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District Court Adopts Subjective Good Faith Defense for Fraudulent Transfer Claims in SIPA Case

Michael L. Cook, Harry S. Davis, and Michael Court*

The authors review a court decision that has practical significance to investors, funds of funds and investment managers concerned about threatened and pending suits from the trustees of failed securities firms.

The U.S. District Court for the Southern District of New York, on April 27, 2014, issued a decision directing the bankruptcy court to dismiss fraudulent transfer complaints brought by the *Madoff* Securities Investor Protection Act of 1970 ("SIPA") trustee against investment funds, their customers and individuals when the trustee failed "plausibly [to] allege that defendant[s] did not act in good faith."[1] According to the court, absent "particularized allegations" plausibly showing bad faith, a bankruptcy trustee in a SIPA case "cannot make out a plausible claim that he is entitled to recover the monies defendants received from their securities accounts."

RELEVANCE OF CASE

This decision has practical significance to investors, funds of funds and investment managers concerned about threatened and pending suits from the trustees of failed securities firms. It has broader implications beyond SIPA cases, potentially affecting all fraudulent transfer cases in the context of alleged Ponzi schemes in the securities markets when bankruptcy trustees seek to recover pre-bankruptcy transfers from investment accounts.

FACTS

The defendants were funds or individuals who had invested directly or indirectly through Bernard L. Madoff Investment Securities LLC ("Madoff Securities"). They moved to dismiss the trustee's fraudulent transfer complaint against them in the bankruptcy court. The motions ended up in the district court to resolve a potential conflict between bankruptcy law and the securities laws.[2]

Following the revelation of Madoff's fraudulent scheme, the Securities Investor Protection Corporation ("SIPC") appointed a trustee under 15 U.S.C. §§ 78aaa–78lll to administer the liquidation estate of Madoff Securities. Each of the

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[1] *SIPC v. Bernard L. Madoff Inv. Sec. LLC* (S.D.N.Y. April 27, 2014).

[2] *SIPC v. Bernard L. Madoff Inv. Sec. LLC* (S.D.N.Y. June 26, 2012).

investors who were defendants in fraudulent transfer cases brought by the trustee had invested through Madoff Securities (some directly and some indirectly) and had withdrawn monies from their accounts over the years before the Madoff fraud had become public. In doing so, these investors had withdrawn both invested capital and purported profits. The SIPA trustee sought to recover those withdrawals from redeeming investors for the benefit of Madoff investors who had not redeemed their investments, relying on the Bankruptcy Code's ("Code") fraudulent transfer provision, Section 548.

FRAUDULENT TRANSFER CLAIM

Under Code § 548(a)(1)(A), the trustee can avoid a transfer of the debtor's property if the *debtor* made that transfer "with actual intent to hinder, delay or defraud" creditors.[3] Transferees can, however, defeat a fraudulent transfer action by asserting the "good faith" affirmative defense under Code § 548(c) and proving that they gave "value" in exchange for the transfer "in good faith." A trustee can also sue a subsequent transferee of the debtor's property under Code § 550(a)(2), subject again to the defense that the transfer was "in good faith."[4] The Code does not define "good faith" in this context, but courts generally have held that the test for "good faith" is an objective one, thereby making it difficult to establish that defense short of trial.[5]

ANALYSIS

Central Issues

The central issues in *Madoff* were whether:

(1) SIPA "alter[ed] the standard the Trustee must meet in order to show that a defendant did not receive transfers in 'good faith'"; and

(2) whether a defendant in a fraudulent transfer suit brought in the context of a SIPA case could prevail on a good faith defense through a motion to

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[3] In addition to "actual fraud," Code § 548(a)(1)(B) authorizes a trustee to seek to avoid a "constructively" fraudulent transfer, but the trustee made no such claim here.

[4] Code § 550(b)(1).

[5] *See, e.g.*, *In re Bayou Grp., LLC*, 439 B.R. 284, 313 (S.D.N.Y. 2010) (holding that "[a]n objective, reasonable investor standard applies to both the inquiry notice and the diligent investigation components of the good faith test"); *In re Thakur*, 498 B.R. 410, 421 (S.D.N.Y. 2013) ("[t]he bankruptcy court applied the correct legal standard, which is an objective standard of reasonableness"); *In re Dreier LLP*, 453 B.R. 499, 513 (Bankr. S.D.N.Y. 2011) (the "good faith inquiry is an objective one that generally asks whether the transferee had information that put it on inquiry notice that the transferor was insolvent"); *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 22 (S.D.N.Y. 2007) (reversing bankruptcy court's grant of summary judgment to bankruptcy trustee, but holding that an objective standard of good faith applies to "whether [transferee] was on inquiry notice of the [debtor's] fraud and . . . whether [transferee] was diligent in its investigation"); *In re M & L Bus. Mach. Co., Inc.*, 84 F.3d 1330, 1336 (10th Cir. 1996) (noting that "the majority of bankruptcy courts" have followed the objective standard).

dismiss, thus avoiding discovery and the expense of trial.

Subjective Standard in SIPA Cases

The court first held that the objective good faith standard normally applicable to fraudulent transfer cases should *not* apply in the context of a SIPA liquidation. Citing its earlier opinion in *Picard v. Katz*,[6] the court said, "in a SIPA proceeding . . . lack of 'good faith' requires a showing that a given defendant acted with 'willful blindness' to the truth."

Rejecting the trustee's objective "inquiry notice approach" (i.e., bad faith present when reasonable person in transferee's position would have investigated further and when diligent investigation would have uncovered fraudulent scheme), the court explained, citing 15 U.S.C. § 78fff(b), that the relevant Code provisions apply in a SIPA case only "to the extent consistent with the . . . federal securities laws." When the "Code and the securities laws conflict, the . . . Code must yield." A "securities investor has no inherent duty to inquire about his stockbroker," and "nothing in SIPA creates such a duty."[7] SIPA was intended to restore public confidence in the nation's securities markets.[8] Requiring an investor to inquire about the dealings of his stockbroker when withdrawing funds from an investment account would impose a burden of investigation contrary to the fundamental purpose of the securities laws, the court reasoned. The court also further extended the subjective standard of good faith here to subsequent transferees under Code §§ 548(c) and 550(b), although they were not direct customers of a covered broker-dealer and not subject to SIPA. As the court explained, it would be impractical to "impos[e] a heightened duty of investigation on a securities market participant even further removed from Madoff Securities itself."

Burden of Pleading Bad Faith

Conceding that Code §§ 548(c) and 550(b)(1) are affirmative defenses that normally must be raised by defendants in an "ordinary bankruptcy" case, the court still held that the burden of pleading bad faith shifts to the trustee in a SIPA case. Relying on the Supreme Court's decisions in *Ashcroft v. Iqbal*[9] and *Bell Atl. Corp. v. Twombly*,[10] the court explained that a claim could not survive a motion to dismiss unless it was "plausible on its face." Thus, "[w]ithout particularized allegations that the defendants here either knew of Madoff Securities' fraud or willfully blinded themselves to it, the Trustee's complaints here cannot make out a plausible claim that he is entitled to recover the monies defendants received from their securities accounts." The court then returned the case to the bankruptcy court to determine if

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[6] 462 B.R. 447, 455 (S.D.N.Y. 2011) (holding that bad faith is present "[i]f an investor . . . intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud").

[7] *See Katz*, 462 B.R. at 455; *Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012).

[8] *In re New Times, Sec. Servs. Inc.*, 371 F.3d 68, 87 (2d Cir. 2004) (rejecting "greater investor vigilance" as a goal of SIPA).

[9] 556 U.S. 662 (2009).

[10] 550 U.S. 544 (2007).

the allegations contained in the trustee's complaint with regard to each of the defendants plausibly alleged that they had actual knowledge of the Madoff fraud or had willfully blinded themselves to such knowledge.

COMMENTS

Institutional investors, funds of funds, investment managers and investors, as well as prime and clearing brokers who find themselves defendants in fraudulent transfer suits brought in SIPA cases should be comforted by the *Madoff* decision. The ruling enables them to challenge a trustee's complaint with a motion to dismiss, possibly avoiding expensive discovery and trial. By enabling these defendants to challenge the fraudulent transfer claims earlier in the process, the ruling may also reduce the pressure to settle rather than litigate.

SIPC and its trustee have no reason to complain. As the court noted, "the Trustee has extensive [pre-litigation] discovery powers under" Bankruptcy Rule 2004, enabling him to "gather information before he ever files a complaint." "It is thus not unreasonable to require that the Trustee provide a plausible basis to claim that a defendant lacked good faith in his initial complaint."

Finally, the decision may also have broader applicability to fraudulent transfer claims involving securities and investment accounts outside of SIPA cases.