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The Good Faith Transferee Defense and Publicly Traded Securities

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Bankruptcy trustees and debtors often use the tools provided under the Bankruptcy Code and state law to recover preferential and other avoidable transfers for the benefit of the estate. When this occurs, how do innocent parties protect themselves from being unexpectedly caught with a tainted asset subject to avoidance? If, for example, the recipient of an otherwise avoidable transaction accepts the transfer in good faith, the bankruptcy estate may be powerless to recover. The good faith analysis generally involves an objective inquiry into whether the transferee should have known that there were problems associated with the transfer at issue. However, the issue is complicated in the world of publicly traded securities where the "should have known" analysis could dampen market liquidity and increase investor uncertainty. The courts have recently shed some light on the issue allowing wary parties to better protect themselves from being the last one standing when the music stops.

General Objective Standard

Chapter 5 of the Bankruptcy Code grants a bankruptcy trustee several avoidance powers, including the power to avoid certain fraudulent conveyances and preferential transfers made by the debtor to third parties. *See* 11 U.S.C. §§ 547 and 548; *see also In re Lancelot Investors Fund, L.P.*, 467 B.R. 643, 647 (Bankr. N.D. Ill. 2012), *aff'd sub nom. Peterson v. Somers Dublin Ltd.*, 729 F.3d 741 (7th Cir. 2013) ("The Bankruptcy Code grants a trustee or debtor in possession many avoidance powers under Sections 544, 545, 547, 548 and 550."). Once a transfer has been avoided, the bankruptcy trustee is permitted to recover both from the initial recipient of the avoidable transfer and subsequent transferees. *See id.* at § 550(a); *see also In re P.A. Bergner & Co.*, 140 F.3d 1111, 1118 (7th Cir. 1998); *In re David Cutler Indus., Ltd.*, 502 B.R. 58, 78 (Bankr. E.D. Pa. 2013) ("Section 550(a) is a recovery provision that gives rise to a secondary cause of action after the trustee has established an entitlement to avoid a transfer under one of the other Code avoidance provisions.") (quotations omitted). However, the bankruptcy trustee cannot recover from a subsequent transferee that takes the transfer (i) for value; (ii) in good faith; and (iii) without knowledge of the voidability of the transfer avoided. *See id.* at § 550(b)(1); *In re Nieves*, 648 F.3d 232, 237 (4th Cir. 2011) ("Any immediate or mediate transferee of the initial transferee, however, has an affirmative defense to recovery if such transferee "takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided.") (quoting 11 U.S.C. § 550(b)(1)). Once the plaintiff has established that a party is an immediate or mediate transferee of the initial transferee, a defendant claiming a defense to liability under Bankruptcy Code section 550(b) bears the burden of proof. *See*

Tavenner v. Smoot (In re Smoot), 265 B.R. 128, 140 (Bankr. E.D. Va. 1999); *In re Knippen*, 355 B.R. 710, 728 (Bankr. N.D. Ill. 2006), *aff'd sub nom. Knippen v. Grochocinski*, No. CIV.A. 07 C 1697, 2007 WL 1498906 (N.D. Ill. May 18, 2007) (holding that the burden of proof is on the transferee asserting a "good faith" defense to liability on an avoided transfer).

The Bankruptcy Code does not provide a definition for good faith. *See Matter of Smith*, 848 F.2d 813, 817 (7th Cir. 1988); *In re Bayou Grp., LLC*, 439 B.R. 284, 309 (S.D.N.Y. 2010). The majority of courts have determined that good faith, as used in Bankruptcy Code section 550(b)(1), should be determined under an objective standard. *See Nieves*, 648 F.3d at 238; *see also In re Teleservices Grp., Inc.*, 444 B.R. 767, 773 (Bankr. W.D. Mich. 2011) ("recent case law strongly favors an objective approach to assessing a transferee's good faith"). Accordingly, in determining good faith for the purposes of a section 550(b)(1) defense, courts analyze what the transferee "knew or should have known instead of examining the transferee's actual knowledge from a subjective standpoint." *Gold v. Laines (In re Laines)*, 352 B.R. 397, 406 (Bankr. E.D. Va. 2005) (quoting *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995)) (internal quotations and citations omitted); *In re Joy Recovery Tech. Corp.*, 286 B.R. 54, 80 (Bankr. N.D. Ill. 2002) ("courts have found a lack of good faith where the circumstances showed that the transferee either knew or should have known about a debtor's poor financial condition or where the transferee gave less than reasonable equivalent value for the benefit received"); *see also Bonded Financial Servs., Inc. v. European American Bank*, 838 F.2d 890, 897-98 (7th Cir. 1988) (in addressing good faith under section 550(b)(1), the court recognized that "the recipient of a voidable transfer may lack good faith if he possessed enough knowledge of the

events to induce a reasonable person to investigate."). The "should have known" component assesses whether the transferee possessed actual knowledge that would lead a reasonable person, practicing in a similar industry, to inquire into the public record to see if the transferred property is voidable. *See Nieves*, 648 F.3d at 240; *see also In re Dreier LLP*, 452 B.R. 391, 448 (Bankr. S.D.N.Y. 2011) ("Transferees asserting an affirmative defense under section 550(b)(1) do not take in good faith if they remain willfully ignorant of facts which cry out for investigation.") (citation omitted).

Subjective Standard for Publicly Traded Securities

In the context of publicly traded securities, recent case law suggests that a subjective standard of good faith may govern – rather than the usual objective "should have known" standard. *See Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 516 B.R. 18 (S.D.N.Y. 2014) (applying subjective standard of good faith to section 550(b) analysis in publicly traded securities context); *In re Bernard L. Madoff Inv. Sec. LLC*, 515 B.R. 117, 139 (Bankr. S.D.N.Y. 2014) (same); *see also Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012) ("Thus, to establish a lack of 'good faith' on the part of securities customers under § 548(c) in the context of a SIPA bankruptcy, the trustee must show that the customer either actually knew of the broker's fraud or 'willfully blinded' himself to it.") (citation omitted).

As is widely now known, Madoff Securities, a registered securities broker-dealer, engaged in a decades-long Ponzi scheme in which it accepted investments from various customers and then issued false monthly statements to those customers indicating consistent, favorable returns on securities transactions purportedly conducted by Madoff Securities on

their behalf. *Id.* at 20. In actuality, Madoff Securities undertook few, if any, securities transactions, and simply used other customers' investment funds to satisfy a customers' withdrawals of funds. *Id.* Some withdrawing customers were individuals, and others were investment funds that in turn transferred the withdrawn funds to their customers. *Id.* Additionally, some of these funds transferred the withdrawn monies to money managers and other professionals who were owed fees in connection with these transactions. *Id.* at 20-21. The trustee appointed under the Securities Investor Protection Act (SIPA) initiated several avoidance actions against both direct customers of Madoff Securities and from various subsequent transferees. *Id.* at 21. The trustee argued that these defendants were sophisticated market participants who, even though they lacked actual knowledge of Madoff Securities' fraud, failed to act in good faith for purposes of Bankruptcy Code section 550(b) because they were aware of suspicious circumstances that should have led them to investigate the possibility of such fraud. *Id.*

The court framed the issue as to whether "good faith" in the public securities context should be judged by a subjective standard of willful blindness or by an objective standard of inquiry notice. *Id.* In the context of securities transactions, the court found that the inquiry notice standard that the trustee sought to impose would be both unfair and unworkable. *Id.* The trustee's suggested approach 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. *Id.* at 22. If an investor "intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud," however, such willful blindness (a subjective standard) is

tantamount to a lack of good faith. *Id.* (quoting *Picard v. Katz*, 462 B.R. 447, 455 (S.D.N.Y. 2011)).

Although the subsequent transferees involved in the Madoff proceedings – including not only indirect investors but also individuals and entities who received fees for services provided to investment funds that were customers of Madoff Securities – were not themselves investors with Madoff Securities itself, the court held that the same standard applied to them under Bankruptcy Code section 550(b). *Id.* at 23. The court held that the outcome made sense as both a matter of statutory interpretation and also reflected the impracticality of imposing a heightened duty of investigation on a securities market participant even further removed from Madoff Securities itself. *Id.* This subjective standard was also found to match Congress's intent to limit the exception to recovery from subsequent transferees to those individuals who themselves acted in good faith. *Id.* (citing S.Rep. No. 95–989, at 90 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5876 ("The phrase 'good faith' in [section 550(b)(1)] is intended to prevent a transferee from whom the transferee could recover from transferring the recoverable property to an innocent transferee, and receiving a retransfer from him, that is, 'washing' the transaction through an innocent third party. In order for the transferee to be excepted from liability under this paragraph, he himself must be a good faith transferee."). In sum, the court found that with respect to section 550(b)(1), "good faith" means that "the transferee neither had actual knowledge of the Madoff Securities fraud nor willfully blinded himself to circumstances indicating a high probability of such fraud." *Id.*

Going Forward

It is important to note that other courts examining Judge Rakoff's decision in Madoff Securities have been quick to emphasize that it is limited to the context of publicly traded securities. *See In re LLS Am., LLC*, No. 12-CV-668-RMP, 2014 WL 3907832, at *2 (E.D. Wash. Aug. 11, 2014) (recognizing that Judge Rakoff emphasized that a standard of actual good faith applied rather than one of objective good faith, but holding that such ruling stemmed from relevant securities laws); *In re Fair Fin. Co.*, No. 10-50494, 2014 WL 7642447, at *15 (Bankr. N.D. Ohio July 30, 2014) (recognizing distinction in good faith analysis for publicly traded securities). Therefore, in the context of most good faith transferee defenses, courts will likely continue to assess whether the defendant knew, or should have known, that something was amiss. However, in the context of publicly traded securities, market participants may be able to breathe a little bit easier and simply assert that they lacked actual knowledge as to the voidability of the transfer. Still, Judge Rakoff pointed out that willful ignorance of "red flags" will not establish the requisite good faith required under Bankruptcy Code section 550(b). Accordingly, parties engaged in the publicly traded securities market must continue to remain vigilant where warning signs exist.