By Arthur J. Steinberg and Michael R. Handler

The Good-Faith Defense to Fraudulent-Transfer Claims

Arthur J. Steinberg
King & Spalding
New York

Michael R. Handler
King & Spalding
New York

Arthur Steinberg is a partner and Michael Handler is a senior associate with King & Spalding in New York.

Now that the longest bull market in history has likely ended, a new batch of "dubious" transactions might soon come to light, and with them, contentious fraudulent-transfer litigation. The recent decision from the U.S. Bankruptcy Court for the Southern District of New York in *Picard v. Citibank NA, et al. (In re Madoff)*[1] addresses an important element in fraudulent-transfer actions: In what circumstance should a transferee's "good faith" be measured by a subjective standard (as compared to an objective standard)? The "good faith" question comes up in establishing the transferee's affirmative defense under § 548(c) of the Bankruptcy Code and the potential liability of a mediate/subsequent transferee of a fraudulent transfer under § 550(b)(2) of the Bankruptcy Code.

Although the Code does not define "good faith" for purposes of either §§ 548(c) or 550(b), most courts have applied an objective person or "inquiry notice" standard — *i.e.*, lack of good faith is present when a reasonable person in the transferee's position, based on the information the transferee knew or should have known (*i.e.*, "red flags"), would have investigated further and uncovered the fraudulent scheme or improper purpose relating to the transfer.[2] In applying this standard, the inquiry frequently turns on what the transferee "should have known" versus what the transferee "actually knew."

In *Picard v. Katz*, a 2011 decision arising from the *Madoff* debacle, however, the U.S. District Court for the Southern District of New York ruled that the *subjective* standard for good faith — not the *objective* standard — should be utilized in *Madoff*-related litigation because the fraudulent-transfer litigation arose in the context of a proceeding under the Securities Investor Protection Act (SIPA), and violations of securities law generally implicate the subjective intent of the defendant.[3] The bankruptcy court's recent decision in *Picard v. Citibank* followed this precedent and applied the subjective good-faith standard in another *Madoff*-related fraudulent-transfer litigation.

In certain situations, the application of the subjective good-faith standard (as compared to the objective standard) in a fraudulent-transfer litigation may be outcome-determinative. Thus, this article considers how the subjective good-faith standard applied in *Picard v. Citibank* differs from the objective standard that is generally applied in non-SIPA proceedings, and why it arguably made a difference in the result in that case.

Statutory and Case Law Background

Under § 548(a)(1), the trustee (or other bankruptcy estate representative) is empowered to, among other things, "avoid any transfer ... of an interest of the debtor in property ... that was made ... on or within [two] years before the date of the filing of the petition," under two different circumstances. The first, known as an "actual intent" fraudulent transfer, occurs if the debtor "made such transfer ... with actual intent to hinder, delay, or defraud any entity to which the debtor was or became ... indebted."[4] The second circumstance, known as a "constructive" fraudulent transfer, occurs if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation" and was insolvent or undercapitalized (or rendered so) as of (or resulting from) such transfer.[5] Section 548(c) provides that "a transferee ... of such a transfer ... that takes for value and *in good faith* has a lien on or may retain any interest transferred ... to the extent that such transferee ... gave value to the debtor in exchange for such transfer."[6]

Section 550(a)(1) allows a trustee (or another debtor estate representative) to recover an avoidable transfer from the "initial transferee of such transfer or the entity for whose benefit such transfer was made." Under § 550(a)(2), the trustee may also recover from "any immediate or mediate transferee of" the initial transferee. In an attempt to recover from the immediate/mediate transferee, the trustee must plead that the initial transfer is avoidable, and that the defendant is a subsequent transferee of the initial transferee (*i.e.*, that the funds at issue originated with the debtor). Section 550(b) provides an affirmative defense from avoidance to a subsequent transferee who "[took] for value ... *in good faith*, and without knowledge of the voidability of the initial transfer."

Whether the transferee can establish "good faith" is a key issue in many fraudulent-transfer

1 Adv. Proc. No. 10-05345 (SMB) D.E. 170 (Bankr. S.D.N.Y. Oct. 18, 2019) (hereinafter, "*Picard v. Citibank*").
2 *See infra* fn.3.
3 *See infra* fn.5.

4 *See* § 548(a)(1)(A).
5 *See* § 548(a)(1)(B).
6 *See* § 548(c) (emphasis added).

litigations. A transferee that can successfully assert a good-faith defense under § 548(c) would only be liable to return transfers received to the extent such transfers exceeded the transfers made to the debtor. If the transferee could not establish the good-faith defense, it would be liable for all transfers received without regard to what it transferred to the debtor.

Prior to *Picard v. Katz, et al.*,[7] courts within the Second Circuit and elsewhere generally applied an objective good-faith standard (*i.e.*, whether alleged "red flag" information would have put a reasonably prudent person on inquiry notice of a fraudulent scheme).[8] However, in *Picard v. Katz*, the district court ruled that the "objective person" good-faith standard has "much less applicability ... in a context of a SIPA trusteeship, where bankruptcy law is informed by federal securities law. Just as fraud, in the context of federal securities law, demands proof of *scienter*, so too 'good faith' in this context implies a lack of fraudulent intent."[9] For the court in *Picard v. Katz*, "willful blindness" must be a conscious and purposeful intention; being "clueless" as a result of anything short of "willful blindness" would preserve a "good faith" defense.[10]

In *Securities Investor Protection Corp. v. Bernie L. Madoff Investment Securities LLC (In re Madoff Securities)*,[11] the district court followed its holding from *Picard v. Katz* and ruled that a subjective standard for purposes of evaluating "good faith" under §§ 548(c) and 550(b)(2) was appropriate for fraudulent-transfer actions brought in SIPA proceedings. The district court explained that the SIPA trustee's proposed objective-person inquiry notice standard "would impose a burden of investigation on investors totally at odds with the investor confidence and securities market stability that SIPA is designed to enhance."[12] Notably, the Second Circuit has not directly ruled on whether the district court's application of a subjective "good faith" standard is appropriate for fraudulent-transfer litigation arising in SIPA proceedings.[13]

Picard v. Citibank

In *Picard v. Citibank NA*, the SIPA trustee sued Citibank as the subsequent transferee from payments made by a Madoff entity to Tremont Partners. Citibank had made loans to Tremont to fund its investments in *Madoff*.

Prior to the complaint against Citibank, the *Madoff* trustee filed a complaint against Tremont to recover the transfers made to Tremont from the Madoff entity. The trustee alleged that Tremont knew that Madoff was not trading securities and was operating a Ponzi scheme, and therefore, Tremont did not have the requisite good faith and thus was not entitled to offset the transfers it made to Madoff. Ultimately, Tremont settled with the *Madoff* trustee.

Citibank responded to the SIPA trustee's lawsuit by filing a motion to dismiss on various grounds, including asserting a defense under § 550(b) that Citibank provided value to Tremont, and that the trustee's complaint "[did] not allege that the Defendants willfully blinded themselves to Madoff's Ponzi scheme." After establishing that Citibank provided value to Tremont by making a loan to Tremont, the bankruptcy court turned to whether the *Madoff* trustee adequately pled that Citibank took the subsequent transfers from Tremont without good faith and with knowledge of the avoidability of the initial transfer (*i.e.*, the transfer from Madoff to Tremont). The trustee argued that "without knowledge" picks up the subjective standard, so "good faith" must mean something different (*i.e.*, the "objective standard"). The bankruptcy court explained that the concepts of "good faith" and "without knowledge" represent separate elements, and while they were related, it did not mean that they were the same. Therefore, it concluded that the subjective standard could still be applied to the good-faith element.

The bankruptcy court, citing the district court's decision in the aforementioned *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Madoff Securities)*,[14] stated that "good faith should be determined under a subjective standard" and that to satisfy this standard, the SIPA trustee must plead that the defendant "willfully blinded" itself to the facts suggesting that Madoff was not actually trading securities.[15] More specifically, "willful blindness" consists of two elements: "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact."[16] The bankruptcy court further explained that "[i]f a person who is not under an independent duty to investigate nonetheless intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith."[17]

Although **Irving H. Picard** (BakerHostetler; New York), the *Madoff* trustee, made various allegations concerning Citibank NA's willingness to continue to do business with Tremont (and, indirectly, Madoff), notwithstanding its suspicions regarding Citibank NA's inability to confirm Madoff's option trades, the risk of fraud and its improbably consistent investment returns, the bankruptcy court concluded

continued on page 65

7 462 B.R. 447 (S.D.N.Y. 2011), *abrogated by Sec. Investor Prot. Corp. v. Madoff Invest. Securities LLC*, 513 B.R. 437 (S.D.N.Y. 2014) (hereinafter "*Picard v. Katz*").

8 *See 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"); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Grp. Inc.)*, 916 F.2d 528, 535 (9th Cir. 1990) (applying objective "good faith" standard); *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330, 1338 (10th Cir. 1996) (same); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995) (same); *but see Goldman v. City Capital Mortg. Corp. (In re Nieves)*, 648 F.3d 232 (4th Cir. 2011) (applying subjective "good-faith standard" to § 550(b)(1) defense analysis).

9 *See Picard v. Katz* at 455.

10 *Id.* ("If an investor, nonetheless, intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith. But if, simply confronted with suspicious circumstances, he fails to launch an investigation of his broker's internal practices — and how could he do so anyway? — his lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.").

11 516 B.R. 18 (S.D.N.Y. 2014).

12 *Id.* at 22.

13 In another *Madoff*-related case, in commenting on the fraudulent-transfer claims that the SIPA trustee brought against certain investors, the Second Circuit stated in a footnote that "[t]he presence of 'good faith' depends upon, *inter alia*, 'whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose.'" *In re Bernard Madoff Inv. Sec. LLC v. Picard*, 740 F.3d 81, 90 n.11 (2d Cir. 2014). That is the objective standard for good faith. The Second Circuit's comment was based on the holding in *In re Bayou Grp. LLC v. Bayou No Leverage Fund LLC*, 439 B.R. 284, 310 (S.D.N.Y. 2010), which, like the *Madoff* scheme, was a Ponzi case, but *Bayou* did not arise in a SIPA proceeding. *Bayou* applied the objective good-faith standard. 439 B.R. 284, 312. Notably, the district court in *Sec. Investor Prot. Corp. v. Madoff Invest. Securities LLC* cast aside the Second Circuit's comment in support of an objective "good faith" standard as *dictum*. 516 B.R. 18, 22, n.2 (S.D.N.Y. 2014).

14 516 B.R. 18 (S.D.N.Y. 2014).

15 *Picard v. Citibank* at 24.

16 *Id.* at 26 (quoting *Global-Tech Appliances Inc. v. SEB SA*, 563 U.S. 754, 769 (2011)). The court further noted that "[u]nder *Global-Tech*, recklessness and 'should have known' do not satisfy the first prong of willful blindness." *See id.* at 28, n.22.

17 *Id.* (quoting *Picard v. Katz* at 455).

from page 19

that the *Madoff* trustee did not plead facts establishing that Citibank NA had a "subjective belief" in the high probability that BLMIS was not trading securities when it made loans to Tremont.[18] The bankruptcy court concluded that the *Madoff* trustee failed to allege anything more than that Citibank "assumed the 'remote' risk that BLMIS [the Madoff trading entity] was not trading securities and might be a fraud and, at most, were reckless and deliberately indifferent to that risk."[19] Finally, the bankruptcy court found that it would have been implausible for Citibank to lend Tremont partners so much money "at a time when they entertained a subjective belief in the high probability that BLMIS was an illegal, criminal enterprise."[20]

Analysis

The bankruptcy court's analysis in *Picard v. Citibank NA* underscores how the applied "good faith" standard could affect the outcome of the underlying fraudulent-transfer claim. Arguably, the facts pled by the SIPA trustee in that case might have satisfied the "objective" good-faith standard for purposes of surviving a motion to dismiss by establishing that an objective person, armed with the facts that Citibank NA possessed, was put on notice that Madoff was a fraud. In contrast, the subjective analysis — and, specifically, the requirement that Citibank NA actively willfully blinded itself to the alleged fraud — was materially more difficult for the SIPA trustee to plead.

By way of illustration, under the objective good-faith standard, the transferee's good-faith defense is vulnerable to the argument that the transferee "should have known better" (that the transferee should have observed the red flags, then become aware of the fraud). Under the willful-blindness criteria set forth in the subjective good-faith standard, the transferee has to actually believe that it was highly probable that there was fraud taking place. Moreover, the transferee had to have taken a volitional act to avoid learning of the fraud; mere inaction did not seem to be sufficient.

Although the bankruptcy court applied a subjective good-faith analysis in *Picard v. Katz*, it considered a quasi-objective person standard: the implausibility of Citibank NA transferring funds to Tremont to invest in Madoff while believing that Madoff was a Ponzi scheme. The implausibility was based on the bankruptcy court's analysis of how Citibank NA would or would not behaved if it were a rational actor, which arguably is much more closely aligned with the objective good-faith standard than the subjective good-faith standard.

It is unclear how the Second Circuit might ultimately rule on the issue. The crux of the district court's rationale for applying the "subjective" standard is based on the fact that federal securities law informs bankruptcy law in the context of a SIPA proceeding. However, this underlying premise is based on a broad reading of the SIPA statute, which provides that "[t]o the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11."[21] The district court found a tension between federal securities law and the Bankruptcy Code and, in reconciling the policy objectives of the two federal statutes, leaned toward the principles of the securities laws to impose a subjective good-faith standard that otherwise is not generally recognized in Bankruptcy Code fraudulent-transfer cases.

Notably, in other circumstances, where the Code's policy objectives conflict with the policy objectives of a federal statute such as in labor law[22] or environmental laws,[23] courts have attempted to reconcile the policy objectives of the two federal statutes. The *Madoff* trustee has appealed the decision in *Picard v. Citibank NA*. If the Second Circuit ultimately gets a chance to weigh in on this issue, we might get greater clarity as to which policy objective will prevail for the application of the good-faith defense. abi

18 *Id.* at 34.
19 *Id.*
20 *Id.* at 35.

21 15 U.S.C. § 78fff(b).
22 *See NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 526-27 (1984) (holding that in context of determining whether to permit rejection of collective-bargaining agreement subject to National Labor Relations Act pursuant to § 365(a) of Bankruptcy Code, debtor must show that agreement burdens estate and equities balance in favor of rejection, as opposed to business-judgment standard generally applicable to debtor's decision to reject executory contracts).
23 *See Midlantic Nat'l Bank v. NJDEP*, 474 U.S. 494 (1986) (holding that trustee in bankruptcy may not abandon property in contravention of state statute or regulation that is reasonably designed to protect public health or safety from identified hazards notwithstanding § 554(a) of Bankruptcy Code, which permits trustee in bankruptcy to abandon any property of estate that is burdensome to estate or that is of inconsequential value).