

LENDER ALERT

Ponzi Schemes, Bankruptcy, & Fraudulent Transfer Lawsuits: A two-step test for proving that the transfers were received in good faith

There have been an increasing number of bankruptcy cases nationwide involving Ponzi schemes. Frequently, those who received payments from a Ponzi scheme find themselves subsequently defending against a clawback action once a bankruptcy or receivership is filed.

The most common clawback actions usually are premised on fraudulent transfers. When defending against a fraudulent transfer lawsuit, the transferee must be prepared to present evidence that it received the disputed transfers in good faith and provided value in exchange for such transfers. Proving “good faith” is frequently the more burdensome component of the transferee’s successful defense as the term itself has generally remained undefined.

A recent decision, however, by the United States District Court for the Southern District of New York has specified what is necessary for a transferee to show it received the transfers in good faith. In *Bayou Superfund, LLC v. D. Canale Beverages, Inc. (In re Bayou Group, LLC)*, 2012 U.S. Dist. LEXIS 14976 (S.D.N.Y. Feb. 6, 2012), the Court found that the transferee must show it was not on “inquiry notice” of the debtor’s insolvency or fraud, and that if on notice, that a “diligent investigation” was either conducted by the transferee or would have been futile.

In *Bayou*, the debtors were hedge funds which collectively comprised a \$450 million Ponzi scheme. The defendants, investors in the hedge funds, had cashed out prior to the public learning of the Ponzi scheme. According to the *Bayou* court, the defendants were on “inquiry notice” if they “had information which would have led a reasonably prudent hedge fund investor to investigate the possibility that Bayou might be insolvent or that the redemption payment might be authorized by a Bayou manager with a fraudulent purpose.” *Id.* at *15. The court found that the defendants had such information, for example: (1) a report disclosing a lawsuit against Bayou alleging criminal and civil wrongdoing; (2) inconsistent representations from Bayou personnel on financial calculations; (3) statements from a Bayou securities employee indicating a lack of confidence in the accuracy of Bayou’s returns; and (4) Bayou’s refusal to address concerns about the lawsuit or allow review of the financials.

Once determined to be on inquiry notice, the defendants then had to satisfy the “diligent investigation” prong of the good-faith test. Although they hadn’t conducted a diligent investigation, the defendants argued that they couldn’t have uncovered the fraud even with such an investigation. The Court disagreed. Evidence showed that an internet search over the course of a few days, which was conducted prior to the time of the redemption, revealed that one of the two officers of Bayou had set up a phony accounting firm which served as Bayou’s “independent” auditor. This information was enough to “have suggested to a ‘reasonably prudent hedge fund investor’ that the Bayou Funds might be operating as a fraud, and that redemption payments made by the Funds might be designed to avoid discovery of the fraud.” *Id.* at 25. Thus, the defendants failed to prove their investments were redeemed in good faith.

Although the *Bayou* court’s ultimate findings are fact specific, the Court has established a logical basis for analyzing whether a transferee received the allegedly fraudulent transfer in good faith. The case, however, leaves open the question of how to proceed when an investigation results in a concern of fraud. Despite this, Texas courts may very well adopt *Bayou*’s test. If you find yourself concerned about an investment you may have made, you should retain counsel immediately to fully understand your options, risks, and defenses.

If you have any questions, please call our office at (214) 752-2222 or email Josh Shepherd at jshpherd@curtislaw.net.

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