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REVERSAL OF DECISION IN BAYOU GROUP BANKRUPTCY OFFERS LITTLE GUIDANCE FOR THE INSTITUTIONAL INVESTOR WISHING TO REDEEM FROM A FRAUDULENT PONZI SCHEME

In a partial reversal of a decision from Bayou Group LLC's bankruptcy case, the U.S. District Court for the Southern District of New York reconsidered a controversial ruling that sent shivers down the spines of institutional investors in 2008. *In re Bayou Group*, LLC, No. 09 Civ. 02577 (S.D.N.Y. Sept. 17, 2010). Specifically, the District Court found the Bankruptcy Court's legal reasoning faulty in deciding that, as a matter of law, all money paid out to redeeming investors within the reachback period could be avoided as a fraudulent conveyance, even though many of these investors had been defrauded themselves. The District Court's recent ruling may do little, however, to help clarify a murky area for institutional investors, leaving them confused as to how they can not only guard against investment risk in unforeseen fraudulent endeavors, but protect themselves from disgorgement of any return they may have innocently received therefrom once a bankruptcy is filed.

The Bayou Bankruptcy

In 1996, Sam Israel, Daniel Marino and James Marquez created the Bayou Fund, a hedge fund aimed at attracting large, institutional investors. Although the Fund began losing money from the outset, and never actually turned a profit thereafter, the Fund's managers manufactured the illusion of profitability by issuing fraudulent financial reports claiming extraordinary annual profits. Israel and Marino misappropriated new investor money for their own personal gain, and created a fictional accounting firm to act as an "independent" auditor verifying their financial statements. Additionally, to avoid detection of their fraud, as well as to lend credence to their financial claims, the Fund regularly honored requests from individual investors who wished to redeem their investments. In so doing, the Fund managed to evade investigation, and therefore, legal inquiry. In sum, the Fund had amassed over $450 million in investments by the time it announced its voluntary liquidation in July 2005.

The Bankruptcy Code provides that, upon a showing of actual or constructive fraud, a trustee in bankruptcy may avoid certain transfers made up to two years prior to the initiation of the bankruptcy case (or up to four years under the law of most states, and six years under New York law), whether or not the recipient was complicit in the fraudulent activity. Accordingly, the trustee in Bayou’s bankruptcy case sought to exercise those avoidance powers as to all Bayou investors who had redeemed their investments prior to the bankruptcy filing, recovering both the principal investment as well as the fictional profits received. In siding with the trustee, the Bankruptcy Court noted that all dividends paid out to investors within the framework of this type of investment scheme – i.e., a "Ponzi" scheme – necessarily constituted actual fraud as a matter of law and had to be returned to the estate for equitable redistribution for the benefit of all creditors. The Court went even further in announcing that any "red flag" that puts an investor on notice "of some potential infirmity in the investment" defeats any possible assertion of a good faith defense. Accordingly, the Court's broad standard, in effect, precluded redeeming investors from raising any defense whatsoever, regardless of the fact that the recipients were themselves victims of the Ponzi scheme.

<u>Bayou Revisited</u>

In September 2010, the U.S. District Court for the Southern District of New York reviewed the Bankruptcy Court's decision. Although the earlier decision was largely affirmed, the District Court ordered a new trial allowing the redeeming investors to rebut the presumption of actual fraud. Specifically, the District Court held that the earlier decision employed the wrong standard in assessing what level of suspicion should prompt a reasonable investor to conduct further investigation.

Although the District Court recognized the difficulty in "attempting to apply absolute rules in this area," Judge Gardephe nevertheless noted that the Bankruptcy Court's reasoning on this point cited no legal authority. Judge Gardephe stated further that the Bankruptcy Court "committed legal error" by substantially broadening the well-established legal threshold at which an investor should be required, at the risk of being deemed complicit in the fraud, to conduct a diligent investigation. In so finding, the District Court Judge opined that before imposing such an onerous burden, bankruptcy courts have required the existence of some objective information indicating either that the investment entity was insolvent or that there was a fraudulent purpose in making a transfer, such that the investor is put on "inquiry notice" of a fraudulent scheme – by contrast, the Bankruptcy Court's lower threshold would preclude an investor from asserting their innocence upon the trustee's mere showing of some "infirmity" in the fund.

Under the Bankruptcy Court's ruling, individual investors, who likely lack the means to conduct a meaningful investigation, inherited an affirmative obligation to personally monitor each entity in which they entrust their money. As a consequence, any showing of a "red flag" or "infirmity" in the investment would leave an investor with the Hobson's Choice of either expending significant personal resources to expose a potentially fraudulent scheme (and therefore prohibiting itself from redeeming upon discovery of a fraud), or immediately trying to redeem its investment (and thus subjecting itself to the avoidance powers of the bankruptcy trustee). In reviewing that decision, the District Court presented a litany of "infirmities" which could potentially fall under the Bankruptcy Court's new umbrella, including "resume puffing, lying to employees or any other act of dishonesty, a failure to pay personal taxes, an unjustified refusal to pay a vendor, sexual harassment or sexual affairs," which might constitute sufficient notice requiring an investor to conduct an independent investigation and, *as a matter of law*, risk liability for receiving a fraudulent conveyance.

Instead, the District Court held that the appropriate inquiry is not whether there was reason to doubt the financial integrity of Bayou, but rather, whether a reasonably prudent institutional investor would suspect either that Bayou might be insolvent or that a transfer from Bayou might be made with a fraudulent purpose. Because the Bankruptcy Court had not considered these issues and potential inquiries, the District Court believed that the Court's decision was premature. Accordingly, Judge Gardephe ordered a new trial on the issue of whether the investors had sufficient information to put them on inquiry notice. The District Court further instructed that, if a factual finding reveals that the investors were on inquiry notice, two additional queries must then be resolved: first, did the investors conduct a diligent investigation under the circumstances; and second, would a diligent investigation have uncovered Bayou's fraud. However, despite the District Court's admonitions against troubling scenarios under the Bankruptcy Court's standard, Judge Gardephe did not offer any specific guidance as to what should prompt a diligent inquiry. On the contrary, Judge Gardephe recognized that the investigation requirement is largely illusory, stating that upon discovery of a "red flag", the "sensible" investor will redeem rather than spend "more time and money on further inquiry."

The Aftermath

Unfortunately, the Bankruptcy Code does not define "good faith", and courts have been wary of assigning any concrete parameters to the term. In the aftermath of the District Court's reversal of the Bayou decision, while an investor has gained a greater chance of asserting a good faith defense, an open question remains as to what, if anything, *might* rise to the level of inquiry notice as a matter of law. The District Court observed that the lack of clarity affords a necessary flexibility, particularly in negotiating the underlying tension between protecting creditors on the one hand, and promoting the ease of commercial transactions on the other. That flexibility, however, is not likely to provide much comfort to the institutional investor faced with the dilemma of retrieving invested money from an enterprise in which they have a colorable suspicion of fraudulent activity vs. conducting an independent investigation and awaiting the distribution procedures of a bankruptcy proceeding.

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