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The Sad Tale of Fraudulent Transfers (Part II)

When Did Ponzi Preferences Morph into Fraudulent Transfers?

Written by:
Paul Sinclair[1]
Polsinelli Shughart PC; Kansas City, Mo.
psinclair@polsinelli.com

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In last month's article[2] on fraudulent transfers under §548(a)(1)(A), we explored the contradiction between the recent decision in *In re Bayou Group LLC*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), and *In re Sharp International Corp.*, 403 F.3d 43 (2d Cir. 2005). *Bayou* held that investors in a Ponzi scheme who received redemption payments had to return them if they knew or should have known of the debtor's fraud. After being on inquiry notice, some through awareness of a Securities Exchange Commission (SEC) complaint, investors were required to return their refunded capital investments unless they could prove that they withdrew the funds because (1) of other reasons unrelated to concern about their investment, or (2) after a diligent investigation, including corroboration with third parties other than the fund, their concerns had been allayed.[3] *Sharp*, in contrast, permitted a bank with knowledge of a debtor's fraudulent conduct to keep a $12.25 million payment, notwithstanding that knowledge.[4]

The two-fold framework for the *Bayou* decision was: (1) the finding by the court that payments to investors by Ponzi schemes are *per se* violations of §548(a)(1)(A) as calculated to hinder, delay or defraud other investors,[5] and (2) an analysis of the "good-faith" defense under §548(c). Section 548 also includes taking for value. However, antecedent debt (the initial capital investment) is value.[6] Thus, any fictitious profits must be returned. Consequently, the key issue determining whether principal must be returned is the meaning of "good faith."

About the Author

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.

Paul Sinclair

By expanding the meaning of "good faith," you sharply limit this defense. By doing so, claims that have historically been considered "preferences" will then become "fraudulent transfers" under state and federal statutes. *Bayou* applied just such a broad and expansive reading of good faith. As quoted by the court from the plaintiff's brief:

> "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.[7]

Once on inquiry notice, in the court's view, 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.[8] Explicitly, the court ruled that even the "inconclusive diligent investigation" failed the good-faith test.[9] It is this *extraordinary* requirement that a transferee "knew or should have known" and conducted an exhaustive, diligent inquiry that is at odds with and contradicted by traditional, circumscribed about concepts of good faith in fraudulent-transfer law.

Feature

This article will consider good faith as developed by case law and interpreted by the 1978 Code's predecessor, the Uniform Fraudulent Conveyances Act (UFCA), federal and state case law development leading up to 1978, interpretation UFCA's language, policy arguments and bankruptcy case commentary on fraudulent transfers as preferences.

Setting the Stage: The Classic View

Fraudulent-conveyance laws find their inception in the Statute of

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1 The author gratefully acknowledges the contribution of Michael Foster, an associate at Polsinelli Shughart PC, who assisted in the research for this article.
2 "The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished," *ABI Journal*, Vol. XXVIII, No. 3, p. 16 (April 2009).
3 396 B.R. at 846 and 853-54.
4 403 F.3d at 52 and 56.
5 396 B.R. at 843.
6 §548(d)(2)(A).
7 396 B.R. at 844-45.
8 *Id.* at 846.
9 *Id.* at 852.

Elizabeth, 13 Eliz., ch. 5 (1570). Many states passed statutes and developed case law based on the classic prohibition against actual fraud by avoiding transfers made with the intent to hinder, delay or defraud creditors. A representative case is *English v. Brown*, 229 F. 34 (3d Cir. 1916), in which a wife who was owed money by her lawyer-husband received multiple transfers of corporate stock to satisfy debts. Although the statutes' language did not include the language "good faith," the traditional analysis required that a transfer was only fraudulent if the grantee had participated in the fraudulent purpose. It was fully permissible for a creditor to press his failing debtor for payments:

> The law throws upon him no duty of protecting other creditors. He has the same right to accept a voluntary preference that he has to obtain a preference by superior diligence. He may know the fraudulent purpose of the grantor, but the law sees that he has a purpose of his own to serve, and if he goes no further than is necessary to serve that purpose, the law will not charge him with fraud by reason of such knowledge.[10]

The court found that there would be no fraud "if she accepted the stock without intent to aid her husband to defraud English brothers, but with the sole purpose of obtaining payment of the debt due her."[11] While *English v. Brown* may seem like older case law, it tracks precisely the language of *Sharp* in 2005 when it absolved the bank of the receipt of the $12.25 million, saying:

> No doubt, State Street was hoping to be replaced by a less cautious lender, and had no intention of precipitating its own loss, but silence and forbearance did not assist the fraud *affirmatively*.[12]

The concept of good faith was set out, possibly for the first time in UFCA, promulgated by the Committee on Uniform State Laws in 1918. This was an effort 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. Those objective factors were set forth in new sections defining constructive fraud, which required finding that the obligation was incurred without fair consideration.

Good faith was then used in two different sections: (1) the definition of fair consideration in §3, which included a requirement of good faith; and (2) in §8 on remedies, which excepted from liability, a purchaser for fair consideration "without knowledge of the fraud." Thus, under this latter section, to recover against a purchaser, a complaining creditor would have to show (1) lack of consideration, (2) lack of good faith and (3) knowledge of the fraud at the time of purchase. Footnote 1 to this section containing the Commissioner's comments makes reference to whether there was "collusion on the part of the grantee."[13] This has been interpreted to mean: "Therefore, the addition of the phrase 'without knowledge of the fraud' indicates that 'fair consideration' might be found in situations in which the transferee knew of the debtor's fraudulent intent."[14] This same commentator also states: "The Commissioners explicitly approved of preferences; they intended the good-faith requirement to capture only cases in which the grantee actively participated in fraudulent acts."[15]

A highly illustrative set of facts occurred in *Smith v. Whitman*, 189 A.2d 15 (N.J. 1963), in which the debtor, a disbarred attorney, had embezzled $100,000 held in trust by him for his nephew, defendant Whitman. In response to his nephew's threats that he would turn him into the prosecutor, the attorney transferred $39,000 to Whitman. The trial court had ruled under New Jersey's version of the UFCA that the threat would negate good faith, an element in fair consideration, and that the money should be returned. In reversing this judgment, Chief Judge Joseph Weintraub began his discussion of the law, stating:

> We start with the proposition that a preference as such is not a fraudulent conveyance. True, a creditor who collects from an insolvent debtor fares better than other claimants. Yet if the transfer were set aside in favor of another creditor, there would be but a substitution of one preference for another. For that reason a preference cannot be undone by a competing creditor whether the preference was obtained through judicial process or by a transfer from the debtor, and the Uniform Fraudulent Conveyance Act did not alter that proposition.[16]

The court pointed out that New Jersey, like the federal statutes at that time, had a four-month reach-back period under its preference statutes. It said that with these preference statutes, a plaintiff could only succeed if it could take this case outside the usual rule. It then addressed the good-faith question:

> The statute does not define "good faith." "Good faith" ordinarily imports honesty of purpose and integrity of conduct with respect to a given subject... So good faith is lacking if the transferee knowingly aids the debtor in the debtor's purpose to secrete assets for the debtor's enjoyment…or joins in a plan designed solely to hinder creditors even though the transfer may be said to be supported by a sufficient consideration… [T]he transferee does not lack good faith because he knew his debtor's purpose to prefer or because he actively sought the preference.[17]

Thus, the threat of prosecution could not amount to a violation of bad faith. The court directed that judgment be entered for defendant Whitman.[18]

Likewise, in *Gilmer v. Woodson*, 332 F.2d 541 (4th Cir. 1964), the court held that good faith cannot be lacking unless the transferee "knowingly participated in the debtor-transferor's purpose to defeat other creditors."[19] *Gilmer* cites for this proposition *4 Remington on Bankruptcy*, §1654 (1957). *Remington*, in this note, explains congressional intent as follows:

> Congress must have known, when it adopted former §67(e), that the ancient statute of 13 Eliz, ch 5, was by the weight of authority construed to require sharing by the transferee of the debtor-transferor's intent to defraud creditors, or at least guilty knowledge on the part of the transferee.[20]

Thus, although *Bayou* correctly asserts that good faith was not defined in the 1978 Code and that there is no legislative history, it had acquired a widely accepted meaning in prior case law.

10 229 F. at 40.
11 229 F. at 41.
12 403 F.3d at 52.
13 "Report of the Committee on Uniform State Laws," 5 *ABA J.* 481, 493 n.1 (1919).
14 Note, December 1983, "Good Faith and Fraudulent Conveyances," 97 *Harv. L. Rev.* 495, n. 64.
15 *Id.* at n. 65.
16 189 A.2d at 18.
17 *Id.* at 20.
18 *Id.* at 22.
19 332 F.2d at 547.
20 *Id.* at 178.

The 1978 Code

When Congress enacted the Bankruptcy Code in 1978, it retained, but substantially revised, good faith in the fraudulent-transfer section. Gone was "fair consideration" from the constructive-fraud section, and "fair-equivalent" as to value was changed to "reasonably-equivalent value." Good faith was moved to §548(c) so that when coupled with "value," it became a defense, not only to constructive fraud, but also to actual fraud as well.

However, as in the UFCA, when Congress rewrote the remedy section, the new §550(b) provided that the trustee could not recover a fraudulent transfer against a subsequent "transferee that takes for value...in good faith, and without knowledge." Thus, Congress' use of "good-faith" combined with "without knowledge" in §550(b), when compared with "good faith" standing alone in §548(c) lends itself to the identical interpretation applied to the UFCA. "[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.'" *Russello v. United States*, 464 U.S. 16,23, 104 S.Ct. 296, 300 (1983) (quoting *United States v. Wong Kim Bo*, 472 F.2d 720, 722 (5th Cir. 1972)). This would mean that Congress "intended the good-faith requirement to capture only cases in which the grantee actively participated in the fraudulent acts."[21]

Since passage of the 1978 Code, and beginning in 1990 with *In re Agricultural Reasearch and Technology Group Inc.*, 916 F.2d 528 (9th Cir. 1990), and continuing with *Jobin v. McKay (In re M&L Business Machine Company)*, 84 F.3d 1330 (10th Cir. 1996), through *In re Manhattan Investment Fund Ltd.*, 397 B.R. 1 (S.D.N.Y. 2007), there are a series of cases that, like *Bayou*, define "good faith" in what they consider an "objective" manner as "knew or should have known" and imposing a high degree of due diligence. As argued in the article last month, these cases rely on a 1894 Supreme Court case for authority, *Shauer v. Alterton*, which had nothing whatsoever to do with federal bankruptcy law or its interpretation.[22]

Juxtaposed to this line of cases relied on by *Bayou* are recent cases that continue to require participation by the transferee in the fraud before liability is imposed under state statutes following the UFCA. *Boston Trading Group Inc. v. Burnazos*, 835 F.2d 1504 (1st Cir. 1988) ("The 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…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.");[23] *Citizen's Bank of Clearwater v. Hunt*, 927 F.2d 707, 711 (2d Cir. 1991); *J.C. Jacobs Banking Co. v Campbell*, 406 So.2d 834 (Ala. 1981); *INNK Land and Cattle Co. v. Kenkel*, 546 NW.2d 585 (Iowa 1996); and *Territorial Savings & Loan Assoc. v. Baird*, 781 P.2d 452, 461 (Utah App. 1989) ("[W]hat constitutes good faith…involves a subjective interpretation of all of the surrounding circumstances."). Even Judge Adlai S. Hardin Jr., the author of *Bayou*, in an earlier opinion in *In re Kovler*, 329 B.R. 17 (Bankr. S.D.N.Y. 2005), interpreting New York's version of the UFCA, cites with approval *Golden Budha Corp. v. Canadian Land Co. of America*, 931 F.2d 196, 201 (2d Cir. 1991), as follows: "If 'the transferee participated or acquiesced in the transferor's fraudulent design…the transaction falls within the condemnation of the fraudulent-conveyance statutes.'"

Bayou and its predecessors, Manhattan Investment, Jobin and Agric. Res., stray far from the well-established standards defining good faith in fraudulent transfer cases.

Policy Issues

The two 1978 statutes, §§547 and 548, are two different sections of the Bankruptcy Code, with different elements, histories and defenses. Preferences are avoided if transferred to third parties in the 90 days before bankruptcy. Fraudulent transfers had a one-year, (now two-year) reach-back period. If Congress had wanted a single statute, it could have written one. Additionally, it did not design the preference statute to provide for a two-year reach-back, and could have done so.

The principal cases relied on in *Bayou* other than *Jobin*, and even *Bayou* itself, simply cite to earlier cases without applying analysis to the decisions reached. *See In re Agric. Res. and Tech Grp.* and *In re Manhattan Investment Fund, supra*. *Jobin* is the one case that sets out an explanation and discusses contrary case law. In analyzing good faith, it discusses the Tenth Circuit's decision in *Richards v. Platte Valley Bank*, 866 F.2d 1576 (10th Cir 1989), but distinguishes it as a case under Colorado's version of the Uniform Fiduciaries Act (UFA). Under the UFA, good faith is defined as "a thing done 'honestly, whether it be done negligently or not.'"[24] It points out that the *Richards* decision is based in part on consideration of the purpose of the UFA—the need for uniform rules to take the place of diverse and conflicting rules concerning breach-of-fiduciary duties.[25]

Jobin is a case that was brought by the trustee to recover $43,500 from an experienced investor, not only as a fraudulent transfer, but also as a preference. Thus, as that court interprets policy, it is looking at a case that combines two recoveries that are sought. It then goes on to distinguish *Richards* and the policy of uniform application of the meaning of words in statutes, saying:

> In the instant case—in which a bankruptcy trustee seeks to recover assets for the benefit of all creditors of a Ponzi scheme—the need for a good faith standard that removes hindrances to commerce is not the paramount concern that it was in *Richards*…"It is the ultimate aim of the preference law in the Bankruptcy Code to insure that all creditors receive an equal distribution from the available assets of the debtor."[26]

Thus the central rationale for good faith, to be defined in a broader sense, is to comport with the purpose of the *preference law* in the Bankruptcy Code, rather than the *fraudulent-transfer law* in the Code, decades of case law interpretation and statutory construction of the provision. This, along with the thin reed of the 1885 law of the Territory of South Dakota (found in *Agric. Res. and Tech. Group*),[27] is the root basis from which the federal broad interpretation of "good faith" is derived.

21 *See* Note 15, *supra*.
22 *See* Note 2, *supra*, and the case discussion following fn. 32 therein.
23 835 F.2d at 1509 and 1512.
24 84 F.3d at 1336-37.
25 *Id.* at 1337.
26 *Id.*
27 *See* Note 22, *supra*.

Jobin proceeds to distinguish *Gilmer* because it preceded the 1978 Code, and other case law because of arguments involving their discussion of objective versus subjective analyses of good faith. This is so, notwithstanding the fact that in *Jobin*, defendant McKay had been promised rates of return on his investment in this Ponzi scheme of 120 percent and 468 percent per year, which, under any court's subjective analysis, should be adequate to overcome a good-faith defense.

Nor is the *Jobin* line of cases, including *Bayou*, the first time aggressive bankruptcy trustees have tried to expand good faith to turn fraudulent transfers into preferences. In *Irving Trust Co. v. Chase Nat. Bank*, 65 F.2d 409 (2d Cir. 1933), the trustee sued Chase under a fraudulent-transfer theory to recover $4,000 paid to the bank 10 days before the bankruptcy filing. The trustee appealed from a dismissal of its complaint, and the Second Circuit affirmed. Section 60 of the Bankruptcy Act, the preference section then in effect, required as an element that the transferee have knowledge that it was receiving a preference, and thus no preference claim was viable against Chase.[28]

Consequently, the trustee argued that it was a fraudulent conveyance under §67(e), citing to a line of state cases dispensing with participation or collusion by the transferee, including *Sherman v. Luckhardt*, 67 Kan. 682, 74 P. 277 (1903). The court in *Chase* rejected the argument, saying that paying an actual debt in good faith, without any plan to injure creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law, the statue of Elizabeth or the Bankruptcy Act. Fraudulent transfers should be confined to:

> situations where the grantee is privy to the grantor's purpose to use the consideration preferentially. To extend it to a payment directly to a creditor innocent of any participation in the debtor's purpose would seem in effect to obliterate section 60b from the statute....[29]

Unlike *Jobin*, the court in *In re Unified Commercial Capital Inc.*, 260 B.R. 343 (Bankr. W.D.N.Y. 2001), had no problem distinguishing between the policies and purposes of the fraudulent transfer and preference statutes. In *Unified*, the trustee brought a fraudulent-transfer action to recover $112,000 paid out to an investor in a Ponzi scheme seven months before the filing. The trustee argued that for Ponzi schemes, the best solution would be for everyone to share *pro rata* in the inevitable loss. The court rejected this, stating that §48 and state law fraudulent-conveyance statutes implement a policy of preventing the diminution of a debtor's estate. Section 547, in contrast, implements a principal policy of equality of distribution.[30] All transfers in furtherance of a Ponzi scheme are preferential, yet under the Code, the trustee may recover only those transfers made within 90 days. "'In short, the Code simply does not provide an effective way for the trustee to recover all transfers in furtherance of a Ponzi scheme.'"(Quoting *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843,887-88 (D. Utah 1987).[31] The court refused to extend the reach of the preference statutes.

Conclusion

Bayou and its predecessors, *Manhattan Investment, Jobin* and *Agric. Res.,* stray far from the well-established standards defining good faith in fraudulent transfer cases. Common sense, statutory interpretation, decades of legal tradition prior to 1978 and authoritative state UFCA case law since that time all tell us that "good faith" means honesty of purpose, or knowing with a high degree of due diligence. The words are subjective, not objective. This is not to ignore the subjective knowledge of a sophisticated investor in cases such as *Jobin* who are promised 120 percent to 468 percent returns. On an overall basis, however, the court in *Unified* summed it up clearly:

> In my view, the fraudulent conveyance statutes cannot and should not be utilized by courts as a super preference statute to effect a further reallocation and redistribution that should be specifically provided for in a statute enacted by Congress... By forcing the square peg facts of a Ponzi scheme into the round holes of the fraudulent conveyance statutes in order to accomplish a further reallocation and redistribution to implement a policy of equality of distribution in the name of equity, I believe that many courts have done a substantial injustice to these statutes and have made policy decisions that should be made by Congress.[32] ■

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28 65 F.2d at 410.
29 *Id.* at 411.

30 260 B.R. at 350.
31 *Id.* at 349.
32 *Id.* at 350.