

September 30, 2010

## Clawback of Fraudulent Transfers from Investors—“Good Faith” Defense Update

Given the overarching Madoff Ponzi scheme as well as other mini-Madoff schemes that surfaced in its wake, many have been following issues arising from the ability of a trustee to claw back transfers (either as preferential or as fraudulent transfers) from investors who redeemed their interests in a private investment fund or managed account that turned out to be a Ponzi scheme. The law generally provides that an investor’s principal investment is protected so long as it is received in good faith and for value. However, the law provides that an investor has no entitlement to fictitious profits—although the calculation of such profits, implications of the statute of limitations, burden of proof and other defenses are less than clear.

To date, much of the discussion of whether such an investor received its transfer in “good faith” was based upon standards set in a bankruptcy court decision from the Southern District of New York involving Bayou Group, LLC and its affiliates. On September 17, 2010, however, the U.S. District Court for the Southern District of New York reversed the bankruptcy court’s decision and found that summary judgment should not have been granted on issues surrounding the “good faith” defenses of transferees who received a return of their principal investment from a Ponzi scheme-like fraud perpetrated by a group of hedge funds. *In re Bayou Group, LLC*, 09 Civ. 02313 (S.D.N.Y. September 17, 2010) (“*Bayou II*”).

In the overturned *Bayou* cases, the bankruptcy court granted summary judgment against transferees who, by virtue of certain red flags, were found by the bankruptcy court to have been on inquiry notice and who were therefore required, but failed, to conduct any investigation. These transferees redeemed their investments in Bayou and were paid the full amounts shown on their account statements, including principal and fictitious profits. (The bankruptcy court denied summary judgment against one transferee found to be on inquiry notice, but who did conduct an investigation that did not uncover the fraud, finding it was a question for a jury<sup>1</sup> as to whether the investigation was sufficient to satisfy the good faith defense.)

In *Bayou II*, the district court reversed the bankruptcy court’s decision that as a matter of law the particular information in possession of the transferees constituted “red flags” that placed the transferees on inquiry notice, creating a duty to conduct a diligent investigation of Bayou. The district court found that this area of the law is so fact specific that it did not lend itself to the types of broad pronouncements of law made by the bankruptcy court. In particular, the

<sup>1</sup> Because a fraudulent transfer claim is a claim for damages, defendants are normally entitled to a trial by jury under the 7th Amendment. The filing of a proof of claim in bankruptcy court, however, waives this right. The appellants in *Bayou II* did not file proofs of claims.

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district court held that as to the purported red flags in *Bayou*, a jury could find, as a factual matter, that they would not have put a reasonable person on the relevant inquiry notice and that summary judgment was therefore inappropriate.

Further, the district court concluded that the bankruptcy court's holding that an investor is placed on inquiry notice when red flags suggested "some infirmity in Bayou or the integrity of its management" was too broad and could include misconduct unrelated to the fraudulent transfer issues. Instead, the district court, following the majority of cases, held that only a red flag that would lead an investor to conclude that Bayou was insolvent or that there was a fraudulent purpose to the transfer created a duty to conduct a diligent investigation. The district court, in analyzing the particular purported red flags in *Bayou* concluded that many of them could be interpreted to mean that the problems at Bayou were not financial or evidence of a fraudulent purpose. For example, in reviewing a purported red flag involving a lawsuit by a former Bayou employee, the district court observed that while the lawsuit might indicate some problem with Bayou or its top management, that was not the standard for whether a transferee is on inquiry notice of a potential fraudulent transfer. Because it was possible to conclude that the employee viewed Bayou favorably and merely wanted some changes made in the behavior of one of its principals, the bankruptcy court could not hold as a matter of law that the lawsuit put the investor on inquiry notice of Bayou's insolvency or the fraudulent purpose behind the transfers. Rather, the issue had to be presented to a jury.

In probably departing from a majority of the courts, the district court also found that the nature of the transferee mattered in the good faith defense. In *Bayou*, the defendant-appellants were, for the most part, other institutional investors, and so the jury, according to the district court, had to determine whether the purported red flags would have put a "reasonably prudent institutional hedge fund investor" on inquiry notice that Bayou was insolvent or the transfers might have a fraudulent purpose. Generally, the law looks to an objective "reasonable investor" standard as to whether the transferee was placed on inquiry notice and whether, if so, a diligent investigation was conducted. The district court followed the example of another judge from the same court in holding the transferees to what would seem to be a more rigorous standard than the "reasonable investor" standard, as institutional investors are presumably more sophisticated and have greater resources for investigation than a typical reasonable investor.

The district court also reversed the bankruptcy court for improperly expanding the scope and depth of the diligent investigation requirement triggered if a transferee is found to be on inquiry notice. The overturned bankruptcy court decision found that a diligent investigation requires that all of the concerns caused by the red flags be laid to rest and, accordingly, once on inquiry notice, a failure to conduct an investigation is fatal to the good faith defense. The question, according to the district court, is whether a diligent investigation would have revealed the insolvency or fraudulent purpose of the transfer. Theoretically, even though the Bayou investors redeemed and were paid in full, consistent with their account statements, under the bankruptcy court's analysis this did not alleviate the need for an investigation (or continuing investigation) in light of the red flags. The district court held, consistent with law in other Ponzi cases, that the court had to consider arguments as to whether a diligent investigation would have uncovered the fraud and that the issue was a factual one that had to be presented to a jury.

## Conclusion

While the appellate decision in *Bayou* is a victory for the transferees, the district court's decision in the case will add to the expense to be incurred by all parties who, absent a settlement, would likely go to a costly jury trial on the inquiry notice and adequacy of investigation issues. For the most part, when a purported red flag is susceptible to different interpretations as to its meaning, the district court held that a jury must decide whether the investor's interpretation was reasonable or whether the red flag put the investor on inquiry notice as to the possible existence of a fraudulent scheme. If the investor conducted an investigation, then the jury must determine whether it was a sufficient investigation. If, as was the case here with these appellants, there was no investigation, the jury must determine whether a reasonable investigation would have uncovered the fraud.

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