summary judgment for the plaintiff trustee against several defendants denying good faith, and denied summary judgment in instances where it found that contested matters of fact required resolution by trial. An initial key inquiry was whether there was a "red flag" putting the individual defendant on inquiry notice. *Bayou III* held that the red flag does not have to show notice of actual fraud, embezzlement or looting, but is sufficient if it notifies the recipient of some potential infirmity in the investment requiring some investigation.[6]

*Bayou Group* involved a hedge fund operated as a Ponzi scheme, which closed in 2005 after a number of its investors had made redemptions.

---

1 *In re Bayou Group LLC*, 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008) (*Bayou III*), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010) (*Bayou IV*).

2 For an analysis of the position rejecting this broader meaning and arguing that the traditional standard is that the transferee must have participated in the fraud in a two-part article, *see* Sinclair, Paul, "The Sad Tale of Fraudulent Transfers," *Am. Bankr. Inst. J.* (April and May 2009).

3 *Bayou III* at 845.

4 *Id.* at 848 (emphasis added).

5 *See* n.1, *supra*.

6 *Bayou III* at 848.

Many of those investors were sued for a return of not only profits, but also their principal investment. The court focused on several red flags that it believed should have tipped off its investors:

1. Several investors became aware that there was an FBI investigation of Bayou;[7]
2. A lawsuit by former employees, the Westervelts (father and son), had been filed against Bayou;[8]
3. One investor found that the registered agent for Bayou's supposedly independent auditor was the president of Bayou;[9] and
4. After one investor learned of the *Westervelt* complaint and made a redemption request in February 2005, Bayou countered with an "unethical" proposal one week before the payment deadline that if the investor would revoke the redemption request, it would be entitled to receive profits from March, reducing those gains to the remaining investors, contrary to the fund agreements.

The *Westervelt* complaint was held to be the initial red flag for many of the defendants. While Bayou management dismissed the suit as that of a disgruntled ex-employee, the court relied on several features of the complaint. The father, Paul Westervelt, had been recruited by Bayou in September 2002 as a principal and shareholder, with a salary of $800,000 per year for five years and a 25 percent ownership stake. The key features of the complaint that the court found telling were:

1. Bayou repeatedly denied Westervelt access to its financial information and business records;
2. Westervelt discovered what he perceived to be possible violations of Securities and Exchange Commission (SEC) regulations governing the operation of hedge funds, and possible violations of SEC and National Association of Securities Dealers (NASD) rules and regulations;
3. Westervelt obtained some documents showing that one of Bayou's bank accounts had been depleted by more than $7 million in December 2002; and
4. when Westervelt wrote to management in March 2003 to resolve these issues, he and his son were promptly fired.[10]

None of the allegations in the complaint suggested that the entire fund was a fraud or a Ponzi scheme, and the court fails to address that even though Westervelt was a highly sophisticated employee with decades of experience in the business and one who had worked at Bayou for six months, he never discovered the fraud.

## Bayou IV *District Court Limits Red Flag Inquiry Standard*

In reversing the granted summary judgment against several defendants, the district court held that the bankruptcy court had "significantly expanded the scope of information prior courts have found sufficient to require inquiry."[11] While the bankruptcy court referred to "some infirmity in the [fund] or the integrity of its management,"[12] the district court said that could cover a host of sins including resume-puffing, lying to employees, other acts of dishonesty, failure to pay personal taxes, an unjustified refusal to pay a vendor, sexual harassment or sexual affairs. As to an infirmity in management, it could include a poor business model, incompetent management, inadequate accounting controls, lack of research capabilities, poor marketing, insufficient capital and a host of other deficiencies. As such, "[t]he phrase is so broad as to be undefinable."[13]

Contrary to that position, the district court said that to put a transferee on notice, the information must suggest insolvency or a fraudulent purpose in making the transfer.[14] It stated that all cases relied on by the bankruptcy court as well as the appellees' briefs recited the "same insolvency/fraudulent-purpose test."[15] The district court further noted that *Bayou III*'s reliance on the phrase "potential problem with the fund" in *In re Manhattan Inv. Fund III*[16] was taken out of context and referred not to a vague "infirmity," but rather possible serious fraud.[17]

The red flags alleged against the appealing defendants in Bayou IV were (1) the *Westervelt* complaint; (2) Bayou's delay in providing net asset values (NAVs), and its ultimate disclosures that management, rather than an offshore administrator was providing these NAVs—and thus they were not independent; and (3) background investigation reports containing negative information concerning Bayou and its principal, Sam Israel.

In reviewing these three red flags, the *Bayou IV* court, after noting that nothing in the complaint alleged fraud, undertook a much more detailed review of the evidence as to the *Westervelt* complaint, noting contrary information, such as Westervelt's letter leading to his termination in March 2003, saying that he was "honored" to be working at Bayou and was prepared to have his clients immediately invest $5 million to $10 million in the fund. Bayou IV holds that Westervelt's vague and conclusory allegations of criminal, regulatory and ethical wrongdoing were insufficient as a matter of law to trigger inquiry notice. It contrasted the *Westervelt* allegations, with the information generally held to be adequate to trigger inquiry notice:

1. The investor promised 468 percent return, use of postdated checks to pay investors and check to investor returned for insufficient funds;[18]
2. The transferees on inquiry notice of insolvency where they knew that debtors had incurred substantial medical debts, were the subject of an impending suit for nonpayment, were behind in their mortgage payments and were facing foreclosure proceedings;[19]
3. Transfer received "was grossly in excess of the value" transferee had provided;[20]
4. There was knowledge that the transferor was simultaneously suffering huge losses and reporting 20 percent profit to investors;[21] and
5. The bank transferee's conduct "was inconsistent with industry practice and in violation of its own written policies and procedures."[22]

As to the NAV calculations, while Bayou's conduct was inconsistent in its response and it ultimately refused to provide the calculations, the *Bayou IV* court said that the ultimate question was whether, as a matter of law, Bayou's handling of the NAV issue would suggest "to a reasonably prudent institutional hedge fund investor[23] that Bayou might

---

7 *Id.* at 860.
8 *Id.* at 867-70.
9 *Id.* at 865.
10 *Id.* at 868.

11 439 B.R. at 314.
12 *Bayou III* at 848.
13 439 B.R. at 314.
14 With respect to the nature of the red flag information, the *Bayou IV* court noted the question of whether it must be specific to the transfer at issue or may relate to the transferor's activities in general, and said that the weight of authority focuses on the circumstances as to the specific transfer at issue. *Id.* at 311.
15 *Id.*
16 397 B.R. 1 (S.D.N.Y. 2007) (*Manhattan Inv. Fund III*).
17 *Id.*

18 *Jobin v. McKay*, 84 F.3d 1330, 1338-39 (10th Cir. 1996).
19 *In re Sherman*, 67 F.3d, 1348, 1355 (8th Cir. 1995).
20 *In re Agric. Res. & Tech Grp.*, 916 F.2d 518, 539 (9th Cir. 1990).
21 *In re Manhattan Inv. Fund III, supra*, 397 B.R. at 23-24.
22 *In re Model Imperial*, 250 B.R. 776, 779 (Bankr. S.D. Fla. 2000). *Id.* at 322.

be insolvent or that a transfer from Bayou might be made with a fraudulent purpose."[24] It found that this issue cannot be resolved as a matter of law in favor of the trustee-plaintiff. One principal reason was that under the operating agreements, Bayou was not contractually obligated to permit appellants to meet with Bayou's auditors to discuss audit procedures, and that further Bayou was not contractually obligated to supply much of the information the appellants sought, including documents supporting the NAVs. These were issues of fact and could not be ruled as a matter of law.[25] Focusing on the background investigation reports as a red flag in *Bayou III*, the court found that Freestone Low Volatility Partners had no good-faith defense because of information contained in two reports. These reports noted:

1. that while Israel had attended Tulane, he had not graduated;
2. the *Westervelt* lawsuit alleged possible SEC and NASD violations, but had been dismissed;
3. a 2002 civil suit brought by a consultant against Bayou and Israel, that had been dismissed with prejudice;
4. a 2003 NASD regulatory action against Israel for permitting two unregistered employees to make OTC securities trades, resulting in an $8,500 fine;
5. a 2004 customer complaint alleging excessive trading, which was settled;
6. a 2003 state of Connecticut administrative fine for $7,500 imposed on Bayou Securities for record violations;
7. that Israel exaggerated his responsibilities at a prior trading firm, alleging that he had been a head trader, when he had never held that title or had that role;
8. a 1992 landlord suit against Israel for unpaid rent; and
9. a 2000 automobile forfeiture action arising from an allegation that Israel had been driving under the influence of alcohol and was found in criminal possession of a controlled substance.

The report of multiple lawsuits concerned Freestone because Israel had said he had not been involved in prior litigation and thus had "lied" about the issue. Generally, Freestone's manager, Gary Furukawa, had a general bias against those involved in "lots of litigation." Furthermore, when questioned by Freestone about these issues, another Bayou principal, Dan Marino, had been evasive and quite defensive.

The Bayou IV court reversed the summary judgment against Freestone, holding that none of the evidence would have caused a "reasonable institutional hedge fund investor" to suspect "Bayou might be insolvent or that any transfer obtained from Bayou might be made for a fraudulent purpose."[26] The question of whether this information put Freestone on inquiry notice required resolution by a jury.

## Additional Red Flags

Collectively *Bayou III* and *IV* rely for their analysis on the following underlying cases discussing red flags: *Boyer v. Crown Stock Distribution Inc.*,[27] *In re Lull*,[28] *Cadle Co. v. White*,[29] *Luzinski v. Gosman (In re Gosman)*,[30] *In re World Vision Entm't Inc.*,[31] *In re Bennett Funding Grp.*,[32] *In re Imperial Corp. of Am.*,[33] *Banner v. Kassow*,[34] *Terry v. June*,[35] *In re Evergreen Sec. Ltd.*[36] and *In re Am. Rehab. & Physical Therapy Inc.*[37]

## Conclusion

When a defendant wishes to prove its good-faith defense under 11 U.S.C. § 548(c), courts hold that its knowledge concerning the transfer or transferor may have been a tip-off, requiring it to further investigate the circumstances involved. These tip-offs are known as red flags, and the defendant, who carries the burden of proof, must negate a "knew or should have known" constructive-knowledge standard. In *Bayou IV*, the district court held that the red flags must suggest insolvency or a fraudulent purpose in making the transfer. "Red flags" that merely suggest some infirmity in the investment fund or the integrity of its management are not sufficient. The authors have explored a series of facts that courts have held to be red flags that meet the constructive-knowledge standard. In an article to be published later, the authors plan to explore allegations made in major ongoing Ponzi scheme cases of red flags causing the defendants to be put on inquiry notice. ■

*Reprinted with permission from the ABI Journal, Vol. XXX, No. 4, May 2011.*

*The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 13,000 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.*

23 *Bayou IV* noted the issue of whether the standard is governed by a *generic, reasonable person test*, or requires a specific focus on the class or *category* of the *transferee*. It followed the category of transferee cases, and thus asked whether the red flag would have put "a reasonably prudent institutional hedge fund inventor on inquiry notice." *Id.* at 313.

24 *Id.* at 325.

25 *Id.*

26 *Id.* at 327.

27 2009 WL 418275, at *14 (N.D. Ind. Feb. 17, 2009), *aff'd in part, rev'd in part*, 587 F.3d 787 (7th Cir. 2009) (affirming bankruptcy court's decision that certain defendants were protected by good-faith defense as they "had no reason to know of the possibly fraudulent nature of the transaction that resulted in the distributions they received").

28 386 B.R. 261, 271 (Bankr. D. Haw. 2008) (no good faith where defendant accepted general transfer (security interest in all of Ponzi scheme operator's personal property) at time when it had knowledge of at least two creditors with multi-million dollar delinquent debt claims).

29 2006 WL 798900, at *8-9 (D. Conn. March 21, 2006) (knowledge prong of good-faith defense requires "mere constructive rather than actual knowledge").