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Feature

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Teleservices Court Rejects Objective Good-Faith Standard

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While the good-faith defense is generally the central issue in defending Ponzi scheme fraudulent-transfer litigation, it became the heart of the matter in *In re Teleservices Group Inc.*[1] In *Teleservices*, a chapter 7 trustee sued the Huntington National Bank for $73,035,429.57, which it had received directly and indirectly from the debtor in payments on an outstanding loan. Huntington raised defenses of good faith and value under §§ 548(c) and 550(b)(1) of the Bankruptcy Code.

Over the last three years, the definition of "good faith" has received significant attention in response to various Ponzi schemes. In *In re Bayou Group LLC (Bayou III)*,[2] the bankruptcy court adopted the "objective" standard for the determination of "good faith," and this decision represents, in the view of some, the high-water mark of law favoring clawbacks by trustees. This analysis was modified on appeal by the district court *(Bayou IV)*, but that court still retained the "objective" standard.[3] Recently, two other district courts in the *Madoff* and *Dreier* cases addressed the good-faith standard and have taken a different view from *Bayou IV*.[4] In previous articles, the authors have described and compared the objective and subjective views of good faith, and set out the mechanics of clawback lawsuits.[5]

In a typical fraudulent-transfer suit, such as one 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. *Teleservices*, which sought the recovery of loan payments, presents a particularly troubling aspect to the good-faith issue because Huntington was being sued for the $73 million that it received over the life of the loan (all of the transfers), while its loan balance was only $16.5 million.[6] This was a revolving loan, and as payments were received, the bank would advance "new" funds to the borrower. The problem was that while under § 547 (preference avoidance) there is a new-value defense, there is no such defense under § 548 (fraudulent transfers).

In re Teleservices: Jettisoning the Objective Approach[7]

Huntington's lending relationship with an organization called Cyberco was brief and tumultuous. Very shortly into their relationship, Huntington personnel noted that large deposits were coming into the Cyberco lockbox from an unfamiliar entity called *Teleservices*.[8] When Huntington officials asked questions, they were told that this entity would "oversee internal finances for all of Cyberco's far-flung operations, including the collection of Cyberco's receivables."[9] Despite this rational explanation, Huntington asked Cyberco to begin finding another lender. From that juncture, and for months to come until Huntington was paid almost in full, Huntington made inquires, conducted various levels of investigations and in the process, obtained information about Cyberco and Teleservices.

1 444 B.R. 767 (Bankr. W.D. Mich. 2011).

2 *Bayou Accredited Fund LLC v. Redwood Growth Partners LP (In re Bayou Group LLC)*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008).

3 *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund LLC (In re Bayou Group LLC)*, 439 B.R. 284 (S.D.N.Y. 2010) (Gardephe, J).

4 *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011) (Rakoff, J.) (the *Madoff* case); *Gowen v. The Patriot Group LLC (In re Dreier LLP)*, 452 B.R. 391 (S.D.N.Y. 2011) (Glenn, J.). For an analysis of these opinions, *see* Paul Sinclair and Monika Machen, "*Katz, Dreier* Cut into Aggressive Trustees' Positions," XXXI *ABI Journal* 1, 48-49, 79-80, February 2012.

5 Paul Sinclair, "The Sad Tale of Fraudulent Transfers," XXVIII *ABI Journal* 3, 16, 78-79, April 2009; Paul Sinclair, "The Sad Tale of Fraudulent Transfers (Part II)," XXVIII *ABI Journal* 4, 44-45, 66-67, May 2009; Paul Sinclair and Monika Machen, "*Katz, Dreier* Cut into Aggressive Trustees' Positions," XXXI *ABI Journal* 1, 48-49, 79-80, February 2012.

6 444 B.R. at 840.

7 As noted in the *Dreier* proceedings, Judge Hughes' recent opinion in *Teleservices* "jettisoned the objective approach in favor of the subjective approach." *Gowan v. Patriot Group LLC (In re Dreier LLP)*, 452 B.R. 391 (Bankr. S.D.N.Y. 2011).

8 *Teleservices*, 444 B.R. at 775.

9 *Id.* at 777.

To say that Judge Jeffrey Hughes "jettisoned" the objective approach in favor of the subjective approach is probably an understatement. *Teleservices*, in an exhaustive opinion covering the history and origins of "good faith" in the Code, ultimately rejected the "objective" standard that had been followed by many courts. Judge Hughes criticized the objective interpretation of good faith, as utilized in *Bayou III*, because the objective interpretation (1) strays from traditional notions of good faith, (2) is inconsistent with "good faith" in other Code sections, (3) is based on a "seminal case" that "has been cited again and again without the benefit of reflection," (4) is inconsistent with three Supreme Court cases, and (5) is inconsistent with the Bankruptcy Act and the distinction between *malum per se* and *malum prohibitum,* which was—and remains—the true congressional intent behind good faith in §§ 548(c) and 550(b).

According to the *Teleservices* court, an objective approach draws attention away from what has traditionally distinguished good faith from bad faith.[10] Whereas the *Bayou III* court determined that good faith under § 548(c) is "somewhat different from a layman's understanding," the *Teleservices* court argued that traditional notions of good faith in interpreting § 548(c) and related § 550(b) simply do not support a different understanding.[11] In support of this position, Judge Hughes looked to Sixth Circuit cases that discussed good-faith in other contexts, including (1) interpreting a good-faith purchaser under § 363(m), (2) interpreting good-faith voting under § 1126(e), (3) interpreting good-faith extensions of credit under § 364(e), (4) interpreting implied good faith *vis-à-vis* § 707(b) abuse, (5) interpreting implied good faith *vis-à-vis* a § 707(a) dismissal and (6) interpreting § 1325(a)(3) good faith. The court concluded that these numerous interpretations of "good faith" in the Bankruptcy Code are "familiar good faith concepts like 'honesty' and 'integrity'" and are quite different than "the new, morally indifferent standard that *Bayou* [*III*] and other courts have embraced."[12]

Having concluded that *Bayou III* and related cases missed the mark, the *Teleservices* court came to the same conclusion as the authors[13] as to the origin of the objective standard: *In re Agricultural Research*.[14] In sum, *Agricultural Research* was the first appellate court to break from the traditional good-faith notions, and it essentially did so without explanation or the briefing of good faith by the parties. Furthermore, the *Agricultural Research* court was not analyzing § 548(c) or 550(b), but was analyzing Hawaii's fraudulent-transfer laws.[15]

Absent from consideration in *Agricultural Research* and likewise in *M & L Business Machine*[16] and *Sherman*[17] (cited in *Agricultural Research* and generally cited in cases such as *Bayou* that promote the objective standard) are three integral Supreme Court cases: *Coder*,[18] *Van Iderstine*[19] and *Dean*.[20] According to Judge Hughes, these decisions "laid out a fundamental distinction between the recovery of actually fraudulent transfers on the one hand and the recovery of other avoidable transfers on the other hand. The former is malum *per se* ["[a] wrong itself; an act or case involving illegality from the very nature of the transaction, upon principles of natural, moral, and public law"[21]]; the latter only *malum prohibitum* [the intent to prefer—innocent and valid, except when made in violation of the express provisions of a statute[22]]… these three cases all stand for the proposition that the *malum per se/malum prohibitum* dichotomy that distinguishes an actually fraudulent transfer from one that is merely preferential carries over to the recipient of the transfer as well."[23]

Judge Hughes' rejection of the trend to the objective approach is arguably centered on this *malum per se/malum prohibitum* distinction. "*Coder*, *Van Iderstine* and *Dean* all interpreted an early version of former Section 67" of the Bankruptcy Act,[24] and after much analysis, he concluded that this distinction continued in § 548(c).[25] First, in enacting § 548(c), Congress "intended good faith to still have the same meaning as it did under the former Act."[26] This is clear because the "Supreme Court now instructs the lower courts again and again to interpret the current Code in a manner that is consistent with prior bankruptcy practice unless Congress has expressly indicated a different intention."[27] Second, contrary to *Bayou III* and other cases applying an objective standard, Congress has not manifested a different approach: "Sections 548(c) and 547(c) still reflect the same *malum per se/malum prohibitum* dichotomy that the Supreme Court long ago observed in *Coder*, *Van Iderstine* and *Dean*. The recipient's good faith is irrelevant when the avoidance is based upon preferential treatment or constructive fraud."[28] Furthermore, in the context of § 549, post-petition transfers, the same dichotomy exists.[29]

Having shunned the objective standard and supported the subjective standard, Judge Hughes wrestled with the practical issue of applying the good-faith defense. Because good faith under §§ 548(c) and 550(b) are affirmative defenses, a difficult question arises of how one goes about proving ignorance of another's fraud.[30] Judge Hughes concluded that circumstantial evidence, in the form of the traditional badges of fraud, should be utilized in this inquiry.[31] As explained by the court, its use of traditional badges of fraud is supported by the long-standing usage of the badges (dating back to the Statute of Elizabeth), the fact that they are found in the Uniform Fraudulent Transfer Act, and the fact that they fit nicely into an analysis of the recipient's own culpability.[32] Accordingly, in order to "successfully assert good faith under either Section 548(c) or 550(b)," a transferee must establish that "he [or she] conducted himself appropriately as various badges of fraud came to his [or her] attention."[33] Because the *Teleservices* court applied the good-faith standard sub-

10 *Id.* at 796.
11 *Id.* at 797.
12 *Id.* at 797-99.
13 *See supra* n. 5.
14 *Teleservices*, 444 B.R. at 799; 916 F.2d 528 (9th Cir. 1990).
15 *Teleservices*, 444 B.R. at 800.
16 84 F.3d 1330 (10th Cir. 1996).
17 67 F.3d 1348 (8th Cir. 1995).
18 213 U.S. 23 (1909).
19 227 U.S. 575 (1913).
20 242 U.S. 438 (1917).
21 *Teleservices*, 444 B.R. at 802.
22 *Id.*
23 *Id.* at 803.
24 *Id.*
25 *Id.* at 806.
26 *Id.*
27 *Id.* (citing seven Supreme Court opinions).
28 *Id.* at 807-8.
29 *Id.* at 808-11.
30 *Id.* at 813.
31 *Id.*
32 *Id.* at 813-14.
33 *Id.* at 815.

jectively, the test is not "how well Huntington measured up against what others in the community might have done in its stead. Rather, Huntington's conduct is to be tested based upon its own honesty and integrity—*i.e.*, its good faith—as it became aware of more and more indicators of Teleservices' fraud upon its creditors."[34]

Understanding that issues may arise when analyzing a defendant's awareness (even with the assistance of the badges of fraud), the *Teleservices* court noted that something short of actual knowledge will suffice: "willful blindness."[35] The court does take one page from *Bayou III*, but only as it relates to willful blindness:

> It is well settled that a transferee may not remain willfully ignorant of facts that would cause it to be on notice of a debtor's fraudulent purpose and then put on blinders prior to entering into a transaction with the debtor and claim the benefit of Section 548(c)'s good faith defense.[36]

Applying the legal standards so thoroughly set forth and analyzed earlier in the opinion, the *Teleservices* court proceeded to apply facts associated with three time periods of Huntington's relationship with Cyberco and Teleservices. With respect to transfers received early in the relationship, the court found that Huntington was afforded the good-faith defense.[37] The court found good faith, despite the fact that during this time period, the bank had discovered that funds were not properly flowing through the lockbox,[38] they had not received, as required, audited financials in a timely matter as required,[39] they noted in internal emails the existence of "red flags"[40] and they asked Cyberco to find a new lender. In the spirit of a true subjective good-faith standard, the court noted that "Huntington's response was by no means perfect," but that it was clear that they were unaware of the fraud being perpetrated, and that they were not turning a blind eye.[41]

The *Teleservices* court next looked to the facts surrounding the end of Huntington's relationship with Cyberco and found the good-faith defense to be inapplicable because Huntington was clearly turning a blind eye.[42] During this time period, they had received subpoenas from the Federal Bureau of Investigation (FBI) related to their investigation of Cyberco, and bank employees in emails referred to the situation as "sticky" and wrote to "keep your fingers crossed."[43] The court concluded that during this time, Huntington may not have actually known of the fraud, but at that time its only concern was to be paid: it was "turning a blind eye to information which, if pursued, would have quickly led it to that conclusion."[44]

Finally, the court examined a time in between the first and second periods where Huntington asked one of their security personnel to investigate, and that person uncovered that Cyberco's principal was a convicted felon (related to previous fraudulent acts) and that there was a pending FBI investigation.[45] For seemingly unknown reasons, the security official kept this highly pertinent information to himself, failing to notify key loan officers.[46] The court refers to this as "pivotal" and "unfortunate."[47] As a consequence, for monies received after this security personnel's discovery (which the court imputed to the bank), there could be no good-faith defense.[48]

Conclusion

Juxtaposing the court's decisions regarding these three time periods provides even more clarity with respect to subjective good faith. First, if a transferee is diligent enough with its inquiries so that it is not deemed to have turned a blind eye, but by inquiring it does not actually discover the fraud, it will be found to have acted in good faith. According to the *Teleservices* court, it does not matter that another more diligent bank would have acted differently (*i.e.*, the objective standard). Second, where a transferee does not actually discover the fraud, but turns its blinders on in an attempt not to discover the fraud, it will not have acted in good faith. Finally, if a transferee actually discovers the fraud, does nothing and continues to receive transfers, it will not have a good-faith defense with respect to those transfers.[49] **abi**

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34 *Id.*
35 *Id.* at 814.
36 394 B.R. at 994 (cited in *Teleservices* at 814).
37 *Teleservices*, 444 B.R. at 818.
38 *Id.* at 775.
39 *Id.* at 780.
40 *Id.*
41 *Id.* at 819.
42 *Id.* at 821-25.
43 *Id.* at 821.
44 *Id.* at 824.
45 *Id.* at 825-30.
46 *Id.* at 825-26.
47 The facts regarding the security personnel's knowledge added another $17,811,998.82 in transfers for which Huntington was liable. *Id.* at 830.
48 *Id.*
49 *See* the Court's helpful summary of its findings, *id.* at 843-44.