

## Dismissal of Madoff Trustee's Claims Clarifies Standards for Fraudulent Conveyance Claims

In the latest turn in the fraudulent conveyance litigation arising out of the liquidation of Bernie Madoff's securities firm, on March 14, 2016, Judge Bernstein of the U.S. Bankruptcy Court for the Southern District of New York (the "Court") issued a decision (the "Decision") on motions to dismiss the intentional fraudulent transfer claims, constructive fraudulent transfer claims, and state-law fraudulent transfer claims brought by Irving H. Picard (the "Trustee"), the trustee appointed for Bernard L. Madoff Investment Securities LLC ("BLMIS"), against defendants Legacy Capital Ltd ("Legacy") and Khronos LLC ("Khronos," together, "the Defendants"). Picard v. Legacy Capital Ltd. (In re BLMIS), No. 08-99000(SMB), Adv. Proc. No. 08-01789 (SMB), Adv. P. No. 10-05286 (SMB), 2016 WL 943773 (Bankr. S.D.N.Y. Mar. 14, 2016). Significantly, the Court dismissed intentional and constructive fraudulent conveyance claims against investors related to redemptions of principal deposits, where the Court found that the Trustee did not adequately plead that the investor (and a related defendant) had actual knowledge of or willfully blinded themselves to BLMIS's fraudulent business practices, notwithstanding the existence of various alleged "red flags" suggesting that Madoff's purported trades were not real. Importantly, the Decision dismissed these claims at the pleadings stage, enabling the defendants to avoid potentially protracted discovery regarding their knowledge of Madoff's historic practices and their investments.

### Background

The BLMIS Securities Investment Protection Corporation ("SIPC") proceeding dates back to 2008, when the case was commenced and the Trustee was first appointed. Since that time, the Trustee has filed various lawsuits against investors in the Madoff funds seeking to avoid redemptions paid by BLMIS to investors as intentional fraudulent conveyances under Sections 548(a)(1)(A) of the Bankruptcy Code, constructive fraudulent conveyances under 548(a)(1)(B) of the Bankruptcy Code, and under applicable state law statutes pursuant to section 544(b) of the Bankruptcy Code.<sup>1</sup>

Prior decisions in the United States District Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit have established that the

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<sup>1</sup> "As a matter of law, the 'Ponzi scheme presumption' establishes the debtors' fraudulent intent as required under both the [Bankruptcy] Code and the NYDCL." Picard v. Madoff (In re BLMIS), 458 B.R. 87, 104 (Bankr. S.D.N.Y. 2011). The Trustee also has sought avoidance of payments made within the 90-day preference period under Section 547(b).

securities safe harbors provided in Section 546(e) bar the Trustee's constructive fraudulent conveyance claims and state-law fraudulent conveyance claims unless the Trustee establishes that the transferee had *actual knowledge* that no securities transactions were being conducted by the Madoff funds.<sup>2</sup> The United States District Court for the Southern District of New York also ruled that defendants could rely on the Section 548(c) "good faith" defense against the intentional fraudulent conveyance claims available to the extent that the transferee "takes for value and in good faith" against avoidance claims brought under Sections 548(a)(1)(A) and 548(a)(1)(B) unless the Trustee is able to plead and prove the transferee's subjective lack of good faith.<sup>3</sup> To establish a lack of good faith, the Trustee must plead and prove that the transferee "either actually knew of the broker's fraud or 'willfully blinded' himself to it." Picard v. Avellino, 469 B.R. 408, 412 (S.D.N.Y. 2012).<sup>4</sup> This decision addresses whether the Trustee's complaint adequately pleads the defendants' actual knowledge of and/or willful blindness to the Madoff fraud such to withstand dismissal of the complaints.

### **Procedural History**

The Trustee initiated the adversary proceeding against Legacy, Khronos, and various other investor defendants on December 6, 2010, and filed an amended fraudulent conveyance complaint on July 2, 2015.

Defendant Legacy – a BVI corporation – invested with BLMIS for seventeen years prior to the commencement of the SIPC proceeding. Starting around 2003, Legacy and certain of its employees began raising internal concerns about BLMIS's investment strategies and returns, including the volume of trading which did not seem consistent with market opportunities, the pricing of trades and its non-traditional fee structures used by the fund. Based on these concerns, Legacy retained Khronos, an outside firm that provided accounting services, to conduct a historical review of the value of Legacy's BLMIS portfolio. Legacy internal correspondence reflects concerns with the investment but Legacy did not close out its positions at that time.

In the adversary proceeding, the Trustee seeks to recover redemptions of principal deposits as well as fictitious profits that Legacy received from BLMIS as an initial transferee and transfers Khronos received from Legacy as a subsequent

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<sup>2</sup> See Picard v. Merkin (In re BLMIS), 515 B.R. 117, 138 (Bankr. S.D.N.Y. 2014); see also SIPC v. BLMIS (In re Madoff Secs.), 476 B.R. 715, 722, 729-30 (S.D.N.Y. 2012), aff'd 773 F.3d 411 (2d Cir. 2014).

<sup>3</sup> See SIPC v. BLMIS (In re Madoff Secs.), 516 B.R. 18, 21 (S.D.N.Y. 2014). Cf. Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (In re Bayou Grp. LLC), 439 B.R. 284, 308, 313 (S.D.N.Y. 2010) (defendant bears burden of proof on good faith defense).

<sup>4</sup> However, the District Court has held that any transfers from BLMIS "that exceeded the return of... principal" "[w]ere not for value" for purposes of the Section 548(c) "good faith" defense. SIPC v. BLMIS (In re Madoff Secs.), 476 B.R. 715, 725 (S.D.N.Y. 2012). And so "fictitious profits" may be recovered in spite of a failure to establish a subjective lack of good faith.

transferee, primarily relying on Legacy and Khronos' own contemporaneous internal documents as evidence of their actual knowledge of the Madoff fraud. Both defendants moved to dismiss the complaint for failing to adequately plead the claims.

### **The Decision**

In its Decision, the Court dismissed the actual and constructive fraudulent conveyance claims against both defendants for failure to adequately plead the defendants' actual knowledge of the fraud at the time of the redemptions.

In its ruling, the Court carefully discussed the heightened standard required to plead that the transferee had "actual knowledge" of the fraud that would enable prosecution of the constructive fraudulent conveyance claims notwithstanding the section 546(e) securities safe harbors defense generally available to these claims. The Court emphasized that actual knowledge "implies a high level of certainty and absence of any substantial doubt regarding the existence of a fact,"<sup>5</sup> not merely a strong suspicion of such fraud.

Similarly, the Court concluded that in order to overcome the Section 548(c) good faith defense available to rebut an intentional fraudulent conveyance claim, the Trustee would need to plead the transferees' lack of "subjective good faith", established by evidence of either actual knowledge of or willful blindness to the fraud. A showing of willful blindness requires both that (1) the defendant subjectively believed that a high probability existed that BLMIS was engaged in sham trading, and (2) the defendant took deliberate actions to avoid confirming its knowledge, by turning a blind eye to its suspicions.<sup>6</sup> Ultimately, the Court found that although allegations of Legacy's strong suspicions that certain trading was not real may satisfactorily plead the first prong, the second prong could not be satisfied where Legacy investigated the activity and did not thereby obtain actual knowledge of the fraud.

While the Trustee argued that various "red flags" indicated to Legacy that BLMIS was engaged a fraud, the Court concluded that these alleged red flags alone cannot support a showing of the defendants' actual knowledge of a fraud. The red flags alleged by the Trustee include:

- That Madoff's purportedly massive trade volume never impacted the market;
- That Madoff's fee structure allowed managers of feeder funds to capture fees without doing anything other than investing in BLMIS and differed from industry standards;

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<sup>5</sup> Legacy Capital Ltd., 2016 WL 943773 (citing Merkin, 515 B.R. at 139).

<sup>6</sup> Id. (citing Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2070 (2011)).

- That redemptions from Madoff reflected impossible rates of return and did not correlate with the returns of the S&P index;
- That a very high percentage of Madoff's purported equity trades fell outside the daily price range;
- That a report prepared by a related hedge fund management company contained indications that the market could not support Madoff's volume of purported options trades.

The Court did find that these red flags could demonstrate that "Legacy strongly suspected that, at a minimum, BLMIS's options trades were not real."<sup>7</sup> However, Legacy still could demonstrate it acted in good faith given the actions taken by Legacy subsequent to learning of these "red flags." The Court emphasized that Legacy hired Khronos to conduct due diligence about its historic investments with BLMIS after internal concerns were raised. The Court also took note that Legacy maintained some of its investment in BLMIS after engaging Khronos to conduct due diligence and concluded that "[t]he notion that Khronos discovered through its diligence that Madoff was a fraud is implausible," as "it is implausible that a fund such as Legacy would entrust its own investors' money with someone it knew was not trading securities."<sup>8</sup> The Court held that because the Trustee failed to adequately plead Legacy's actual knowledge or willful blindness, the Trustee could not sustain a claim with respect to the redemption of principal deposits and instead would be limited to a claim for the recovery of fictitious profits within the two-year period prior to the BLMIS liquidation under Section 548(a)(1)(A).

For similar reasons, the Court also found that the Trustee failed to adequately plead that Khronos willfully blinded itself to any red flags or had actual knowledge that it was receiving the proceeds of a fraudulent transfer in accepting payment for its services from Legacy. The Court also concluded that Khronos gave "value" for the payments it received from Legacy by providing accounting and historical pricing services and dismissed the Trustee's claims seeking to recover subsequent transfers from Khronos.<sup>9</sup>

### **Significance of the Decision**

Where an investment broker fails because of prior fraudulent investment practices, it is common for the appointed trustee to pursue avoidance claims against investors seeking the return of payments received in the years prior to the liquidation.

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<sup>7</sup> Id.

<sup>8</sup> Id.

<sup>9</sup> Id.

This Decision reaffirms the stringent standards for bringing such claims in light of the section 546(e) securities safe harbor and the section 548(c) “good faith” defense. In particular, the Decision strengthens the developing consensus in Bankruptcy Courts within the Southern District of New York that a defendant’s awareness of potential “red flags” is not a sufficient basis to sustain such claims where the defendant does not turn a willful blind eye to such potential concerns.

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