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2009 Volume I No. 22

A Prime Brokers Good Faith Defense to Fraudulent Transfers

Michael Maffei, J.D. Candidate 2010

The exposure of Madoff Ponzi scheme, and others like it, will undoubtedly have an impact on the way that bankruptcy courts deal with fraudulent transfers to prime brokers, particularly the degree to which the prime broker on inquiry notice of fraud must act with diligence. Due to the recent economic tumult, the number of bankruptcies is continually growing. Another result of the economic decline is that a large number of investment funds have failed. After these funds failed, many prime brokers discovered that some of the funds were not operating funds at all. They were in fact Ponzi schemes.

As these funds begin to file for bankruptcy, prime brokers may try to avoid severe losses themselves by retaining the value of early fraudulent transfers they received from the funds. Part one of this discussion will present a description of Ponzi schemes and how these schemes make fraudulent transfers to prime brokers. Part two will be an overview of how bankruptcy proceedings deal with fraudulent transfers under section 548 of title 11 of the U.S. Code, 11 U.S.C. §§101-1532 (collectively the Bankruptcy Code). Part three will focus on an exception to fraudulent transfers under section 548(c) of the Code based on good faith. Finally, part four will provide a discussion of a recent case, which when decided provided a less stringent good faith exception to prime brokers but now seems to be an isolated exception to the rule.

Cite as: *A Prime Brokers Good Faith Defense to Fraudulent Transfers*, 1 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 22, at 1 (2009), http://www.stjohns.edu/academics/graduate/law/journals/abi/sjbrl_main/volume/v1/Maffei.stj (follow "View Full PDF").

I. FRAUDULENT TRANSFERS FROM A PONZI SCHEME TO A PRIME BROKER

A fraudulent transfer occurs when funds, procured by fraud, are transferred from a Ponzi scheme to a prime broker. Ponzi schemes by their very definition are fraudulent. Black's Law Dictionary defines it as "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments." (8th ed. 2004). Courts have determined that intent to defraud is always present in a Ponzi scheme. In fact fraud is the only possible outcome of a Ponzi scheme,

> One can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. Indeed no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a certainty constitutes intent in the eyes of the law.

In re Independent Clearing House Co., 77 B.R. 843, 860 (D.Utah 1987). Prime brokers and brokerage houses are the recipients, or transferees, of fraudulent transfers from these Ponzi schemes. This commonly occurs when the prime broker receives and controls money transferred from the Ponzi scheme investment fund to create accounts at the brokerage and purchase stock for the fund through these prime brokers. For the purposes of a bankruptcy proceeding, the bankrupt and exposed Ponzi scheme investment fund is the debtor, the funds investors are the creditors, and the prime broker takes on the role of the transferee.

II. FRAUDULENT TRANSFERS AS CONTROLLED BY THE BANKRUPTCY CODE

In a bankruptcy proceeding, fraudulent transfers are controlled by section 548 of the Code. Section 548(a)(1) provides that, "[t]he trustee may avoid any transfer of an interest of the debtor

in property, or any obligation incurred by the debtor, that was made or incurred within 2 years before the date of the filing . . . .” 11 U.S.C. §548(a)(1). The transfer that the trustee seeks to avoid must have been made by the debtor “with actual intent to hinder, delay, or defraud any entity to which the debtor was . . . indebted.” 11 U.S.C. §548(a)(1)(A). The effect of this section is to prevent parties from dispersing to third parties money and property that would otherwise be available to creditors in a bankruptcy proceeding. In the case of Ponzi schemes, this section prevents the person operating the scheme from spending all the secondary investors’ money to pay off initial investors a high return to encourage future investment. It also protects a creditor from a debtor disbursing property and interests of value for nothing or less than reasonably equivalent value to third parties (11 U.S.C. §548(a)(1)(B)). An example of this type of disbursing would be a Ponzi scheme operator who sends funds, invested by defrauded creditors, to his or her family members in an attempt to insulate the value of those funds from creditors in an inevitable bankruptcy proceeding.

III. THE GOOD FAITH EXCEPTION TO FRAUDULENT TRANSFERS

However, under section 548 of the code, a transferee (or recipient) of a fraudulent transfer may be able to keep the value it received from the debtor if the transferee falls under the good faith exception. This exception is explained in section 548(c) of the code which states,

> a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

(11 U.S.C. §548(c)) Simply put, the Code allows a transferee who is in good faith, or unaware of the fraudulent intent of the debtor, to retain any value he or she received from the debtor to extent that he or she gave the debtor something in return. The burden of proving good faith is on

the transferee. *See In re Actrade Fin. Tech. Ltd.*, 337 B.R. 791 (Bankr. S.D.N.Y. 2005). What section 548 lacks is a definition of what good faith is. Due to the lack of a concrete definition in the Code, it has been left to the courts to determine what exactly a good faith transferee is.

The courts have widely accepted that there is no precise definition or bright line rule of what constitutes good faith under section 548(c). The lack of a clear-cut definition has been widely acknowledged by the courts. The absence of a precise definition was recognized by the First Circuit in *In re Roco,* 701 F.2d 978, 984 (1st Cir. 1983), when the court acknowledged that "the good faith requirement here is not susceptible of precise definition." The Ninth Circuit also acknowledged the lack of a precise definition of good faith when that court found a lack of good faith, "[n]otwithstanding the lack of a precise definition." *In re Agricultural Research and Technology Group, Inc*., 916 F.2d 528, 536 (9th Cir. 1990). In the absence of a bright line rule, different courts have taken different approaches in analyzing what constitutes good faith. *See In re Independent Clearing House Co.,* 77 B.R. at 861 (reviewing the various approaches taken by courts in determining what constitutes good faith).

The analysis most commonly applied by courts examining good faith is a two-part objective test that focuses on inquiry notice and diligent investigation. The first application of this two part test came in 1894 when the Supreme Court, in examining a fraudulent transfer, stated,

> knowledge or actual notice of circumstances sufficient to put him, as a prudent man, upon inquiry as to whether his brother intended to delay or defraud his creditors, and he omitted to make such inquiry with reasonable diligence, he should be deemed to have notice of such fact, and therefore such notice as would invalidate the sale to him.

(*Shauer v. Alterton*, 151 U.S. 607, 621 (1894)) This two part test was applied and explained in an opinion of the Ninth Circuit in 1990. When analyzing whether the transferee acted in good faith, the court stated that "courts look to what the transferee objectively 'knew or should have known'

in questions of 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, then the transfer is fraudulent." *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d at 535-36 (citations omitted in original).

The courts' application of the inquiry notice and diligence test has traditionally been very strict. Strict application inquiry notice allows the circumstances of a transfer, independent of any actual knowledge of fraud or even any suspicion of fraud on the part of the transferee, to serve as evidence of the transferee's knowledge of fraudulent intent. The idea that existing circumstances can impute knowledge of debtor's fraud on a transferee was seemingly well settled in case law. Case law on the subject even went so far as to say that willful ignorance of facts that would put a transferee on notice, acting like horse with blinders or an ostrich with its head in the sand in fear of fraud, will deny the transferee the protection of the good faith exception. *See In re Model Imperial, Inc.*, 250 B.R. 776, 798 (Bankr. S.D.Fla. 2000) (stating that a good faith defense is invalid where circumstances would put transferee on notice of fraud); *see also In re Cannon*, 230 B.R. 546, 592 (Bankr.W.D.Tenn.1999) (holding that a transferee cannot enter into a transaction with debtor with blinders on and claim good faith). Transfers would no longer be protected by the good faith defense if the transferee had inquiry notice of the fraud, unless due diligence was done by the transferee to confirm or rule out actual fraud. If on inquiry notice, the degree of diligence required of the transferee to sustain a good faith defense has been very high, suggesting close scrutiny of the future debtor's financial history. *See In re World Vision Entertainment, Inc., 275* B.R. 641, 659-60 (Bankr.M.D.Fla. 2002)

IV. *MANHATTAN INVESTMENT FUND LTD v. GREDD*: A RECENT APPLICATION OF THE GOOD FAITH EXCEPTION

Recently, a much more relaxed view of inquiry notice and diligence was taken by the court in *Manhattan Investment Fund Ltd. v. Gredd* (*In re Manhattan Inv. Fund Ltd.*), 397 B.R. 1 (S.D.N.Y. 2007). In *Gredd,* the court held that Bear Stearns, the prime broker for a Ponzi scheme holding itself out as a hedge fund, was on inquiry notice for over a year but that its diligence (which never discovered the fraudulent nature of the fund) may have been sufficient to establish a good faith defense. The court remanded for a determination of good faith. This case was decided on December 17, 2007 and at the time seemed to send a message, namely that it is acceptable for prime brokers to continue to deal with funds for which they have inquiry notice of fraud as long as they are diligent in investigating that fund and do not achieve actual knowledge of fraud. To understand why test of inquiry notice and diligence applied by the *Gredd* court is less stringent, it is important to know what the exact facts considered by the court in making their determination.

The facts of the *Gredd* case are rather straightforward. The trustee in *Gredd* was seeking to avoid $141 million in fraudulent transfers of funds by the Manhattan Investment Fund, a Ponzi scheme (the Fund), to Bear Stearns. The funds that were transferred by the Ponzi scheme were to maintain a margin account with Bear Stearns. These funds could be used at Bear Stearns discretion, making Bear Stearns a transferee of the funds. The $141 million that the trustee was seeking to recover was the total transfers for one year prior to the Manhattan Investment Fund's collapse and bankruptcy. The fund collapsed because it was reported to the SEC by Bear Stearns in December 1999, one year after Bear Stearns first became suspicious of the fund. In December 1998 at a cocktail party a managing director of Bear Stearns, Fredrik Schilling, spoke with an investor who said the fund was posting a 20% profit. This was news to Shilling, who believed

the Fund was losing money. The next day Shilling spoke to others at Bear Stearns and learned that the Fund had lost between $150 and $200 million in 1998. This fact was not disclosed to the investor he spoke with do to confidentiality concerns, but Schilling did tell the investor to send him a writing request for information, which Schilling passed to the Bear Stearns legal department. Bear Stearns then interviewed the Fund's manager. It accepted the Fund's manager's explanation that the inconsistency arose from the Fund's use of at least eight prime brokers. Next, Bear Stearns contacted the Fund's auditor which reported no problems with the Fund as of the spring of 1999. Finally, in December 1999, Bear Stearns learned that it was the lone prime broker and that it had been lied to. It was at this point that Bear Stearns reported the Fund to the SEC. *In re Manhattan Investment Fund*, 397 B.R. at 2-3.

From these facts, the Bankruptcy Court concluded that Bear Stearns was on inquiry notice of the fraud and that no rational trier of fact could conclude that Bear Stearns acted diligently. In drawing this conclusion and granting summary judgment, the Bankruptcy Court considered that the fact that had the fund done in December of 1998 what it did in December of 1999, it could have discovered the fraud an entire year earlier. *See Gredd v. Bear Stearns Securities, Corp*., (*In re Manhattan Investment Fund Ltd.),* 359 B.R. 510, 526. Aside from this lack of timeliness, the Bankruptcy Court also did not find Bear Stearns acceptance of the Fund's manager's explanation reasonable, holding that "Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong." *Id*. It was based on these reasons that the Bankruptcy Court held that Bear Stearns did not act with sufficient diligence to carry their burden and prove good faith.

The District Court hearing Bear Stearns appeal did not agree with the Bankruptcy Court's decision. The District Court agreed with the bankruptcy court that Bear Stearns was on inquiry

notice as of December 1998 when the issue first came to Schilling's attention. However, the District Court held that there was sufficient evidence that Bear Stearns' actions could lead a trier of fact to conclude that it had acted with the necessary diligence to satisfy good faith. *In re Manhattan Investment Fund*, 397 B.R. at 26. However, in its opinion the District Court cites what it calls "proactive efforts" that show diligence and good faith and in the same paragraph says, "[i]t is undisputed that what Bear Stearns did next . . . was diligent." *In re Manhattan Investment Fund*, 397 B.R. at 25. Based on these proactive efforts that were taken by Bear Stearns, the District Court found that an issue of material fact existed.

A closer examination of the District Court's decision shows that there was a clear departure from the accepted analysis of good faith. The District Court's analysis did not look to what the "transferee objectively 'knew or should have known." *In re Agricultural Research and Technology Group, Inc*., 916 F.2d at 536. Bear Stearns knew of inconsistencies in the Fund for a year before it reported the Fund. The first thing that Bear Stearns learned about the Fund was the smoking gun: the Fund was telling investors of large profits (20%) when Bear Stearns believed the Fund to be losing money. Bear Stearns confirmed that the fund had lost money. It continued to maintain accounts for the Fund because the manager of the Fund told Bear Stearns that they were not the only prime broker and that's why there was a discrepancy. It was at this point-shortly after the cocktail party in December 1998, when Bear Stearns learned of the inconsistency that Bear Stearns should have investigated to determine whether if this explanation was true. Bear Stearns should have known the truth at this point but did not. It was not until months later in December of 1999 that Bear Stearns finally learned that it had been lied to by the Fund manager and that it was in fact the sole prime broker. Knowing that they had been lied to, Bear Stearns reported the Fund to the SEC and stopped accepting transfers. The District Court's

view allows for a transferee to put on "blinders" (*In re Cannon*, 230 B.R. at 592) and seemingly allows a transferee to accept transfers while on inquiry notice right up to the point of acquiring actual knowledge. This was a clear departure from the accepted standard.

Had the District Court applied a strict application of the good faith analysis, it is unlikely that it would have reversed the bankruptcy court's grant of summary judgment. There was sufficient evidence that Bear Stearns should have known of the fraud. Under the traditional good faith analysis, what the transferee should have known for the circumstances and if diligent inquiry would reveal the fraud, is enough to deny good faith. The *Gredd* case seems to be the exception to this rule. From the record, there was ample evidence, from the end of 1998 on, that there was a problem with the Fund. On top of the problems with the Fund, Bear Stearns did not even try to corroborate the excuses the Fund's manager was giving them. It is unlikely that a trier of fact would find Bear Stearns to have acted in good faith.

Unlike the District Court in *Gredd*, courts examining the good faith exception claimed by recipients of transfers from Ponzi schemes in the future will likely apply the traditional strict test of inquiry notice and diligence. It is unlikely that courts in the current economic climate are going to be very forgiving to prime brokers going forward. The loose view taken by the *Gredd* court will likely be an isolated event. With the economic world as well as the general public now aware of the scale and scope of hedge funds posing as Ponzi schemes, it is highly unlikely that any court will ever allow such a lax interpretation of diligence once there is inquiry notice. It is more probable that the traditional strict test of the good faith exception will become even stricter, requiring not just diligent inquiry but active oversight of funds that raise suspicion. Courts will no longer accept arguments from brokers who will claim they have no reason to know or should not have known from the circumstances. The economic climate as it exists today is one of

distrust on a large scale. In the future that should translate into inquiry notice being found from even the slightest inconsistency and diligence being established by the most vigilant oversight possible. The *Gredd* decision is the last remnant of a happy go lucky economy that was living in blissful ignorance.