LITIGATION: EVIDENCE
LITIGATING PONZI SCHEMES: WINNERS AND LOSERS
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A. Are lucky recovering investors safe from fraudulent transfer claims? Where can investors and the estate turn to recover part of the invested funds?

1. Bayou Litigation

a. Background:

i. Bayou Fund formed in 1996, managed by Bayou Management LLC with all trading activity conducted through Bayou Securities LLC which was owned by Bayou Group, LLC.

ii. Fund concealed trading losses by falsifying financial disclosures and misrepresenting investment performances. Independent auditors were let go and ostensibly replaced by "Richmond-Fairfield Associates, CPA, PLLC," a fictitious accounting firm.

iii. Fund assets were also depleted for the personal benefit of Bayou principals through high volume trading commissions and incentive bonus payments based upon non-existent profits.

iv. At time of collapse in 2005, existing investor-creditors held approximately $250 million in invested principal.

v. Adversary proceedings brought by Fund against investors who successfully redeemed their investments within one year of the public collapse of Bayou in August 2005.

vi. Claims brought by Fund under sections 548(a) and 544 of the Bankruptcy Code and sections 273-76 of the New York Debtor and Creditor Law to recover as fraudulent conveyances the amounts paid to redeeming investors, including principal invested and "fictitious profits" fraudulently reported by Fund's prior management.

(A) Fund Operating Agreements provided that any investor could redeem the "whole or any part of the amount in his or its Capital Account at the end of any calendar month" upon 15 days notice.

(B) Since financial statements fraudulently overstated the assets and failed to disclose the Fund's losses, and, therefore, overestimated the investment accounts of all of the

> redeeming investors, the redemption payments made in respect of greatly reduced or non-existent principal and fictitious profits exceeded the redeeming investors' contractual entitlements.

b. Bayou Court found that all investors were creditors of the funds in which they invested in two ways. First, under the terms of the funds' operating agreements, each investor had a contractual right to redeem part of all of his account balance, limited to a pro rata share of the NAV of the fund. Second, as a result of the fraud, each investor had a tort claim for rescission of the entire amount actually invested in the funds.

c. Intentional fraudulent conveyance under section 548(a)(1)(A)

i. Section 548(a)(1)(A) provides:

> (a)(1) The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily –
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> > (A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or . . .

ii. The *entire* amount of any transfer made with actual intent to hinder, delay or defraud creditors may be avoided, whether or not the debtor received value in exchange. *Sharp International*, 403 F.3d 43, 56; *In re Bayou Group, LLC*, 362 B.R. 624, 629-30 (Bankr. S.D.N.Y. 2007) ("*Bayou I*").

iii. Trustee need not prove debtor's intent to hinder, delay or defraud the transferee or any other particular creditor or that the debtor actually did, in fact, hinder, delay or defraud the transferee or any other creditors. *See* 5 Collier on Bankruptcy ¶ 548.04[1] (15th ed. rev. 2006); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995).

iv. Intent of the transferee is not relevant except under the "good faith" defense of section 548(c).

d. Constructive fraudulent conveyance under section 548(a)(1)(B)

i. Section 548(a)(1)(B) provides:

> (a)(1) The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily –
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> (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
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> (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
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> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
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> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
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> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

ii. Plaintiff bears the burden of showing that the transferee received less than reasonably equivalent value and that the debtor was insolvent, undercapitalized, or intended to incur debts beyond its ability to pay.

iii. Bayou Court found, as a matter of law, that redeeming investors had given reasonably equivalent value for their redemptions to the extent of their original investments.

e. Redeeming investors' "good faith" defense under section 548(c)

i. Section 548(c) provides:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

ii. Bayou Court determined that redeeming investors gave "value" to the extent of their actual investments.

iii. "Good faith"

(A) "Good faith" must be determined according to an objective standard, not the subjective knowledge or belief of the transferee. *In re Manhattan Inv. Fund Ltd.*, 2007 WL 440360 at *17 (S.D.N.Y. 2008); *Enron Corp. v. Avenue Special Situations Fund II, L.P. (In re Enron Corp.)*, 340 B.R. 180, 207 (Bankr. S.D.N.Y. 2006).

(B) Transferee does not take in good faith "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose." *Jobin v. McKay (In re M&L Bus. Machine Co., Inc.)*, 84 F. 3d 1330, 1338 (10th Cir. 1996). Good faith requires either that: (1) the transferee was not on "inquiry notice" or (2) if on notice, the transferee was diligent in its investigation of the transferor. *In re Manhattan Inv. Fund Ltd.*, 2007 WL 440360 at *17.

(C) Once on inquiry notice, Transferee may be able to show good faith, if a diligent inquiry allays concern relating to the "red flag" and the transferee can point to objective evidence that its decision to redeem was based upon extrinsic factors not related to the financial health of the fund.

2. Madoff – "Net Equity" litigation

a. Background

i. Madoff's fraud

(A) Madoff and his investment firm (BLMIS) accepted money from customers for the purposes of investing those funds

on customers' behalf. However, BLMIS did not actually make any investments. Instead, BLMIS would send customers account statements showing various fictitious "trades" and other account activity which never actually occurred. The "trades" shown on the account statements reflected trades in existing blue-chip securities at their actual trading prices, but were calculated by BLMIS with the benefit of hindsight, based on historical data, in order to show predetermined rates of return.

(B) In order to perpetuate its Ponzi scheme, BLMIS satisfied the claims of redeeming investors by raising additional funds from other customers. Due to the fact that no trades were actually being made, any investor who over time withdrew more from BLMIS than he originally invested also withdrew fictitious profits comprised of the principal investments of other customers.

ii. SIPA/SIPC Coverage

(A) SIPC provides coverage to satisfy the "net equity" claims of brokerage customers, up to $500,000 per customer (with $100,000 limit on claims for cash).

(B) SIPA provides that Trustee must satisfy net equity claims (up to SIPC limits) "insofar as such obligations are ascertainable from the books and records of the debtor, or are otherwise established to the satisfaction of the Trustee.

b. SIPC/Trustee's Position

i. Net equity calculated on cash in/cash out basis

(A) Determination of whether customer claims are for securities or cash depends not on what is *actually* in the customer's account but on what the customer has been told by the debtor in written confirmations. *In re New Times Sec. Servs.*, 371 F.3d 68, 86 (2d Cir. 2004) (*New Times I*).

(B) However, the determination of a customer's net equity which determines the amount of a customer's claim is based not upon customer's reasonable expectations, but upon the debtor's books and records.

(C) Debtor's books and records are broader than simply the account statements sent to customers, but include all of the internal accounting and bookkeeping of BLMIS, which

show that no securities were actually purchased, nor could they have been purchased retroactively at the prices BLMIS was reporting to customers

(D) Net equity calculated based upon account statements unfairly favors redeeming investors over those who invested later in time and or did not make withdrawals.

(E) Trustee's position establishes 3 categories of customer claimants:

(1) Net Winners – Customers who withdrew more funds than the customer deposited with BLMIS. According to the Trustee these customers have zero net equity under the cash in/cash out basis, have no right to any payment from SIPC, and may be subject to clawback for any fictitious profits withdrawn from BLMIS

(2) Net Losers (Over-the-Limit) – Customers who invested $500,000 or more than they withdrew from BLMIS. According to the Trustee these customers are entitled to an allowed claim for the amount invested, less the amount withdrawn, and will receive SIPC protection in the full amount of $500,000.

(3) Net Losers (Under-the-Limit) – Customers who invested more than they withdrew from BLMIS, but less than $500,000 more. According to the Trustee these customers will receive SIPC protection only in the amount of the difference between what they invested and what they withdrew, even though their account statements may have reflected a balance of over $500,000.

c. Claimant's Position

i. Net equity calculated based upon last account statement

(A) The purpose of SIPA is to maintain investor confidence in securities markets by protecting the legitimate expectations of investors.

(1) Investors have a legitimate expectation that the account statements they receive accurately reflect their holdings.

(2) SIPC has an obligation to insure investors against loss, including a broker's fraud. Fact that SIPC was insuring a thief should not provide justification for forcing investors, rather than SIPC, to bear loss. SIPC fund is the true beneficiary of the Trustee's cash in/cash out method for valuing net equity.

(B) SIPC has previously used the last statement method to determine net equity and should be judicially estopped from advancing a new theory of net equity.

(C) *New Times* (see below) provides controlling law in the Second Circuit on the determination of net equity for customers who received statements indicating they were invested in actual bona fide securities.

(D) Trustee's zero-sum argument that using account statements to calculate net equity is a red herring in that, regardless of claimant's ultimate entitlements to BLMIS estate assets, SIPC is required to advance up to the full limit of $500,000 to each customer. Reducing SIPC coverage simply benefits the financial institution members of SIPC who should have caught BLMIS' fraud in the first instance.

d. New Times

i. In *New Times* the Second Circuit dealt with two categories of claimants. The first group of claimants received fraudulent statements indicating that they owned actual existing securities (i.e. IBM, Google, etc.) where in fact the broker did not buy or hold such securities. The second group of *New Times* claimants received statements indicating that they owned mutual funds which in reality did not exist, they were completely fictitious (i.e. XYZ Fund, etc.). The Second Circuit held that, with respect to the first group of claimants who received statements indicating ownership of actual securities, the account statements were the appropriate way of determining net equity while, while those customers who received statements showing fictitious securities could not have a reasonable expectation that they actually owned such securities because such securities verifiably did not exist. Accordingly, with respect to the second group of *New Times* claimants the Second Circuit approved a calculation of net equity based upon the cash in/cash out method.

ii. The Trustee likens the BLMIS claimants to the second group of *New Times* claimants because, according to the Trustee's logic,

BLMIS could not have retroactively made the trades it purported to make at the prices it purported to make them. Accordingly, the Trustee argues, the only appropriate method of calculating net equity is the cash in/cash out method because incorporating the fictitious profits indicated in customer's statements would serve to further BLMIS' fraud where customers' funds were not actually exposed to market risk.

iii. The Claimants on the other hand argue that their claims are more akin to the first class of *New Times* claimants, because their account statements indicated ownership of existing securities and there was no way for customers to verify that BLMIS was not actually engaging in the trades it purported to be.

B. Do some investors have superior claims on estate distributions because they earlier sought to withdraw their investment or held different contractual claims or interests?

1. Sagecrest – Topwater litigation

a. Background

i. Debtor investment fund and equity committee brought adversary proceeding to disallow, or in the alternative, to subordinate proofs of claim filed by redeeming investors on account of redemption notices which were issued prepetition, but which the fund refused to pay.

b. Claimant's Arguments

i. Redeeming investors claim that notice of redemption terminated their equity interest in the fund and established a fixed debt obligation of the fund to pay redemption amounts thus establishing redeeming investors as unsecured creditors of the fund entitled to payment ahead of the equity interests of other non-redeeming investors.

ii. Fund Operating Agreement provides that "redemption price will be paid to the redeeming Member promptly following the effective date of redemption."

iii. Redeeming investors timely notified fund of their redemption, which, pursuant to the Operating Agreement, became fixed at the end of the quarter (June 30, 2007), prior to the bankruptcy petition.

iv. Delaware Limited Liability Company Act establishes creditor status

(A) 6 Del. Code § 18-606 provides:

> Right to distribution. [U]nless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution.

(B) Section 18-606 is identical to section 604 of the ABA Prototype Limited Liability Act (1992). The drafter's comments to the section 604 of the ABA Prototype explain:

> "This provision is intended to permit an LLC to convert equity to debt rather than actually paying a redemption distribution and to protect the right of the payee to receive payment even if the LLC becomes insolvent prior to the subsequent payment."

v. Treatment of redemption claims as liabilities comports with generally accepted accounting principles.

vi. Mere non-payment of an effective redemption does not change or alter the character of the redeeming member's rights as a creditor for the amounts due.

vii. Claims are not subject to subordination under 11 U.S.C. § 510(b) because (i) redeeming investors ceased to be equity holders when their redemption amounts became fixed, and (ii) claims are seeking recovery only for debt obligation, not "damages" related to the purchase or sale of a security.

viii. Claims are not subject to subordination under 11 U.S.C. § 510(c) because the redeeming investors are not guilty of any inequitable conduct with respect to their redemption requests.

c. Debtor's Arguments

i. Claims are subject to subordination under 11 U.S.C. § 510(b) because they flow directly from the claimant's attempt to transfer their equity interests back to the fund, creating a nexus between the claim and the purchase or sale of securities.

(A) In subscribing to the fund and obtaining the economic benefits of ownership claimants also accepted the attendant risk of loss.

(B) Operating Agreement allows the fund manager to defer or delay redemption payments or to disallow redemption requests altogether. Specifically, the Operating Agreement provides that:

"[U]ntil redeemed, a redeeming Member's Interest shall remain subject to the risks of the business and Company."

(C) Claims for breach of an agreement to repurchase equity interests are subject to subordination. *Citing In re Alta+Cast, LLC*, 301 B.R. 150 (Bankr. D. Del. 2003)

ii. Claims are subject to subordination under 11 U.S.C. § 510(c), even absent inequitable conduct, because courts have consistently held that claims arising from redemption rights should be equitably subordinated.

C. When are there viable claims that the estate representative or investors can directly pursue against professionals that advised the failed entity

1. *In Pari Delicto* Defense as a Bar to Trustee's Claims Against Professionals

a. *In pari delicto* is a common law doctrine which bars a plaintiff from recovering against a defendant where the plaintiff bears at least equal responsibility for the wrongful conduct forming the basis of the claim.

i. In the corporate bankruptcy context, a trustee may be barred from bringing claims against professionals based upon their alleged participation in or facilitation of a fraudulent scheme, if the fraudulent acts of the debtors' principals are imputed to the debtor corporation under principles of agency law. Because a corporation can act only through its agents, a corporation may only bear responsibility for a fraudulent scheme if the fraudulent acts of its agents can be imputed to the corporation as principal.

(A) An agent's wrongful conduct committed in the course of employment is generally attributable to his employer.

(1) Adverse Interest Exception - The adverse interest exception to the general rule of imputation arises when an agent acts in furtherance of a scheme to defraud his principal for the agent's sole benefit. Because the agent is acting outside the scope of his agency, courts will not impute the agent's knowledge and actions to the principal.

(2) Sole Actor Exception to the Adverse Interest Exception – Where an agent is the sole representative of a corporation or dominates and controls the corporation, courts will impute the agent's knowledge to the corporation as principal on the basis that as the sole representative or controlling person, the agent has no one to whom he can impart his knowledge, or conceal it, and the corporation must bear the responsibility for allowing an agent to act without accountability.

ii. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001)

(A) Third Circuit held that creditors' committee, as assignee of the bankruptcy estate's causes of action, had standing to bring deepening insolvency claims against various professionals who had allegedly facilitated ponzi scheme fraud. However, because the creditors' committee stood in the shoes of the debtor in bringing its claims, its claims were barred by the professionals' *in pari delicto* affirmative defense.

(1) In so holding the court rejected the creditors' committee's argument that it was an innocent successor to the debtor, and thus the *in pari delicto* doctrine should not apply to its claims because the officers who had perpetrated the fraud had been removed from control of the debtor and no party to the fraud would benefit from the committee's claims.

(2) Trustee in bankruptcy (and thus creditors' committee) accedes only to those "legal or equitable interests of the debtor in property *as of the commencement* of the case." 11 U.S.C. § 541(a)(1). Accordingly, the trustee is also subject to the same defenses that could have been asserted by a defendant had the action been instituted by the debtor, and the fact that an innocent third party may succeed to the claims in bankruptcy does not abolish the *in pari delicto* defense.

(B) A recent development which may limit the reach of the *R.F. Lafferty* decision can be found in *Official Comm. of Unsecured Creditors of Allegheny Health, Education and*

Research Foundation v. PricewaterhouseCoopers, LLP, 2008 WL 3895559 (3d Cir. July 1, 2008). Noting that the Supreme Court of Pennsylvania has indicated that the primary rationale for imputing an agent's fraud to his principal is to protect innocent third parties who do business with the agent, the Third Circuit certified to the Supreme Court of Pennsylvania the question of whether imputation is appropriate where the party invoking the doctrine is not an innocent third party but rather an alleged co-conspirator in the agent's fraud.

2. Individual Investors May Have Viable Claims Against Professionals

a. In *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006) the Eleventh Circuit indicated that, although a debtor's claims against its professionals may be barred by the *in pari delicto* doctrine, individual creditors harmed by the debtor's ponzi scheme could separately pursue their claims free from the bar of *in pari delicto*. *Id*. at 1151.