Mets Owners Score Important Victory in Madoff Case

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The recent $162 million settlement agreed to by Irving Picard, the trustee for liquidation of Bernard L. Madoff Investment Securities, and Fred Wilpon, Saul Katz, and numerous family members and related entities, including the New York Mets, garnered plenty of headlines. Somewhat lost in the shuffle was the holding by Senior U.S. District Court Judge Jed S. Rakoff relating to the good faith defense available to recipients of transfers made with actual intent to hinder, delay, or defraud creditors. That holding could have significant impact in other "actually fraudulent" fraudulent transfer cases.

While the trustee sought recovery against the Wilpon/Katz entities on a number of theories, many did not survive the defendants' motion to dismiss. *Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities, LLC v. Katz et al.*, 462 B.R. 447 (S.D.N.Y. 2011). The main claims that did survive were avoidance actions brought under Bankruptcy Code Section 548(a)(1)(A), which allows for avoidance of transfers made with "actual intent to hinder, delay or defraud" creditors. The relevant intent is that of the transferor, not the transferee, and the intent of the transferor to hinder, delay or defraud is presumed—conclusively so, in many circuits—in the context of a Ponzi scheme. *Id.*at 453 & n.5. See also *SEC v. Resource Dev. Int'l, LLC*, 487 F. 3d 295 (5th Cir. 2007), *In re Arctic Research & Tech. Group*, 916 F. 2d 528 (9th Cir. 1990).

The recipient of a transfer made with actual intent to hinder, delay, or defraud, however, can retain the transfer to the extent the transferee received the transfer in good faith and gave value. 11 U.S.C. § 548(c).

Because it was conceded that Madoff was perpetrating a Ponzi scheme, the trustee's prima facie case was established. *Picard v. Katz*, 462 B.R. at 447, 453. The court found, however, that value had been given by the Wilpon/Katz entities in connection with those transfers, which constituted a return of

principal. *Id*. at 453. As a result, the court held that if the Wilpon/Katz entities received the principal transfers in good faith, they could retain them. *Id*. at 453.

Thus, the stage was set for the noteworthy part of the dismissal opinion: the standard to be applied in determining whether an allegedly fraudulent transfer was received in good faith. The trustee argued that, to satisfy the good faith defense, the recipient of an allegedly fraudulent transfer must prove that it was not on "inquiry notice" of the fraud. *Id*. at 455. The court characterized inquiry notice as an objective standard that focuses on whether the recipient of the transfer had knowledge of information which would have caused a reasonable person to conduct a further investigation into what its transferor might be up to. *Id*. at 455. While acknowledging that the inquiry notice standard "is not without some precedent in ordinary bankruptcies ...," the court rejected the inquiry notice standard because the Madoff case was a Securities Investor Protection Act (SIPA) trusteeship. *Id*.at 455.[1]

The court reasoned that SIPA trusteeships are informed by federal securities law and, "[J]ust as fraud, in the context of federal securities law, demands proof of scienter, so too 'good faith' in this context implies a

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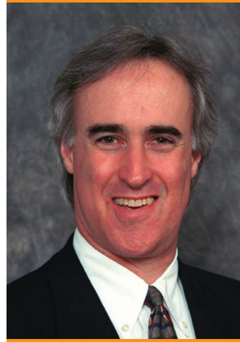
lack of fraudulent intent." *Id.*at 455. The court went on to note, "[A] securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty." *Id.*at 455. The court then concluded that, given the overlay of the federal securities laws and the lack of any duty on the part of a securities customer to inquire about the broker, a securities customer in receipt of an actually fraudulent transfer from a broker can retain that transfer as long as the customer can prove that he, she, or it was not "willfully blind" to the truth. *Id.* at 455,456.

The court defined willful blindness as intentionally choosing to blind oneself "to the 'red flags' that suggest a high probability of fraud." *Id.* at 455. The court characterized willful blindness as a subjective standard focusing on the actual knowledge of the defendant as opposed to the inquiry notice standard which, as noted, is objective and focuses on the impact known facts would have on a reasonable person. *Id.*



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Willful Blindness v. Inquiry Notice

The court's adoption of the subjective willful blindness standard rather than the objective inquiry notice standard was an important victory for the Wilpon/Katz Entities, and it is likely that other fraudulent transfer defendants will cite the dismissal opinion in support of application of the willful blindness standard in their cases. The reasoning employed in the dismissal opinion in arriving at the application of the willful blindness standard raises some important questions, however.

First, while the court acknowledged that the inquiry notice standard had been adopted in other cases applying the good faith defense under Section 548(c), almost all of the applicable reported authority has adopted the inquiry notice standard. See, *e.g., Gredd v. Bear Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 23 (S.D.N.Y. 2007), aff'd 2009 U.S. App. LEXIS 11806 (2nd Cir. June 2, 2009); *Brown v. Third Nat'l Bank (In re Sherman),* 67 F. 3d 1348, 1355 (8th Cir. 1995); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Grp.),* 916 F. 2d 528, 535-36 (9th Cir. 1990); *Jobin v. McKay (In re M&L Bus. Mach. Co.),* 84 F. 3d 1330, 1334-38 (10th Cir. 1996); *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Group, LLC),* 439 B.R. 284, 310-12 (S.D.N.Y. 2010); *Armstrong v. Collins*, 2010 U.S. Dist. LEXIS 28075, at *82-83 (S.D.N.Y. March 24, 2010) (action under UFTA): But see *Meoli v. The Huntington National Bank (In re Teleservices Grp. Inc.),* 444 B.R. 767, 815 (Bankr. W.D. Mich. 2011).

In fact, the dismissal opinion does not cite any cases in which the willful blindness standard was applied in the context of Section 548(c) or, for that matter, in a bankruptcy case. Rather, all of the cases cited by the court to support its adoption of the willful blindness standard involved actions arising under other federal laws: *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 215 (1976)("scienter"—i.e., more than mere negligence—is required to prove a violation of SEC Rule 10b-5); *In re New Times Sec. Servs.,* 371 F. 3d 68, 87 (2nd Cir. 2004) (defrauded investors with no suspicion that brokerage statements reflected nonexistent securities positions held claims for "equities," not "cash," under SIPA); and *United States v. Rodriquez*, 983, F. 2d 455, 458 (2nd Cir. 1993)(jury instruction in criminal drug possession case; "conscious avoidance" of probable facts equates to knowledge). 462 B.R. at 455.

Second, nothing in Section 548(c), which the court and the parties acknowledged was the controlling statute, suggests that what constitutes good faith varies depending on the legal relationship between the transferor and transferee (in the *Madoff* case, securities customer and stockbroker) or that it is informed by laws governing those relationships (in the *Madoff* case, the federal securities laws). Further, to the extent the dismissal opinion is based on the fact that securities customers, albeit highly sophisticated ones in this case, have no obligation to inquire about their stockbrokers under federal securities laws, the same might and likely will be said of other relationships.

For example, while financial institutions have "know your customer" duties to inquire as to the identity of new borrowers and depositors, and are subject to other reporting duties as to certain currency transactions, no law or regulation imposes a general independent duty on them to inquire into the source of loan repayments, the most obvious source of fraudulent transfer exposure for lenders.

Time will tell whether the dismissal opinion becomes a springboard for a general rethinking of the good faith defense or, rather, is ultimately treated as being limited to its peculiar facts and the players involved. What seems likely is that it will provide grist for substantial amounts of future litigation.

[1] 15 U.S.C. §§ 78aaa et seq.