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A legal update from Dechert's White Collar and Securities Litigation Group

Fraudulent Conveyance Law in Context of Ponzi Schemes Clarified by Recent Decisions

Two recent decisions by bankruptcy courts in the Southern District of New York have addressed the application of fraudulent conveyance law to alleged Ponzi schemes. A Ponzi scheme may be generally described as a fraudulent investment scheme whereby money contributed by defrauded investors is used to pay overstated principal and/or false profits to earlier investors (who may have been equally defrauded) in order to induce new investment and otherwise prolong the fraud.

The courts respectively (i) denied a motion to dismiss brought by nearly 100 investors of the Bayou Hedge Funds and (ii) granted a motion for summary judgment against Bear Stearns, the prime broker for the Manhattan Investment Fund. Dechert is bankruptcy and litigation counsel to the Bayou entities in the first matter referenced. These decisions will impact the manner in which fraudulent conveyance actions are adjudicated in the future.

Executive Summary

Dechert represents the Bayou Hedge Funds as debtors in possession pursuant to a bankruptcy petition filed May 30, 2006, by the court-appointed managing member of the Bayou Hedge Funds and certain related entities. The founders of the Bayou funds—Samuel Israel III ("Israel"), Daniel E. Marino ("Marino"), and James Marquez—have pleaded guilty to federal mail and wire fraud counts and are awaiting sentencing. By decision entered February 23, 2007, Bankruptcy Judge Hardin denied motions to dismiss filed by nearly 100 defendants in fraudulent conveyance actions who had redeemed their investments in the two years prior to the implosion of the Bayou funds in August 2005.

The January 9, 2007, Manhattan Investment Fund decision represents the remainder of the seven-year-old implosion of that hedge fund, run by Michael Berger, "a convicted felon and fugitive." The summary judgment decision of Judge Lifland finds that Bear Stearns, Manhattan Investment Fund's prime broker, must return to the bankruptcy estate approximately $141 million in margin payments made in the year prior to SEC seizure of the fund's assets and the bankruptcy petition. The court held that as a matter of law such payments were made by Berger with actual intent to defraud the hedge fund's investors.

Prior to this summary judgment decision, Bear Stearns had repeatedly, albeit unsuccessfully, moved to withdraw the reference to Judge Lifland and for leave to appeal his denial of its previous motion to dismiss. Bear Stearns has appealed as of right from the entry of summary judgment. The decision discusses and applies the stockbroker and conduit defenses to fraudulent conveyance actions which are peculiar to financial services defendants.

The Bayou Case

In the *Bayou* decision,[1] the court sets forth the pleading standards for claims of actual fraudulent conveyance under the bankruptcy code,[2] and for claims of constructive fraudulent conveyance under the bankruptcy code.[3] Furthermore, the decision distinguishes the Second Circuit's most recent fraudulent conveyance decision, *Sharp Int'l*

1 *In re Bayou Group, LLC* 2007 WL 582530 (Bankr. S.D.N.Y. Feb. 23, 2007).

2 11 U.S.C. § 548(a)(1)(A).

3 11 U.S.C. § 548(a)(1)(B).

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Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.).[4]

The facts as alleged in *Bayou* are as follows. The Bayou entities and hedge funds were operated by Israel and Marino as a massive Ponzi scheme from 1999 continuing through 2005. Plaintiffs in the adversary proceedings consist of the Bayou entities themselves, and Defendants are investors that redeemed all or a portion of their investments in Bayou within two years prior to the collapse of the fraudulent scheme.

As a result of the Ponzi scheme, Israel and Marino "siphoned many millions of dollars from the Bayou Hedge Funds for their personal benefit, disseminated false financial reports indicating that the Bayou Hedge Funds had enjoyed substantial investment gains when in fact they had experienced substantial losses, created a phony accounting firm to certify those false financial reports, and caused the Bayou Hedge Funds to make redemption payments to certain investors in inflated amounts derived from those false reports."[5] Consequently, hundreds of investors lost principal investments totaling approximately $250 million.

In its decision denying defendants' motions to dismiss, the court delineated the following fundamental principles:

- Fraudulent conveyance claims based on actual fraud under Section 548(a)(1)(A) of the Bankruptcy Code avoid the entire amount of any transfer made with the actual intent to hinder, delay, or defraud creditors, regardless of whether or not the debtor received value in exchange, unless the transferee can prove its affirmative defense of good faith under Section 548(c).[6]

- The Ponzi scheme presumption applies broadly to "any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall the disclosure of fraud."[7]

- The presumption of actual intent to hinder, delay or defraud is "intuitive" and "inescapable" from the facts alleged in the complaint—that intentionally overpaid redemptions of entirely fictitious profits and overstated principal amounts were made to earlier investors by using funds attained from new investors.[8]

- Defendants' tort claims for rescission of the principal invested constitute value for purposes of Section 548(a)(1)(B). Accordingly, claims based on constructive fraud are limited to any fictitious profits paid to defendants.[9]

- Fictitious profits cannot be retroactively deemed to constitute payments on antecedent debts, either as contractual interest or statutory prejudgment interest under New York Civil Practice Law and Rules Section 5001. "Defendants' receipt of their redemption payments extinguished any putative rights to statutory prejudgment interest."[10]

- Plaintiffs are not obligated to plead a lack of transferee good faith. Defendants must plead good faith as an affirmative defense in the first instance.[11]

The court noted that in fraudulent conveyance actions "the court must focus precisely on the specific transaction or transfer sought to be avoided in order to determine whether the transaction falls within the statutory parameters of either an intentional or constructive fraudulent conveyance."[12] In other words, transfers made in the context of an overarching fraud are not necessarily themselves fraudulent. Thus, in *In*

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4 403 F.3d 43 (2d Cir. 2005).

5 Decision at 2.

6 *Id.* at 4-5.

7 *Id.* at 8.

8 *Id.* at 9.

9 *Id.* at 10.

10 *Id.*

11 *Id.* at 14.

12 *Id.* at 13.

re Churchill Mortgage Investment Corp., the specific transactions at issue were not inherently fraudulent because they were commission payments to broker dealers that were lawfully hired and appropriately compensated for their services.[13] In *In re Sharp Int'l Corp*, the specific transfer at issue involved the repayment of a bank loan which resulted in the preference of one creditor over others.[14] In *Sharp*, the repayment of the loan was not in and of itself fraudulent because the intent of the debtor was to accurately repay (not overpay) a bona fide debt.

The court found in *Bayou*, as distinguished from *Churchill* and *Sharp*, the complaint adequately alleged that the transfers, as conscious overpayments, were inherently fraudulent.

The Manhattan Fund Case

In *Manhattan Investment Fund, Ltd. v. Bear Stearns Sec. Corp.*, the court addressed stockbroker, conduit, and good faith defenses to fraudulent conveyance actions.[15] In *Manhattan Investment Fund*, the Trustee obtained summary judgment avoiding transfer payments that were made to Bear Stearns in furtherance of an alleged Ponzi scheme orchestrated by Michael Berger ("Berger"), who created and used the fund as a vehicle for fraud. The three categories of transfers involved approximately $141.1 million in margin payments that Berger transferred to Bear Sterns, approximately $1.7 billion in short sale proceeds generated by sale of the stock that the fund borrowed from Bear Stearns, and approximately $1.9 billion in securities that were purchased with the short sale proceeds and given to Bear Sterns to cover the stock loans to the fund.

The court held the investment scheme involved to be a Ponzi scheme because it involved money contributed by later investors to pay earlier investors, resulting in the illusion of profitability in the hopes of attracting new investors. Accordingly, the court found that, as a matter of law, the transfers were made with actual intent to hinder, delay or defraud creditors. "Moreover, acts taken in furtherance of the Ponzi scheme, such as paying brokers commissions are also fraudulent" because every payment made by the debtor enabled the fraud to continue.[16]

The only issues remaining were whether Bear Stearns was a mere conduit, not a true transferee; whether public policy precluded recovery; and whether Bear Stearns could establish the affirmative defense of good faith.

Initial Transferee Status

In order to be an initial transferee, as opposed to a mere conduit, courts require that the entity involved have the requisite dominion and control over the transferred asset. Entities that have a special legal relationship with the debtor can become initial transferees when they take control of an avoidable transfer. The court found that Bear Stearns had a security interest in the transferred monies, held the monies as collateral for short sales, was able to prohibit the fund from withdrawing the transferred monies as long as short sale positions were open, and had the ability to use the transferred monies to purchase securities without the fund's consent. Accordingly, Bear Stearns was held to be an initial transferee because it had "the ability to exercise control and use the Transfers to protect its own economic well-being and thus, is not a mere conduit with respect to those Transfers."[17]

Public Policy Considerations

The court found that while Congress limited a trustee's ability to avoid margin payments to ensure against an industry collapse subsequent to a massive fraudulent scheme, the Bankruptcy Code specifically provides for the avoidance of payments under certain circumstances. "Where the Bankruptcy Code specifically provides for the avoidance of margin payments it cannot be said that allowing just that would be contrary to public policy."[18]

Good Faith Defense

The court found that while determination the transferee good faith defense is generally an issue of fact, that does not necessarily preclude summary judgment when there is an absence of evidence that could support a finding of good faith. The court held that Bear

13 256 B.R. 664 (Bankr. S.D.N.Y. 2000).

14 403 F.3d 43.

15 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007).

16 Decision at 5.

17 *Id.* at 9.

18 *Id.*

Stearns was on inquiry notice of the Manhattan Investment Fund fraud well before the Ponzi scheme collapsed, and therefore would be unable to satisfy its burden of showing that it had acted with the diligence required to establish good faith under 11 U.S.C. § 548(c).

The court held that in 1998, Bear Stearns learned that the fund's stated performance was suspect through a series of conversations with other investors and conference calls with the fund. Moreover, while Bear Sterns continued raising the margin requirement on the fund to over 50% while the fund continued to lose money, they failed to consult "easily obtainable sources of information that would bear on the truth of any explanation received from the potential wrongdoer" until December 1999.[19] Accordingly, the court denied summary judgment on the issue of the affirmative good faith defense.

Conclusion

The rulings by the court will have implications for future fraudulent conveyance actions. These cases serve to demarcate pleading and proof of actual transferor fraud, constructive fraud, the Ponzi presumption, the initial transferee/mere conduit status of brokers, and the transferee good faith defense.

19 *Id.* at 14.

Practice group contacts

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