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Second Circuit Applies Federal Bankruptcy Law, Not Securities Law, in Madoff SIPA Liquidation

September 2, 2021

"[L]ack of good faith in a SIPA [Securities Investor Protection Act] liquidation applies an inquiry notice, not willful blindness, standard, and that a SIPA trustee does not bear the burden of pleading the transferee's lack of good faith," held the U.S. Court of Appeals for the Second Circuit on Aug. 30, 2021. *In re Bernard L. Madoff Investment Securities LLC,* 2021 WL 3854761, 91 (2d Cir. Aug. 30, 2021) ("Madoff"). Reversing the district court's imposition of federal securities law in this fraudulent transfer action, the Second Circuit applied federal bankruptcy law when holding that good faith is an affirmative defense under sections 548(c) and 550(b)(1). It rejected the district court's requiring the trustee to "bear the burden of pleading the transferee's lack of good faith," *id*., at *17, refusing to depart "from the well-established rule that the defendant bears the burden of pleading an affirmative defense." *Id*. at 57.

The *Madoff* decision makes the following essential points:

- A SIPA liquidation is to be conducted like a Chapter 7 bankruptcy liquidation;
- The federal securities laws do not apply in a SIPA liquidation;
- Federal bankruptcy law, not securities law, governs fraudulent transfer litigation in a SIPA liquidation (" … no reason to depart from the meaning of the good faith defense under [Code] Section 548 and 550 as it is applied in an ordinary bankruptcy [case]."). 2021 WL 3854761 at *15.
- " … SIPA does not compel departing from the well-established burden-of-pleading rules … [meaning that] the initial or subsequent transferee bears the burden of pleading good faith." *Id*.
- "[P]lacing the burden to plead good faith on the initial and subsequent transferees does not contradict the goals of SIPA." *Id*., at *18.

Relevance

The appellate courts have been wrestling with the good faith issue in fraudulent transfer litigation over the past 20 years. *See Janvey v. GMAG* LLC. 977 F.2d 422, 428 (5th Cir., 2020) (reversed district court's judgment in favor of defendants who received fraudulent transfer "while on inquiry notice of a Ponzi scheme."; "good faith defense must fail" because defendants never "diligently investigated their initial suspicions of [debtor's] fraud while on inquiry notice."; receiver's suit brought under Texas Uniform Fraudulent Transfer Act ("TUFTA"), not under Bankruptcy Code § 548, which "is not necessarily substantively congruent with state law counterparts, despite a common ancestry."; Texas Supreme Court had answered certified question from Fifth Circuit that "transferee on inquiry notice [had] to conduct an investigation into the fraud, ... irrespective of whether a hypothetical investigation would

reveal fraudulent conduct."; but Fifth Circuit left 'for another day ... what actions a party must take to show that [it] diligently investigated fraud for the purposes of a TUFTA good faith defense."); *Templeton v. O'Cheskey*, 785 F.3d 143,164(5th Cir. 2015) (in Code § 548 suit, transferee may "rebut" proof of inquiry notice by showing that it "conducted a 'diligent investigation' into [its] suspicions"), citing *In re Bayou Group LLC*, 439 B.R. 284, 314-15 (S.D.N.Y. 2010) (reversing bankruptcy court, held that information suggesting mere "infirmity in [debtor) or in integrity of its management" is insufficient to trigger inquiry notice; "the great weight of authority holds that it is information suggesting insolvency or a fraudulent purpose in making a transfer that triggers inquiry notice," but an investigation may not be required if the transferee can establish that a diligent investigation would not have uncovered debtor's insolvency or a fraudulent purpose; "a transferee is entitled to offer evidence and to argue to the finder of fact that no diligent investigation would have disclosed the transferor's insolvency or fraudulent purpose. If the transferee can meet its burden of demonstrating that a diligent investigation would not have led to the discovery of the fraud, it may prevail on this prong of the good faith affirmative defense."); *Gold v. First Tenn. Bank Nat'l Ass'n (In re Taneja)*, 743 F.3d 423 (4th Cir. 2014) (applying good faith test under section 548(c); bank officers had expert knowledge of industry and investigated collateral for debtor's mortgages; market-wide economic conditions hindered officers' ability to detect underlying fraudulent conduct by debtor; lender established good faith under both (a) subjective and (b) objective standard by having neither (1) actual knowledge of fraud nor (2) " information that would [reasonably] have led it to investigate further"; its actions "were in accord with [its] and the industry's usual practices"); *In re Hannover Corp*., 310 F.3d 796, 800 (5th Cir. 2002) (independent third party unaffiliated with debtors acted in good faith when it accepted payments from debtors on contract that had been negotiated at arms-length; transferee's "state of mind" important; no way of learning of debtor's insolvency; knew of SEC suit from newspapers, but "undertook its own investigation, contacting the SEC and the ... court ... receiving assurances ... from the ... court ... .").

Facts

The trustee sued the initial transferee ("A") who received $212 million from Madoff and three subsequent transferees (collectively, "B") for roughly $350 million. The initial transferee, A, was a so-called "feeder fund," a firm that "pooled money from investors and invested directly (or indirectly) with [Madoff]." 2021 WL 3854761, at *1. The subsequent transferees here were investors with the feeder fund who withdrew money from the fund, after the fund "received" it from Madoff. *Id*.

Madoff "was a sham." *Id*., at 2. "It sent its customers account statements with fabricated returns; in actuality, it was making few, if any, trades … . The customers' funds were co-mingled in [Madoff's] bank account. When customers withdrew their profits or principal, [Madoff] paid them from this co-mingled account. As a result, each time [Madoff] transferred payments to a customer, it was money stolen from other customers." *Id*.

The Madoff SIPA liquidation was "conducted ... as though it were being conducted under … chapter 7 of [the Code]." *Id*. at 3, quoting 15 U.S.C. § 78 (fff)(b). Because customer claims could not be paid in full, the SIPA trustee was empowered to "recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Code]." *Id*., quoting 15 U.S.C. §78(fff)-2(c)(3).

The trustee sued the defendants here "because, as alleged, [Madoff] made fraudulent transfers to them, which are voidable under [Code] §548." *Id*., at *4. According to the trustee, he could also "recover those

transfers under [Code] §550 from subsequent transferees and [the] initial transferee… unless they took the transfers for value and in good faith," under Code §§548(c) or 550(b)(1) *Id*. The Second Circuit explained that §550(b)(1) provides "'a complete defense to recovery of the property transferred,' whereas under §548(c), 'the transaction is still avoided, but the transferee is given a lien to the extent that value is given in good faith.'" *Id*., citing 5 Collier, Bankruptcy ¶ 548.09 (16th ed. 2021).

The Subsequent Transferees. According to the trustee's proposed amended complaint, the subsequent transferees, B, who received repayment of loans, had "uncovered facts suggesting that [Madoff] was engaged in fraudulent activity." *Id*. Specifically,

- B was "unable to independently verify that [Madoff] maintained segregated customer accounts, or even that the assets existed in any account";
- B was "unable to find any evidence that [Madoff] was in fact making the options trades it was reporting to its customers";
- B's "quantitative analysis" showed that Madoff's "returns outperformed the market in a manner that appeared statistically impossible";
- B "knew [Madoff] lacked an independent custodian for its customers' assets, giving [Madoff] sole control over customers' funds and making it more likely [Madoff] could steal or misuse those funds"; and
- B "was unable to confirm Madoff's purported options trades."

Id., at *4-*5. As a result of these facts, among others, the trustee argued that B received payments "when [it was] willfully blind to circumstances suggesting the high probability of fraud at [Madoff]." *Id*. at *5.

The Initial Transferee. The initial transferee, A, was "suspicious" of Madoff's returns and analyzed Madoff's "purported investment strategy" and "produced a report" that showed the following:

- "The market could not support the options volumes [Madoff] purported to trade";
- "Many of Madoff's trades were at improbable prices, and … there was no footprint of its trades"; and
- A later investigation "confirmed that the trades were 'statistically impossible' and revealed that [Madoff] lacked a capable auditor and the staff necessary to conduct research on [Madoff's] investment opportunities."

Id., at *5. Again, the trustee sought to recover the initial transfers because A received payments with "willful blindness to circumstances suggesting a high probability of fraud at [Madoff]." *Id*.

The Lower Courts

The defendants successfully moved to withdraw the litigation from the bankruptcy court to the district court under 28 U.S.C. §157(d) (withdrawal proper if "resolution of the proceeding requires consideration of both [the Code] and other [federal] laws … regulating organizations or activities affecting interstate commerce."). *Id*., at *6. A and B had asked the district court to determine whether "SIPA and other

securities laws alter[ed] the standard the [trustee] must meet in order to show that a defendant did not receive transfers in 'good faith' under either [Code sections] 548(c) or … 550(b)." *Id*.

The district court "made two rulings on the 'good faith' defense. *Id*. It first required "a showing that the defendant acted with *willful blindness* to the truth, that is, he intentionally chose to blind himself to the red flags that suggest a high probability of fraud." *Id*. When doing so, it "rejected applying an *inquiry notice* standard, 'under which a transferee may be found to lack good faith when the information the transferee learned would have caused a reasonable person in the transferee's position to investigate the matter further.'" *Id*.

The district court also held that, in a SIPA liquidation, "the trustee bears the burden of pleading the defendant's lack of good faith." *Id*. It acknowledged, though, that in an ordinary bankruptcy case, "the defendant bears the burden of pleading this affirmative defense under both Section 548(c) and Section 550(b)(1)." *Id*.

On remand from the district court, the bankruptcy court dismissed the claims against both transferees and held the trustee's proposed amended complaint did "not plausibly allege willful blindness." *Id*. Still, the bankruptcy court also allowed the trustee to seek "to avoid and recover fictitious profits transferred to [A], payments it received in excess of its principal." *Id*., at n.13.

Relevant Standard for Defendants' Good Faith Defense. The Second Circuit explained the substantive differences when defining "good faith" in a SIPA liquidation or bankruptcy case. "[A] willfully blind defendant is one who takes *deliberate* actions to avoid confirming a *high probability* of wrongdoing *and who can almost be said to have actually known the critical fact*s." *Id*. at 21, quoting *Global-Tech. Appliances, Inc. v. SEB S.A*., 563 U.S. 754, 769 (2011) (emphasis added). In contrast, inquiry notice only "requires knowledge of suspicious facts that need not suggest a 'high probability' of wrongdoing but nonetheless sufficient to induce a reasonable person to investigate." *Id*., at 7, citing *Merck & Co. Inc. v. Reynolds*, 559 U.S. 633, 650-51 (210).

The district court held that "the inquiry notice standard for good faith applicable under the… Code 'must yield' to the willful blindness standard for good faith required under the securities laws." *Id*. It reasoned that the inquiry notice standard, applied in bankruptcy cases, "would impose a burden of investigation on investors totally at odds with the investor confidence and securities markets stability that SIPA is designed to enhance." *Id*., at 22.

The Second Circuit's Analysis

Code §§ 548(c) and 550(b) Apply an Inquiry Notice Standard. The court joined "all of our sister circuits that have addressed the issue in holding that a lack of good faith under Section 548 and 550 of the… Code encompasses an inquiry notice standard." *Id*. at *12. It relied on the "historical usage of the phrase 'good faith' (… in the context of fraudulent [transfer] law)," Second Circuit precedent, and the "the legislative history of the… Code" to "reject the heightened willful blindness standard" applied by the district court and relied upon by the defendants. *Id*. According to the Second Circuit, "a court must examine what facts the defendant knew; … determine whether these facts put the transferee on inquiry notice of the fraudulent purpose behind a transaction [and] would have led a reasonable person in the transferee's position to conduct further inquiry into a debtor-transferor's possible fraud." After finding the transferee's having been "put on inquiry notice, the court must inquire whether 'diligent inquiry [by the transferee] would have discovered the fraudulent purpose' of the transfer." *Id*.

No Willful Blindness Standard for Lack of Good Faith in a SIPA Liquidation. The Second Circuit rejected the "district court's theory… that SIPA prohibits the trustee from utilizing the inquiry notice standard under the… Code because it is inconsistent with the willful blindness standard under federal securities laws." *Id*. First, a SIPA liquidation case must be "conducted in accordance with, and as though it were being conducted under [the Code]." *Id*., quoting 15 U.S.C. § 78fff. Therefore, the "general fraudulent intent requirement in the [securities law] is irrelevant to the *specific* context of a SIPA liquidation." *Id.* at *13. "A § 10(b) action for securities fraud is meaningfully different from a SIPA liquidation." *Id*. And the securities laws do not "prescribe a uniform willful blindness requirement." *Id*. at *14.

Nor is the "inquiry notice standard… 'unworkable' and contrary to SIPA goals," as the district court reasoned. *Id*. A transferee's "duty to conduct a diligent investigation arises *only* when a transferee is actually aware of suspicious facts that would lead a reasonable investor to inquire further into a debtor-transferor's potential fraud." *Id*. This requirement is "not overly burdensome on the customers and indirect investors of broker-dealers." *Id*. Whether an investigation is adequate requires "a fact-intensive inquiry to be determined on a case-by-case basis, which naturally takes into account the disparate circumstances of differently situated transferees," something the courts "routinely conduct… without a hitch." *Id*., citing *Janvey v. GMAG LLC*, 977 F.3d 422, 428 (5th Cir. 2020) (no diligent inquiry after being put on inquiry notice).

The Trustee Was Not Required to Plead a Transferee's Lack of Good Faith. The Second Circuit rejected (a) the district court's requiring the trustee to plead lack of good faith and (b) B's denial that "good faith is an affirmative defense under Code § 550." *Id*. at *15. Although Code §§ 548 and 550 "are silent on the pleading burden," courts have "uniformly… held good faith is an affirmative defense under these sections." *Id.*, citing *Picard v. Gettinger*, 976 F.3d 184, 190 (2d Cir. 2020). Once a trustee establishes a *prima facie* case under the fraudulent transfer provisions, the trustee may recover unless the transferee establishes an affirmative defense. *Id*. The defendant transferee "bears the burden of establishing its good faith [affirmative defense] under [Code] § 548(c)." *Id*.

Because "good faith" addresses "the transferee's knowledge of suspicious facts and other information 'peculiarly within the knowledge and control of the defendant, [that fact] supports the allocation of the pleading burden on the defendant-transferee." *Id*. at *17. In view of the "structural similarity of § 552 to § 548, the case law, and the legislative history, … the transferee has the burden to show that it took (1) for value, (2) in good faith [, and (3) without knowledge of the voidability of the transfer." *Id*. at *18, quoting 5 Collier, *Bankruptcy* ¶ 550.03 (16th ed. 2021).

Finally, "placing the burden to plead good faith on the initial and subsequent transferees does not contradict the goals of SIPA." *Id*. The district court's "requiring the trustee to plead the transferee's *lack* of good faith would do more to hinder SIPA's goal of distributing customer property 'as promptly as possible after the appointment of a trustee' by delaying the trustee's actions to recover the property." *Id*.

Remand for Trial. The Second Circuit vacated the dismissal of the trustee's suit and remanded the litigation for trial. Given the detailed facts in the trustee's proposed amended complaint, the defendants will have an uphill battle. They will have to argue that had they conducted an investigation, they would have been unable to complete it because of Madoff's active concealment of his fraud. *See*, e.g., *Bayou Group*, 439 B.R. 284, 314-15 (S.D.N.Y. 2010) (no diligent investigation would have disclosed transferor's

insolvency or fraudulent purpose); *Hanover Group*, 310 F.3d 796, 800 (5th Cir 2002) (no way of learning of debtor's insolvency).

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