AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Katz, Dreier Cut into Aggressive Trustees' Positions

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Feature

The collapse of the Bayou Group of hedge funds in August 2005 was the precursor to a wave of Ponzi scheme litigation now reaching a spectrum of decision-making by bankruptcy and district courts. The objective of these fraudulent-transfer suits is the return of payments made to defendant investors prior to the funds' collapse, including not only profits or interest, but the return of the defendant investors' principal redemptions as well.

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In an adversary proceeding out of *In re Bayou Group LLC ("Bayou III")*,[1] the U.S. Bankruptcy Court for the Southern District of New York issued a wide-ranging decision on many aspects of fraudulent-transfer law, and this decision represents, in the view of some, the high-water mark of law favoring clawbacks by trustees. In *Bayou III*, the court adopted the "objective" standard for the determination of "good faith," and after a detailed analysis, granted summary judgment for some defendants, granted summary judgment against others, and denied summary judgment where it found that factual disputes precluded such a ruling.

This decision was followed by *In re Bayou Group LLC ("Bayou IV")*,[2] in which the district court reversed summary judgments for the trustee, modified the legal standard for the defendants' objective good-faith defense, and moved the cases toward trial on that defense. On May 25, 2011, after trial to a jury, the court entered judgments against seven defendants totaling some $13 million.[3] While some defendants have paid their individual judgment, others continue to challenge the objective standard and its duty of diligent inquiry.

Since those judgments were entered, two other opinions from the Southern District of New York have differed sharply with *Bayou IV*'s determination of the meaning of "good faith": *Picard v. Katz*,[4] the Madoff trustee's billion-dollar fraudulent-transfer suit against the Mets' owners, and *Gowan v. The Patriot Group LLC (In re Dreier LLP)*,[5] involving the demise of New York's Dreier law firm from a Ponzi scheme in which Marc Dreier sold $700 million of bogus Solow Realty Development Corp. notes. As reported in the news, these decisions have caused a sharp decline in market trading in the purchase and sale of Madoff claims.

Setting the Stage: The Mechanics of Clawback Suits

In a typical fraudulent-transfer suit against investors who redeemed their Ponzi investments prior to a collapse, the trustee will assert claims to recover lost profits or interest, as well as the return of principal. These claims are generally asserted under: (1) a constructive fraudulent theory under § 548(a)(1)(B) or state law, made applicable through § 544(a); and (2) an actual fraud theory under § 548(a)(1)(A), or applicable state law. The advantage of the state law fraudulent-transfer claims is that § 548 only has a two-year reach-back period, while state law may reach back four years, or, as in New York, six years.[6] False profits are readily recoverable, and often there are few defenses to their recovery except to the extent that defendants may be able to argue that there is a time value to money. As to interest paid in a redemption payment, courts reach differing conclusions based upon the specific facts of each case.[7]

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The primary focus of litigation in this area is whether investors must pay back their original principal received in the redemption payment. The constructive fraudulent claims under § 548(a)(1)(B) require proof that the debtor received less than "reasonably equivalent value." A later subsection, § 548(d)(2), defines "value" as including the satisfaction of "antecedent debt." Courts have interpreted the investors' state law recission claim against the fraudulent scheme to constitute "antecedent debt," thus constituting value,[8] causing a constructive fraudulent-transfer claim to fail. This brings squarely into play an actual fraud claim. The actual intent to defraud in

1 *Bayou Accredited Fund LLC v. Redwood Growth Partners LP (In re Bayou Group LLC)*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), *rev'd in part, sub nom., Christian Bros. High School Endowment v. Bayou No Leverage Fund LLC (In re Bayou Group LLC)*, 439 B.R. 284 (S.D.N.Y. 2010).
2 *Christian Bros.*, 439 B.R. 284 (S.D.N.Y. 2010) (Gardephe, J.).
3 *See, e.g.*, 09-cv-02313-PGG, Doc. 44.
4 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011) (Rakoff, J.).
5 452 B.R. 391 (Bankr. S.D.N.Y. 2011) (Glenn, J.).
6 Uniform Fraudulent Transfer Act § 9(a); N.Y. McKinney's CPLR § 213.
7 *See* discussion of cases in *In re Dreier LLP*, 452 B.R. at 437-38.
8 *Jobin v. McKay (In re M&L Business Machine Co. Inc.)*, 84 F.3d 1330, 1341-42 (10th Cir. 1996).

Ponzi scheme cases is inferred from the schemer's intent to maintain its operation by paying earlier investors.[9] Thus, it is presumed that each payment going out to the investor was made with the actual fraudulent intent to further the Ponzi scheme. Consequently, the investors' only defense may be under § 548(c), by proof of "good faith" and "value," and with value shown by the recission claim, the remaining issue is the defendant's "good faith."

Good Faith in Bayou III *and* IV

Bayou III noted that "good faith" is not defined in § 548 of the Bankruptcy Code, but must be determined using an "objective" or "reasonable-person" standard. Courts look to what the transferee knew or should have known. It is a two-step test: (1) the transferee cannot be found to have received the transfer in good faith if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose; and (2) once on notice, the investor must conduct a diligent inquiry to discover the fraudulent purpose.

The 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.[10] A failure to then investigate will preclude assertion of a good-faith defense.[11] *Bayou III* further found that the inquiry must lead to the conclusion that the investors' concerns were allayed or set to rest. It acknowledged that this test will almost never be met if fraud is involved because the investor will first be confronted with stonewalling, and it will immediately redeem its investment before the inquiry can be completed.[12]

Bayou IV concluded that the bankruptcy court's interpretation, with the expanded inquiry-notice duty, renders the good-faith defense largely illusory when a transferor is actually engaged in fraud.[13] It takes the position that the trigger for the inquiry is not merely that "there is a problem with the fund," but rather that red flags indicate either fraud or insolvency on the part of the fund. As to due diligence, *Bayou IV* permits factual development to support the argument that the investigation would be futile—or practically impossible—to discover the fraud.[14]

Based on the jury instructions given by the *Bayou IV* court, it is arguable that the test for good faith is still illusory. As posed to the jury, the question was "not whether a reasonable investor would have in fact conducted a diligent investigation before closing its account. Instead…once a Defendant was on notice of…possible fraud or insolvency, the Defendant or their advisor was required to conduct a diligent investigation. The question then is whether that...diligent investigation could have uncovered the fraud."[15] Because a reasonable, objective investor when confronted with warning signs (or "red flags") of problems with an investment will immediately withdraw its funds without further inquiry, the jury was given a charge inconsistent with expected behavior, thus setting up another illusory test.

> Bayou III *and* IV*'s insistence that, after perceiving a "red flag," investors...must undertake a thorough investigation of possible fraud by their broker, is at odds with the common-sense decision to bail out of an investment once its soundness is challenged.*

Picard v. Katz

In *Picard v. Katz*, the Madoff trustee, appointed under the Securities Investor Protection Act (SIPA), filed a 373-page complaint against the Mets owners seeking recovery of more than a billion dollars. District Judge Jed Rakoff, in his Sept. 27, 2011, opinion,[16] dismissed all claims except those alleging actual fraud and equitable subordination, reducing the complaint to some $386 million. First, the court invoked the § 546(e) settlement-payment exclusion to dismiss the preference, constructive-fraud and state law claims, leaving only claims for actual fraud under § 548(a)(1)(A), which is then limited to payments made to the investors in the two years prior to filing.[17]

Turning to the issue of good faith, while defendants vehemently denied that they ignored any red flags, both sides agreed that if the defendants willfully blinded themselves to the fact that Madoff Securities was involved in some kind of fraud, that this might constitute a lack of good faith.[18] Beyond "willful blindness," the trustee alleged that defendants were on "inquiry notice" of the fraud but failed to diligently investigate Madoff Securities, constituting a lack of good faith, citing to *In re Manhattan Inv. Fund Ltd*.[19] The trustee further argued that a failure to further investigate constitutes a lack of good faith unless even diligent inquiry would not have unearthed the fraud, citing to *In re Agric. Research & Tech. Group*.[20]

The court clearly distinguished between the objective-standard of inquiry approach and the subjective-standard of the inquiry (or willful blindness) approach. It then, based on SIPA being "informed by federal securities law," required more than "negligence nonfeasance" to posit liability—squarely rejecting the Madoff trustee's argument that good faith is defined by the objective duty of inquiry standard.[21] "A securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty."[22] The court equated "conscious avoidance" with "willful blindness," meaning that the defendant was aware to a high probability of the facts and consciously avoided confirming the facts. "But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices—and how could he do so anyway?—his lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship."[23]

In re Dreier

Gowan v. The Patriot Group, LLC (In re Dreier LLP)[24] represents yet another multi-million dollar bankruptcy case with its origins in a "brazen" Ponzi scheme.[25] This decision is the bankruptcy court's ruling on a motion to dismiss a complaint against the Patriot Group LLC (the "defendant") seeking under both New York law and § 548 to recover $16.5 million, which included $1.5 million in interest, based on an 11 percent per annum rate. Ultimately, the *Dreier* court granted the motion to dismiss the

9 *In re Dreier*, 452 B.R. at 424.
10 *Bayou III*, 396 B.R. at 844-45.
11 *Id.* at 847.
12 *Id.* at 852.
13 *Bayou IV*, 439 B.R. at 316.
14 *Id.* at 318.

15 Case 09-cv-02313 (S.D.N.Y.), Doc. 41, page 16.
16 2011 WL 4448638.
17 *Id.* at *3.

18 *Id.* at *4.
19 397 B.R. 1, 22-23 (S.D.N.Y. 2007).
20 916 F.2d 528, 536 (9th Cir. 1990).
21 2011 WL 4448638; *id.* at *5.
22 *Id.*
23 *Id.*
24 452 B.R. 391 (S.D.N.Y. 2011).
25 *Id.* at 398 ("Among the most recent spate of frauds and Ponzi schemes, the crimes of Marc Dreier stand out as among the most brazen.").

constructive-fraud claims as to recovery of principal, but permitted the actual fraud claims to remain under both New York law and § 548.[26]

Addressing the recovery of principal, the court extensively surveyed the affirmative defense of "good faith" under both § 278(1) of the New York Debtor and Creditor Law (NYDCL) and § 548(c) of the Bankruptcy Code.[27] Under the NYDCL, divergent tests had developed in determining the "good faith" standard to be applied. Citing to the Second Circuit in *HBE Leasing*, it found that "'good faith' is satisfied if the transferee acted without either actual or constructive knowledge of any fraudulent scheme."[28] Some New York state court decisions "appear to have required a more active avoidance of the truth," such as a "conscious turning away" from the subject.[29]

Other New York opinions, however, require an inquiry as to whether there was a "failure to deal honestly, fairly and openly." The "earmarks" of the latter version of the "good-faith" defense are "(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 to, or knowledge of the fact that the activities in question will hinder, delay or defraud others."[30] Ultimately, the *Dreier* opinion reached no conclusion on the New York standard for "good faith."

As to "good faith" under § 548(c), the *Dreier* court noted that most courts have applied an "objective" or "reasonable person" standard, citing to *Bayou Grp., Manhattan Inv. Fund* and *Agric. Research & Tech. Group*.[31] In its view, however, the Second Circuit has not proclaimed its adherence to any specific standard.[32]

Analyzing *Manhattan Inv. Fund*, the district court noted that Judge Naomi Buchwald, after considering whether what Bear Stearns knew or should have known triggered a duty to investigate further, found that Bear Stearns as the fund's prime broker had a duty to inquire based on certain "red flags" suggesting the hedge fund was perpetrating a fraud. But as to the defendant, Patriot Group, the *Dreier* court found that, unlike Bear Stearns, Patriot Group did not appear to have owed a duty to anyone (other than its own investors) to investigate Dreier's fraud, citing to *Restatement (Second) of Torts*, § 12(2) (1965). Even without a duty, Patriot Group could not ignore facts of which it was aware.[33]

In support of this alternative standard that good faith precludes conscious turning away or looks to whether the defendant had a duty to inquire, the *Dreier* court refered to 3B Fed. Jury Prac. and Instr. 161.58 (5th Ed. 2011) ("To be held responsible for conscious avoidance or failure to investigate, defendant __________ must either be under a duty to investigate or have consciously avoided knowledge knowing the consequences of such avoidance."), and 1 Garrard Glenn, *Fraudulent Conveyances and Preferences* § 304, at 532 (1940) ("It comes always to a question of the grantee's good faith as distinguished from mere negligence. There must, indeed, be more than negligence. There must be a conscious turning away from the subject.").

Conclusion

While *Bayou III* and *IV*, based on 20 years of case law following *Agric. Research & Tech. Group*, imposed on the definition of "good faith" a standard of "knew or should have known" with a rigorous duty of inquiry, that standard has been decisively rejected by both judges Rakoff and **Martin Glenn** in the *Madoff* and *Dreier* cases. The *Dreier* court has distinguished *Manhattan Inv. Fund* on the basis that Bear Stearns, as a prime broker, had a duty to investigate, which was not present in either the SIPA or the *Dreier* investment context. Moreover, *Bayou III* and *IV*'s insistence that, after perceiving a "red flag," investors—regardless of their degree of sophistication—must undertake a thorough investigation of possible fraud by their broker, is at odds with the common-sense decision to bail out of an investment once its soundness is challenged. ■

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26 As to the claims for recovery of the $1.5 million in interest, the defendant claimed that value had been provided because it was a contractual interest payment for the time value of the use of money. The court rejected this "value" argument because (1) Dreier LLP, the debtor, was not a signatory or obligor on the notes, and thus the payments did not extinguish a contractual obligation of the debtor; (2) the payment in excess of principal did not reduce a valid contractual debt because there was no valid contract; and (3) to the extent Patriot Group would assert a claim for an amount in excess of its principal, the court would subordinate such a claim, based upon *Restatement (Third) of Restitution and Unjust Enrichment*, § 61. *Id.* at 438-40.

27 *See id.* at 445-451.

28 *HBE Leasing Corp. v. Frank*, 48 F.2d 623, 635-36 (2d Cir. 1995).

29 *Dreier*, 452 B.R. at 446.

30 *Id.* at 447.

31 *Id.*

32 *Id.* at 448.

33 *Id.* at 449.