

**ALERTS**

## Fifth Circuit Blocks Fraudulent Transferee's Good Faith Defense

**January 16, 2019**

"A ... transferee [who] received fraudulent transfers with actual knowledge *or inquiry notice of fraud or insolvency*" loses any "good faith" defense available under the Texas version of the Uniform Fraudulent Transfer Act ("TUFTA"), held the U.S. Court of Appeals for the Fifth Circuit on Jan. 9, 2019. *Janvey v. GMAG LLC*, 2019 WL 141107, \*3 (5th Cir. Jan. 9, 2019) (emphasis added). Although the "TUFTA good faith affirmative defense is an exception to the rule that fraudulent transfers must be returned," the Fifth Circuit reasoned that "no court has considered extending TUFTA good faith to a transferee on inquiry notice who later shows an investigation would have been futile." *Id.* at \*4, \*5. Significantly, in reversing the district court's dismissal of an SEC receiver's fraudulent transfer complaint in a Ponzi scheme case, the court "declined to rely on [Bankruptcy Code] §548(c) [case law] to interpret TUFTA good faith." *Id.*, citing *G.E. Capital Commercial Inc. v. Worthington Nat'l Bank*, 754 F.3d 297, 312 n.21 (5th Cir. 2014) (Code "§ 548(c) is not necessarily substantively congruent with state-law counterparts, despite a common ancestry.").

### Relevance

*GMAG* shows the different approaches taken by courts when applying fraudulent transfer law under the Uniform Fraudulent Transfer Act ("UFTA") and under the Bankruptcy Code ("Code"). In fact, the Fifth Circuit struggled with differences between the two seemingly identical statutes in 2015 and 2016 after asking for and receiving guidance from the Texas Supreme Court on the meaning of "value" in TUFTA's good faith defense provision. In *Janvey v. Golf Channel Inc.*, 834 F.3d 570, 572 (5th Cir. 2016),

the court reluctantly affirmed the dismissal of the SEC receiver's fraudulent transfer suit against an advertising firm for \$5.9 million it had received in good faith from a Ponzi scheme debtor. In response to the Fifth Circuit's certified question, the Texas Supreme Court ruled that the defendant's "media advertising services had objective value and utility from a reasonable creditor's perspective at the time of the transaction, regardless of [the debtor's] financial insolvency at the time." *Janvey v. Golf Channel Inc.*, 487 S.W. 560, 570 (2016). The Fifth Circuit could therefore not apply TUFTA "in a way that would nullify a statutory affirmative defense [good faith receipt of funds in exchange for reasonably equivalent value] whenever [the] debtor was operating a Ponzi scheme."

The district court in *Golf Channel* had dismissed the receiver's complaint, relying on the defendant's statutory good faith affirmative defense, reasoning that the defendant "looks more like an innocent trade creditor than a salesman perpetrating and extending the [debtor's] Ponzi scheme." In its earlier 2015 decision, the Fifth Circuit had held that the *Golf Channel* case was "different" because the debtor had been "engaged in a Ponzi scheme," but reluctantly vacated that ruling when it received a definitive answer from the Texas Supreme Court on the Texas state law issue – the meaning of "value" in TUFTA. According to the Fifth Circuit, the Texas court interpreted "the concept of 'value' under TUFTA differently than we have understood 'value' under other states' fraudulent transfer laws and under Section 548(c) of the ... Code." Significantly, the defendant's good faith in *Golf Channel* was undisputed, in contrast to the alleged facts in *GMAG*, where the defendant's good faith was the key issue.

## Facts

The defendants in *GMAG* (collectively, "M"), had invested in the debtor's Ponzi scheme and had later received \$88.2 million in cash from the debtor. After the receiver sued, M returned \$8.5 million, representing so-called "fictitious profits" on its original investment.

M had an investment committee monitor its \$79-million investment in the debtor. When it learned that the SEC was investigating the debtor, M's investment committee resolved to "take back, at minimum, [M's] accumulated interest ... ." 2019 WL 141107, at \*1. According to the receiver, M's later redemptions were "the result of mounting skepticism about" the debtor. *Id.*

The receiver sued M to recover the redeemed funds, asserting a fraudulent transfer under TUFTA and unjust enrichment. The district court rejected the receiver's unjust enrichment claim before trial, only presenting to the jury the issue of whether M received \$79 million as a fraudulent transfer in good faith. According to the jury, M had "inquiry notice that [the debtor] was engaged in a Ponzi scheme, but not actual knowledge." *Id.* at \*2. The court had defined inquiry notice for the jury as "knowledge of facts relating to the transaction at issue that would have excited the suspicions of a reasonable person and led that person to investigate." The jury further found that "an investigation [by M] would have been futile," having been told by the district court that futility existed if "a diligent inquiry would not have revealed to a reasonable person that [the debtor] was running a Ponzi scheme." *Id.* Rejecting the receiver's argument that "the jury's finding of inquiry notice defeated [M's] TUFTA good faith defense as a matter of law," the district court held that M had "satisfied [its] good faith defense," limiting the receiver to the \$8.5 million it had already received from M.

## The Fifth Circuit

*TUFTA's Good Faith Defense.* "Recipients of fraudulent transfers can prevent clawback actions by proving they received property 'in good faith and for a reasonably equivalent value' [but...] bear the burden of proving" that good faith defense. *Id.* The Texas Supreme Court has not defined "good faith," but Texas lower courts "have overwhelmingly adopted an objective definition: 'A transferee who takes property with knowledge of such facts as would excite the suspicions of a person of ordinary prudence and put him on inquiry of the fraudulent nature of an alleged transfer does not take the property in good faith and is not a bonafide purchaser.'" *Id.* at \*3, citing *Hahn v. Love*, 321 S.W. 3d 517, 527 (Tex. App. - Houston [Pt Dist.] 2009, pet. denied); and *GE Capital Commercial Inc. v. Worthington Nat'l Bank*, 754 F.3d 297, 313 (5th Cir. 2014).

*No Futility Exception for TUFTA Good Faith Defense.* In fraudulent transfer cases based on the Code's good faith provision, §548(c) (transferee "that takes for value and in good faith ... may retain any interest transferred ... to the extent that such transferee ... gave value to the debtor in exchange for such transfer"), a transferee may "rebut" proof of inquiry notice by showing that it "conducted a 'diligent investigation' into [its] suspicions." *Id.*, citing *Templeton v. O'Cheskey*, 785 F.3d 143, 164 (5th Cir. 2015). Further, courts in Code cases also permit a "transferee on inquiry notice to rebut

inquiry notice by proving that the fraudulent scheme's complexity would have rendered any investigation futile." *Id.*, citing *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund LLC*, 439 B.R. 284, 317 (S.D.N.Y. Sep. 17, 2010).

The district court in *GMAG* applied this "futility exception," reasoning that the Texas Supreme Court "would adopt the diligent investigation requirement" because the Code "may be used to interpret [TUFTA]" *Id.*, citing *Janvey v. Democratic Senatorial Campaign Comm'n Inc.*, 712 F.3d 185, 194 (5th Cir. 2013). It found no binding precedent "requiring the conclusion that a transferee on inquiry notice who fails to investigate lacks good faith." *Id.* The district court still "held that a transferee with inquiry notice must conduct a diligent investigation into the facts that put [it] on inquiry notice to retain TUFTA good faith." *Id.* In addition, reasoned the lower court, the transferee could "satisfy TUFTA good faith by proving that such an investigation would have been futile." *Id.* M had retained good faith, said the district court, because the jury found "that an investigation into the [Ponzi] scheme would have been futile despite M's inquiry notice." *Id.* at \*4.

*Texas Law: Transferees With Inquiry Notice Have No Good Faith Defense.* Both "Texas lower courts and federal district courts considering TUFTA good faith rely on *Hahn* to hold that transferees [with] actual knowledge or inquiry notice of fraud cannot claim TUFTA's good faith defense." *Id.* at \*4. No court, though, "has ... extend[ed] TUFTA good faith to a transferee on inquiry notice who later shows an investigation would have been futile." *Id.* In the Fifth Circuit's view, the district court in *GMAG* mistakenly supplemented applicable Texas law's "good faith analysis with interpretations of ... Code good faith" cases under Code §548(c). *Id.* The Fifth Circuit may have "relied on §548 to interpret various TUFTA provisions because TUFTA is based on UFTA, which itself is based on §548," but the court has "previously declined to rely on §548(c) to interpret TUFTA good faith." *Id.*

First, "neither §548(c) text nor its legislative history defines good faith." *Id.* at \*5, citing *Jimmy Swaggart Ministries v. Hayes*, 310 F.3d 796, 800 (5th Cir. 2002). Courts have disagreed "as to what conditions ... allow a transferee this defense." *Id.* Courts have also disagreed on whether a transferee on inquiry notice "must satisfy a 'diligent investigation' requirement"; and "the case law is not clear" as to the nature of the investigation requirement and "whether §548(c) permits a futility

exception.” *Id.*, citing *Bayou*, 439 B.R. at 312 (recognizing futility exception) and *Zayed v. Buysse*, 2012 W.L. 12893882, at \*22-23 (D. Minn. Sep. 27, 2012) (rejecting futility exception). Because of this “lack of conformity,” the Fifth Circuit declined to rely on Code “interpretations to construe TUFTA good faith.” *Id.* Instead, the court held that “failing to inquire when on inquiry notice does not indicate good faith.” *Id.*

“No prior court considering TUFTA good faith has applied a futility exception” in the good faith context. *Id.* For that reason, the Fifth Circuit declined “to hold that the [Texas] Supreme Court ... would do so.” At most, a transferee might “offer up evidence of undertaken investigations to prove a reasonable person’s suspicions would not have been aroused when the transfer was received.” *Id.* But the complexity of the scheme “does not excuse a finding of inquiry notice and does not warrant the application of TUFTA good faith.” *Id.*

## Comment

*GMAG* is another example of the Fifth Circuit’s construing two virtually identical statutes differently, depending on the applicability of federal or state law. Had the *GMAG* claims been asserted under the Code, M would have been able to assert a futility defense. Until the Texas Supreme Court rules differently from Texas lower courts, no futility exception is available to a fraudulent transferee on inquiry notice of the debtor’s fraud when TUFTA applies in the Fifth Circuit. But see *In re Polaroid Corp.*, 472 B.R. 22, 43, 52 (Bankr. D. Minn. 2012), *aff’d*, 779 F.3d 857 (8th Cir. 2015) (“In the Eighth Circuit, corollary provisions in the federal and state law that address intentionally fraudulent transfers receive the same construction and application ... Harmonizing the construction of cognate legislation is as appropriate for the defense as it is for the main remedy.”); *In re IFS Financial Corp.*, 417 B.R. 419, 446 (Bankr. S.D. Tex. 2009) (TUFTA fraudulent transfer suit; defendant “received ... transfers in good faith”; “... had no reason to question the legitimacy ... of the investments prior to receipt of the disputed transfers”; defendant “inquired about the [transferor’s] operations [and] found ... explanation very persuasive.”), *aff’d*, 669 F.3d 255 (5th Cir. 2012); *In re World Vision Entertainment, Inc.* 275 B.R. 641, 660 (Bankr. M.D. Fla. 2002) (“The defendants did not perform the minimal due diligence steps needed to demonstrate that they acted in good faith”; claims brought under UFTA and Code). As noted by the leading bankruptcy treatise, “[t]he UFTA [was] ... drafted after [Code]

section 548 ... by the same individuals.” 5 Collier, *Bankruptcy* § 548.09 [5] (16th ed. 2018).

*Authored by Michael L. Cook.*

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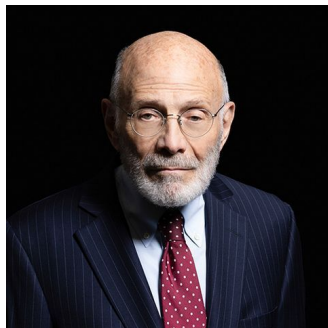
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