Adversary Proceedings

Presented by the May Pupilage Team
Led by Howard Cohen

Delaware Bankruptcy American Inn of Court
May 13, 2014 at 5:30 p.m.
United States Bankruptcy Court for the District of Delaware
824 Market Street, 5th Floor, Courtroom No. 5
Wilmington, Delaware 19801

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE: TELEXFREE, LLC, *et al.*[1], Debtors.	Chapter 7 Case No. 14-00000 (Jointly Administered)
BRYA KEILSON, as chapter 7 trustee of the bankruptcy estate of TelexFree, LLC, *et al.*, Plaintiff, v. ABC INC., Defendant.	Adv. Proc. No. 16-0000

MEDIATION STATEMENT

II. STATEMENT OF FACTS

A. PROCEDURAL HISTORY

On April 14, 2014, TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. filed a voluntary petition for relief pursuant to chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). On April 1, 2016, Brya Kielson, as chapter 7 trustee ("Trustee") for the bankruptcy estates of TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. (collectively "TelexFree" or "Debtors") sued 1) a good faith investor who received more than the value of his investment; 2) a good faith investor who invested more than he received; 3) an IT vendor defendant for payments received within ninety (90) days of the petition date and everything else paid in the two (2) years prior to the bankruptcy filing; 4) an auditor for state law causes of action; and 5) a broker who sold securities for the Debtors. On May 15, 2016, one of

[1] The "Debtors" in these Chapter 7 cases are TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc.

the four principals of TelexFree entered into a plea agreement with the Securities and Exchange Commission.

B. THE DEBTORS

TelexFree was a Massachusetts-based "multi-level marketing" company that purported to be in the business of selling local and international telephone service plans that use "voice over internet" ("VoiP") technology. From at least November 2012 until April 15, 2014, TelexFree and its principals, James M. Merrill, Carlos N. Wanzeler, Steven M. Labriola and Joseph H. Craft (collectively, the "Principals"), acting through promoters such as Sanderley Rodrigues de Vancelos, Santiago De La Rosa, Randy N. Crosby and Faith R. Sloan (collectively, the "Primary Promoters"), raised more than $300 million, largely from the Brazilian and Dominican immigrant communities in Massachusetts and twenty other states, through a fraudulent and unregistered offering of securities. (TelexFree publicly claims to have raised more than $1 billion, but documentation for that claim has not been made public.)

TelexFree offered the VoiP program along with a passive income program that allows investors to purchase either a $289 or $1,375 investment. The $289 program offers one advertisement kit and ten VoIP Programs, while the $1,375 option allows the purchaser to receive five advertisement kits and fifty VoIP Programs. By using the so-called advertisement kits, which is an "effortless" process consisting of several minutes of work per advertisement, participants are purportedly able to generate extensive returns without the need for any VoIP Program sales. In addition, participants received an additional VoIP Program for posting a daily advertisement, which they were then able to sell to TelexFree for $20. This program promised substantial returns - 200% per year or more - for becoming promoters of the business. TelexFree promised to pay promoters for: (a) placing duplicative TelexFree ads on internet sites - a process

which, by itself, generates no revenue; and (b) recruiting other investors who pay the membership fees that constitute the lion's share of monies taken in by TelexFree. Until changes to its compensation plan in March 2014, TelexFree did not require promoters to sell its VoiP product in order to qualify for payments.

Despite the appearance of having a legitimate VoiP business, the Debtors actually operated an elaborate pyramid scheme. Documents available to date indicate that the Debtors' VoiP sales revenues - approximately $1.3 million - have generated barely 1% of the nearly $1.1 *billion* needed to honor its promises to promoters for placing internet ads. As a result, in classic pyramid fashion, TelexFree paid its older investors, not with revenue raised from the sale of its VoiP product, but with money received from newer investors.

The company's financial records indicate that, from mid-November 2013 until mid-April 2014, TelexFree transferred approximately $30 million from TelexFree operating accounts to the Principals, the Primary Promoters, and to affiliated companies. Tens of millions of additional investor funds received by TelexFree are presently unaccounted for.

On March 9, 2014, TelexFree changed its compensation plan so that promoters would now be required to sell VoiP product in order to qualify for the payments that TelexFree had previously promised to pay them. The rule change generated a storm of protests from promoters who can not recover their money. On April 1, 2014, dozens of promoters descended on the company's office in Marlborough, Massachusetts to complain - in part because, as one of them told the press, the VoiP service is "almost impossible to sell". Then on April 14, TelexFree filed for bankruptcy under chapter 11, as well as a motion to reject executory contracts ("Motion to Reject"). In the Motion to Reject, TelexFree admitted that it cannot meet its obligations with its VoiP revenues and that it is therefore seeking authority to reject all its current obligations to

promoters. On April 15, 2014, the Securities and Exchange Commission sued TelexFree, the Principals, and the Primary Promoters.

C. The Defendants

1. Winning Investor Defendant

The first Defendant is a good faith investor who received more than the value of his investment. Defendant invested $137,500.00 in TelexFree in October 2012. By October 2013, Defendant's account reflected a gain of $367,500.00. Defendant then withdrew $300,000.00. By April 2014, Defendant's account reflected an additional gain of $183,750.00. Therefore, Defendant invested $137,500 and received $300,000.

2. Losing Investor Defendant

The second Defendant is a good faith investor who invested more than he received. Defendant invested $137,500.00 in TelexFree in October 2012. By October 2013, Defendant's account reflected a gain of $367,500.00. Defendant withdrew $37,500.00. By April 2014, Defendant's account reflected an additional gain of $183,750.00. Therefore, Defendant invested $137,500 and received $37,500.

3. IT Company

The third defendant is an IT company who was sued for payments received within 90 days of the petition date as well as payments that it received in the two (2) years prior to the petition date.

4. Auditor

The fourth defendant is an auditor who was sued for state law causes of action, such as breach of fiduciary duty, negligence in not discovering the scheme, etc.

5. Broker

The fifth defendant is a broker who sold securities for the Debtors. Broker received $5 million in commission. The trustee seeks avoidance of principal and commission from broker under sections 544 and 548 of the Bankruptcy Code.

PONZI SCHEME AVOIDANCE ISSUES

I. PONZI SCHEMES – INVESTOR ISSUES

Innocent investors in a collapsed Ponzi scheme are typically viewed as tort creditors holding a claim for restitution for their investment. Donell v. Kowell, 533 F.3d 762, 774-75 (9th Cir. 2008) ("when Kowell and the other innocent victims gave money to Wallenbrock, they were not actually investors, but rather tort creditors with a fraud claim for restitution equal to the amount they gave."). While the only fair and equitable way to treat victims would be to fully repay each one of them, this is normally impossible. Therefore, courts endeavor to find the most equitable way to distribute a debtor's assets.

Defrauded investors typically fall into one of three categories: (a) those who received nothing in return for their investment; (b) those who received some value after making their investment, but less than the amount they invested; and (c) those who received value in excess of the full amount of their investment. Each category of aggrieved investors has different positions with respect to what should be recoverable, even if it comes at the expense of others. Thus far, courts have not developed a consistent model for recovery for each category. See, e.g., SEC v. Forte, 2009 U.S. Dist. LEXIS 116802, at *13 (E.D. Pa. Dec. 15, 2009) (rejecting argument that a return of principal should not be recovered from good faith investors); SIPC v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010), aff'd, 654 F.2d 229 (2d Cir. 2011) (finding investors should not be permitted to claim unpaid fictitious profits but leaving open the issue of whether a trustee could recover such profits actually paid to investors).

A. Components of an investor's claim

Investor claims generally include the following components. The treatment of each component depends upon the distribution methodology adopted by the court (see section B below).

1. Principal – in other words, all amounts invested and not returned.

2. Profits – fictitious amounts that were promised, but remain unpaid.

(i) A majority of courts have found clams for fictitious profits should be disallowed because it would allow recovery of arbitrary amounts or would be inequitable. See, e.g., In re New Times Sec. Servs, Inc., 371 F.3d 68, 88 (2d. Cir. 2004) (finding that fictitious amounts were not appropriate since it "would allow customers to recover arbitrary amounts that necessarily have no relation to reality"); Official Cattle Contract Holders Comm. v. Commons (In re Tedlock Cattle Co.), 552 F.2d 1351, 1353 (9th Cir. 1997) (holding that trustee may use an "equitable" theory in excluding fictitious profits in a claim); CFTC v. Equity Fin. Grp., *LLC*, 2005 U.S. Dist. LEXIS 20001, at *77 (D.N.J. Sept. 2, 2005) (holding that it would be

inequitable to "recognize[e] profits or other earnings in claims for distributions that would the detriment to later investors").

(ii) The minority view is that investors should be compensated for the time value of the use of their funds. See, e.g., Lustig v. Weisz &Assocs., Inc. (In re Unified Commercial Capital), 2002 WL 32500567, at *8 (W.D.N.Y. June 21, 2002)(finding value where payments to creditors "were not simply payments of nonexistent profits, but of a contractually provided-for, commercially reasonable rate of interest on what amounted to a loan").

B. Distribution Methodologies[1]

1. Overview

Investors in a failed Ponzi scheme are often pitted against each other, and typically advocate for a particular distribution methodology that favors their particular facts. For example, an investor that never received anything after investing is likely to favor a distribution method that requires investors who received value from the debtor to give it all back, so that the "pot" can then be divided ratably among all investors. Investors that received value, on the other hand, will naturally resist giving it back. Instead, they often advocate for a distribution scheme that permits investor claims for lost profits, such as those shown on their account statements. In response, courts have developed several different distribution methodologies.

2. Net Investment Method

Under the net investment method, an investor's claim consists of the amount of principal invested, less any distributions paid by the debtor. Under this approach, investors may not assert a claim for their lost profits or account statement balances. Courts adopting the net investment method treat account statements as works of fiction. *See*, e.g., In re Bernard L. Madoff Inv. Sec., LLC, 654 F.3d 229, 235 (2d Cir. 2011) (in SIPA proceeding, holding that "the Net Investment Method [is] more consistent with the statutory definition of "net equity" than any other method advocated by the parties or perceived by this Court. There was therefore no error.... Use of the Last Statement Method... would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations."); Barnard v. Albert (In re Janitorial Close-Out City Corp.), Adv. No. 11-8952-AST (Bankr. E.D.N.Y. Feb. 8, 2013) (granting summary judgment on trustee's claim to avoid and recover payments to investor in excess of cash investment).

3. Last Statement Method

Under the last statement method, an investor's claim is for the balance reflected on its last prepetition account statement. Investors that have received payments from the debtor

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[1] For a thorough overview, see Kathy Bazoian Phelps and Hon. Steven Rhodes, *The Ponzi Book: Unraveling Ponzi Scheme* § 20.04 (2012).

typically argue in favor of this method. Some courts have utilized the last statement method. See CFTC v. Richwell, Ltd., 163 B.R. 161 (N.D. Cal. 1994) (adopting receiver's plan to distribute Ponzi scheme assets under which certain investors' claims based upon account statements).

4. Other Variations

Some courts employ other methodologies, such as the "Rising Tide" method. Under the Rising Tide method, investors are permitted to retain prepetition distributions made to them, but those distributions are treated as a postpetition distribution by the trustee or receiver. Investors that received nothing prepetition receive a larger share postpetition than other investors. See SEC v. Huber, No. 12-1285 (7th Cir. Nov. 29, 2012) (Posner, J.), at *12 (approving receiver's use of rising tide method).

C. Investor Claims and Section 502(d)

Assume that an investor received some prepetition distributions on its investment, but not nearly enough to cover its full investment. Assume further that the trustee asserts that some or all of those distributions are recoverable as fraudulent transfers. Does Section 502(d) require the disallowance of the investor's claim until it repays the asserted fraudulent transfers? Judge Walsh has answered this question in the negative. See Zazzali v. AFA Financial Group, LLC, 477 B.R. 504, 517 (Bankr. D.Del. 2012). A Ponzi scheme trustee therefore must obtain a judgment on an avoidance claim before asserting a disallowance claim under Section 502(d). Interestingly, although an investor facing an avoidance claim may successfully challenge bankruptcy court jurisdiction under Stern v. Marshall, when the avoidance claim is coupled with a Section 502(d) claim, the challenge may fail. See SIPC v. Bernard L. Madoff Inv. Sec. LLC, 12 MC 115 (S.D.N.Y. Jan. 4, 2013), at *14 ("whenever the Bankruptcy Court must resolve a § 502(d) claim brought by the Trustee, it may also finally decide avoidance actions to the extent that those actions raise the same issues as the § 502 (d) claim and thus would "necessarily" be resolved by it.").

D. Strategic and Ethical Considerations

1. Collective action

Similarly-situated investors may find it useful for their respective counsel to consult and coordinate in the pursuit of common issues and goals. In that regard, bankruptcy courts have recognized and upheld the common interest doctrine. See In re Leslie Controls, Inc., 437 B.R. 493 (Bankr. D. Del. 2010) (common interest doctrine applied to debtor's prepetition legal analysis shared with creditors committee and future representative in plan development).

2. Privilege

A bankruptcy trustee inherits the attorney-client privilege if the debtor is a corporation. See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343, 358 (1985) (bankruptcy trustee inherits debtor corporation's attorney-client privilege). The trustee

can waive the privilege, and thereby compel the disclosure of privileged information. Outside investors who "bought in" on the basis of prospectuses or private placement memoranda prepared by company counsel may benefit from such waivers. On the other hand, company directors and insiders who may be implicated if their communications with company counsel are disclosed cannot prevent the trustee's waiver simply because it may result in their incrimination. *Id.*, 471 U.S. at 353–54 (goal of uncovering insider fraud "would be substantially defeated if the debtor's directors were to retain the one management power that might effectively thwart an investigation into their own conduct.").

II. PONZI SCHEME AVOIDANCE ACTIONS – ORDINARY CREDITORS

In bankruptcy, Ponzi schemes are like a virus - infecting everything they touch. Even commonplace, non-investor transactions, such as routine dealings with trade creditors and banks, are typically subject to heightened scrutiny. As a result, these otherwise unremarkable transactions often give risk to preference or fraudulent transfer claims brought by a bankruptcy trustee or estate representative.

A. Preference Claims

Typically, it is not difficult for a debtor or trustee to establish a *prima facie* preference action under section 547(b) in a bankruptcy case for payments made to a creditor within ninety days (or, for an insider, one year) of the filing of a bankruptcy petition and the same is true in Ponzi scheme cases. Rather, the big issue in Ponzi scheme preference actions is whether the ordinary course of business defense may be used to shield a preference defendant from liability.

As most bankruptcy attorneys are well aware, under section 547(c)(2), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), to establish the ordinary course of business defense, the defendant has the burden of proving that: (a) the debt satisfied by the transfer was incurred by the debtor in the ordinary course of the business and financial affairs of the debtor and the transferee (typically the defendant); and (b) either the transfer was: (i) made in the ordinary course of business or financial affairs of the debtor and the transferee (the "Subjective Payment Test"); or (ii) made according to ordinary business terms (the "Objective Payment Test"). See 11 U.S.C. § 547(c)(2)(A)-(B). Before BAPCPA, in addition to showing the debt had been incurred in the ordinary course of business, a defendant had to satisfy both the Subjective Payment Test and the Objective Payment Test- under BAPCPA a defendant need only satisfy one of these tests.

Courts generally agree that an investor who received payment on account of its investment cannot successfully maintain an ordinary course of business defense under section 547(c)(2) of the Bankruptcy Code. See e.g., Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Investments Assocs., Inc.), 48 F.3d 470, 475 (10th Cir. 1995); but see In re American Continental Corp., 142 B.R. 894, 900 (D.Arizona 1992). What is less clear, however, is whether a third-party creditor, such as (by way of example only) a telephone company or trade vendor, can assert an ordinary course of business defense.

Some courts adopt a bright line test, concluding, as a matter of law, that the ordinary course of business defense is unavailable to any preference defendant in a Ponzi scheme case. E.g., Danning v. Bozek (In re Bullion Reserve of North America), 836 F.2d 1214, 1219 (9th Cir. 1988), cert. denied, 486 U.S. 1056, 100 L. Ed. 2d 925, 108 S. Ct. 2824 (1988) ("transfers made in a 'Ponzi' scheme are not made in the ordinary course of business"); Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.), 819 F.2d 214, 217 (9th Cir. 1987); Henderson v. Buchanan, 985 F.2d 1021, 1025 (9th Cir. 1993); In re Taubman, 160 B.R. 964, 991 (Bankr. S.D. Ohio 1993) (same); Wider v. Wootton, 907 F.2d 570, 572 (5th Cir. 1990) (same). In support of this rule, courts reason, among other things, that a Ponzi scheme is not a legitimate business and, therefore, no transfer can be made in the ordinary course of "business" of such a debtor under section 547(c)(2). See Graulty, 819 F.2d at 216-17. These decisions also appear to be driven significantly by policy considerations - namely, discouraging preferential payments to creditors in the context of an illegal Ponzi scheme and promoting an equality of distribution among creditors in such a case. See id. at 217. Under this test, non-investor creditors would appear to be precluded from asserting an ordinary course of business defense regardless of, among other things, any particularized circumstances surrounding the payment or the nature of the goods or services provided by the defendant.

Other courts apply a more flexible test that would permit non-investor creditors to assert the ordinary course of business defense in certain Ponzi scheme cases. See Sender v. The Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Investments Assocs., Inc.), 48 F.3d at 475 (*dictum*); In re M & L Business Machine Company, Inc., 84 F.3d 1330, 1332 (10th Cir. 1996); In re American Continental Corp., 142 B.R. 894, 900 (D. Ariz. 1992); accord Breeden v. Northeast Binding Sys. (In re Bennett Funding Group, Inc.), 253 B.R. 316, 319-23 (Bankr. N.D.N.Y. 2000) (permitting ordinary course of business defense to be asserted even though at least a portion of the debtor's business consisted of a Ponzi scheme); cf. Harder v. JPPCS, Inc. (In re Graff), 454 B.R. 745 (Bankr. W.D. Mo. 2011) (in a non-Ponzi scheme case in which fraud may have been involved, the court permitted the defendant subcontractor to assert an ordinary course of business defense even though the debtor may have been involved in improper activities in connection with the preference payment).

The question then becomes, assuming, arguendo, that the ordinary course of business defense may be asserted by a non-investor creditor, how should that defense be analyzed and applied? The jurisprudence on this issue is uneven. Dictum in the Hedged-Investments case suggests that, if the transfer arises from a run-of-the-mill credit transaction, a regular ordinary course of business analysis should suffice. There, the court stated that:

> the purposes of § 547(c)(2) clearly are served by permitting its application to noninvestor-creditors whose transfers are received in the ordinary course of business. Again, the purposes of § 547(c)(2) are to leave undisturbed normal financial relations, because doing so does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy, see 11 U.S.C.A § 547 at 141, and to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business of the debtor and the debtor's transferee. 4 Collier on Bankruptcy, P 547.10 (15th ed. 1991). If, for instance, a Ponzi scheme uses telephone services, is billed for that service, and pays the phone company, disallowing the avoidance of that payment following a bankruptcy

> petition is consistent with the purposes of § 547. In addition, it is consistent with the over arching purpose of the preference provision to avoid a creditors' rush to the bank to dismember a debtor as it slides into bankruptcy. . . . Because such a transfer would be according to ordinary business terms as well as in the ordinary course of business, it would be defensible against a preference avoidance action.

Hedged-Investments Assocs., 48 F.3d at 476. This analysis was embraced in Graff, where the court emphasized that the source of the funds used to pay a defendant is not relevant to a *prima facie* preference action or to any defenses asserted in the action. See Graff, 454 B.R. at 754. While Graff may be a fraud case, it is not a Ponzi scheme case. In Graff, although the debtor was alleged to be involved in some type of malfeasance or misfeasance pertaining to the funds that it was supposed to use to pay the defendant as well as the funds it actually used to make the payments, the debtor ran a legitimate business and not a Ponzi scheme. It is unclear whether the Graff court's analysis or conclusions would have differed had the debtor been running a pure Ponzi scheme business, although *dictum* in the opinion suggests that result would have remained the same.

By comparison, in Bennett Funding the court permitted a preference defendant to assert an ordinary course of business defense, but only to the extent that the transfers at issue related to a portion of the debtor's business that had some economic substance and profit potential. See 253 B.R. 321-23. In Bennett, the debtor was in the office equipment leasing business and in fact leased equipment to third parties. The creditor sold office equipment to the debtor to be used in the debtor's leasing business and the debtor made the alleged preference transfer to pay for the equipment. The debtor's fraudulent scheme involved obtaining payments from investors secured by the leases – but the security was illusory as the debtor either pledged the same leases to multiple investors or falsified the leases altogether. Still, because at least part of the leasing business was real and not a fraud, the court permitted a preference defendant who transacted with the facially valid leasing arm of this business to assert an ordinary course of business defense.

B. Ordinary Creditors' Intent: Ponzi-Scheme Presumption and Good Faith / For Value

There are two types "fraud" giving rise to fraudulent transfers under the Bankruptcy Code: intentional fraud under section 548(a)(1)(A) ("actual intent to hinder, delay, or defraud") and constructive fraud section 548(a)(1)(B) (debtor received less "than reasonably equivalent value," and was insolvent). Intentional fraud typically must be proved by establishing certain "badges of fraud" which provide circumstantial evidence that the transferor had the request fraudulent intent. See Zazzali v. Mott (In re DBSI, Inc.), 2011 WL 115876, at *3 (Bankr. D. Del. 2011) (listing badges of fraud :"(1) the relationship between the debtor and the transferee; (2) consideration for the conveyance; (3) insolvency or indebtedness of the debtors; (4) how much of the debtor's estate was transferred; (5) reservation of benefits, control or dominion by the debtor over the property transferred; and (6) secrecy or concealment of the transaction").

Once fraud is established, the burden shifts to the defendant-transferee, who must establish that he or she took for value and in good faith. 11 U.S.C. § 548(c) ("[A] transferee . . .

that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that the transferee or oblige gave value to the debtor in exchange for such transfer or obligation."). An ordinary creditor that supplied goods or services on credit will argue that payment for such goods or services was value. See 11 U.S.C. § 548(d)(2)(A) ("'[V]alue' means property, or satisfaction or securing of a present or antecedent debt of the debtor. . . .").

Actual fraud can be difficult to prove, as it requires to trustee to prove several badges of fraud. Constructive fraud also has its hazards, as trustee must establish "less than reasonably equivalent value" and insolvency, both of which must usually be established by an expert witness. However, the so-called "ponzi-scheme presumption" – pursuant to which all transfers made in furtherance of a Ponzi scheme are presumed to have been made with fraudulent intent - may be a powerful tool for the trustee. Courts often discuss this presumption in determining creditor's good faith / for value defense. See Zazzali v. AFA Fin. Group, LLC (In re DBSI, Inc.), 477 B.R. 504, 510-11 (Bankr. D. Del. 2012) (discussing Ponzi-scheme presumption and its application).

In order to establish a presumption, the trustee must prove (1) Ponzi scheme existed and (2) that the transactions were part of the scheme. Usually, it will be difficult for an ordinary creditor to contest that the scheme existed (e.g., guilty plea by perpetrators, examiner report, etc.). An ordinary creditor will, however, dispute that his ordinary credit relationship with debtor was part of the Ponzi scheme. See Gold v. First Tennessee Bank, N.A. (In re Taneja), No. 10-01225, 2012 WL 3073175 (Bankr. E.D. Va. 2012) (refusing to apply Ponzi-scheme presumption where trustee did not establish the existence of a Ponzi scheme and, alternatively, trustee did not establish that the transferees were party to the scheme).

Generally speaking, in addition to establishing value, to obtain a finding of good faith, it must be determined whether, using an objective standard, the creditor was on inquiry notice of fraud and, if so, whether under an objective standard its investigation of the fraud was sufficient. See Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.), 397 B.R. 1, 22-23 (S.D.N.Y. 2007). In short, the Bear Stearns court had to determine "whether what Bear Stearns or should have known triggered a duty to investigate further and whether its investigation was reasonable under the circumstances." Id. at 23.

In the Bear Stearns case, Bear Stearns was broker for hedge fund that was operating a Ponzi scheme. Bear Stearns undertook some investigation, and found no "smoking gun." Court held that a reasonable fact-finder could find that Bear Stearns had made reasonably diligent inquiries and thereby preserved its defense. Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.), 397 B.R. 1 (S.D.N.Y. 2007). The jury ultimately found that Bear Stearns was in good faith, and dismissed trustee's case. Following a trial, the jury did, in fact, find that Bear Stearns had conducted itself in good faith. Gredd v. Bear Stearns Sec. Corp., 328 Fed. Appx. 709 (2009) (affirming trial court's jury change regarding good faith).

If fraudulent intent has been established, at least one bankruptcy court in the Southern District of New York held that the good faith defense may be defeated by the mere existence of a red flag putting the transferee on inquiry notice of "some infirmity in [the debtor] or the integrity of its management." In re Bayou Group, LLC, 396 B.R. 810 (Bankr. S.D.N.Y. 2008), aff'd in part and rev'd in part, 439 B.R. 284 (S.D.N.Y. 2010). On appeal, however, the

district court reversed the bankruptcy court's decision on the standard to be applied in determining good faith, finding it too broad and holding instead that "the great weight of authority holds that [the relevant information putting a creditor on inquiry notice] is information suggesting insolvency or a fraudulent purpose in making a transfer." Bayrou Group, 439 B.R. at 314.

Assorted Case Law in the Third Circuit

1. DBSI (Bankr. D. Del. Aug. 27, 2012). The court can infer the necessary intent from the circumstances of the case, particularly the presence or absence of "badges of fraud." Lists 6 traditional badges. The court recognizes the Ponzi presumption, which posits that "all payments made by a debtor in furtherance of a Ponzi scheme are made with actual fraudulent intent." Yet, the presumption does not relieve the trustee of the burden to show that the transfers were made *in furtherance of* the Ponzi scheme. The court must focus precisely on the specific transaction or transfer sought to be avoided in order to determine whether that transaction falls within the statutory parameters of an actually fraudulent transfer. The court states this situation is identical with the World Vision case and also cites Bayou II to support its decision not to dismiss the intentional fraud claims. The court distinguishes the Sharp case.

2. SEC v. Forte, 2010 WL 939042, (E.D. Pa. Mar. 17, 2010). This case addresses Pennsylvania's intentional fraud statutory provisions regarding whether investors have to return principal in addition to profit in the context of approving a Consent Order. The court held that "the mere existence of a Ponzi scheme is sufficient to establish 'actual intent to defraud.'" The court also ruled that "good faith" is a defense and the investor must establish (1) innocence and (2) exchange of fair value. The court considers whether investors ignored "red flags" revealing the true nature of the investment so they could continue to receive profits – should the investor have known that the investment was too good to be true.

3. In re Rose, 425 B.R. 145 (Bankr. M.D. Pa. 2010). Here the court considers whether a debtor should be denied a discharge under a fraudulent transfer theory based on a Ponzi scheme. The court discusses fraudulent transfer cases and states that in fraudulent transfer cases, "many courts have applied the 'Ponzi Scheme Presumption' to support a finding of actual fraudulent intent necessary to avoid a transaction pursuant to § 548." The opinion includes cites to 5 cases.

4. In re Image Masters, 421 B.R. 164 (Bankr. E.D. Pa. 2009). In the context of a motion to dismiss, the court addressed intentional fraud claims under the Code and Pennsylvania statute. Here, a second company refinanced mortgages held by conventional mortgagees. The second mortgagee was supposed to make payments to the conventional mortgagees, who were sued by the trustee for the debtors.

The court held that the Code and Pennsylvania statute establish that a transferee who receives the transfer in exchange for value and in good faith has a defense to an action based on actual fraud. The defendants have the burden of proving that they took for value and in good faith. The court found that the defendants were not aware of the artifice and scheme of the

debtors and that was no contractual relationship between the debtors and the defendants obligating debtors to make payments to the defendants. Further, nothing in the complaint suggested that the defendants were in any way connected with the Ponzi scheme or that defendants acted with anything less than good faith. The court held, even accepting every allegation as true, that the defendants received the transfers for value and in good faith.

The court also held that a plaintiff must allege with particularity that the debtor made the transfer with actual intent to defraud a creditor, but that courts permit specific allegations of certain factors, known as badges of fraud to satisfy Rule 9(b). There are 11 badges listed. Only the insolvent badge was addressed and the court found that was insufficient to satisfy Rule 9(b). Further, regarding whether the conventional mortgagees knew or should have known about the Ponzi scheme, the court held that allegations of fraud based "on information and belief" did not satisfy Rule 9(b). Finally, the court held that the conventional mortgagees did not have a duty to investigate the debtor and that a mortgagee owes no fiduciary duty to a mortgagor. In sum, the complaint did not (1) contain factual allegations that showed the requisite intent or (2) connect defendants with the fraudulent scheme orchestrated by the debtors and its principal.

The trustee relied upon the fraudulent manner in which the debtors and their principal operated their Ponzi scheme to defraud the homeowners. The court did not agree with the proposition and instead agreed with the cases in which the court concluded that the general fraudulent intent underlying the Ponzi scheme was insufficient to establish the fraudulent transfer cause of action. Instead, a plaintiff must set forth factual allegations of fraudulent intent in connection with the specific transfer sought to be avoided and must show some direct connection between a defendant and a debtor's fraudulent Ponzi scheme.

The court in Actrade Fin'l, described a situation very similar: It is recognized that in an intentional fraudulent conveyance case the relevant inquiry is whether the transferee knew of the transferor's intent to defraud his creditors "in any way." The transferee "need not have actual knowledge of the scheme that renders the conveyance fraudulent"; constructive knowledge of a scheme to defraud will suffice. However, the trustee failed to allege with sufficient specificity facts that show that transferee was complicit with or had knowledge of an intentional scheme to defraud creditors of debtor. This is especially true when the transfer was to a third party who was neither an investor nor in any other way directly involved in the Ponzi scheme.

As the court explained at length in Balaber–Strauss: The statutes require an evaluation of the specific consideration exchanged by the debtor and the transferee in the specific transaction which the trustee seeks to avoid, and if the transfer is equivalent in value, it is not subject to avoidance under the law. Not every transaction which has the effect of "exacerbating the harm to creditors by increasing the amount of claims while diminishing the debtor's estate" is a fraudulent conveyance. Section 548 is not a catch-all provision. It allows the trustee to avoid only the transfers prescribed by the statute.

The Trustee's theory ignores the actual transaction between Debtor and defendant and the undisputed equivalence in value between the transfer and the defendant's services, and instead focuses on collateral conduct of the Debtors' management (the overall operation of the

Ponzi scheme), which is extraneous to any particular transaction between Debtor and defendant. To say that defendant's transaction conferred no value on the Debtors is fiction insofar as the particular transaction itself is concerned. Fraudulent conveyance law, under both state and federal statutes, is concerned with the reality of whether the transferee conferred equivalent value on the debtor *in the transaction sought to be avoided.* The fact that the debtor's enterprise as a totality is operated at a loss, or in a manner that is fraudulent, does not render actually or constructively fraudulent a particular transaction which in and of itself is not fraudulent in any respect.

The court recognizes that Judge Carey, when a Judge in this District, ruled that a plaintiff can rely upon the general fraudulent intent inherent in a Ponzi scheme to satisfy the "actual intent to defraud" element of an intentional fraudulent transfer. But his holding applied only when the transferee did not take the transfer in good faith and for reasonably equivalent value. See Liebersohn v. Campus Crusade for Christ, Inc. (In re C.F. Foods, L.P.), 280 B.R. 103, 111 (Bankr. E.D. Pa.2002) ("It is also reasonable, and, in this case, appropriate, to infer that, *except for transfers to a person who took in good faith and for a reasonably equivalent value ....* all other transfers made by the debtor during an on-going Ponzi scheme are part of the overall fraud.") (emphasis added). The court agreed with and endorsed the cases which expressly hold that the general fraudulent nature of the Ponzi scheme does not provide the requisite intent to support a cause of action for an actually fraudulent transfer.

5. In re Norvergence, Inc., 405 B.R. 709 (Bankr. D.N.J. 2009). Chapter 7 trustee brought an adversary proceeding against leasing companies to which debtor sold its customer contracts and asserted claims for, among others, intentional fraudulent conveyances. The court's opinion was on motions to dismiss and for more definite statement.

The Court found that an intentional fraudulent conveyance requires the establishment of two elements: (1) a transfer of an interest of the debtor in property, or any obligation incurred by debtor; and (2) with actual intent to hinder, delay, or defraud creditors. Regarding intent, the absence of any of the enumerated badges of fraud will not preclude the finding of actual fraud. The Trustee urges that there are at least four badges present: the Debtor absconded, removal or concealment of assets, the value of the consideration received by Debtor was not reasonable equivalent to the value of the asset transferred or the amount of the obligation incurred, Debtor was insolvent or became insolvent shortly after the transfer was made or the obligation incurred.

In addition to pleading sufficient badges of fraud, the Trustee also urged that intent can be shown by establishing the existence of a Ponzi or Bust-Out scheme. "Proof of a Ponzi scheme will be sufficient to establish the Ponzi operator's actual intent to hinder, delay, or defraud creditors for purposes of actual fraudulent transfers." The Trustee contends that the NorVergence business model, also characterized here as the "Salzano Scheme" resembles that of a Ponzi Scheme or Bust-Out Scheme and therefore NorVergence's intent to defraud is shown. The Trustee argues that even if the Defendants possess a good faith defense, such a defense will not stand as an appropriate challenge to the adequacy of the Trustee's claims on a motion to dismiss the Complaint under Rule 12(b)(6). The availability of the defense must be left for discovery and/or trial. An analysis addressing actual intent to defraud a creditor is driven by 12 factors, also known as the "badges of fraud," set forth in N.J.S.A. 25:2–26. Generally, the

existence of one badge can cast suspicion on the transferor's intent. A finding of several in one transaction generally provides conclusive evidence of an actual intent to defraud. The movant's opposition to Count I and II pertains to the "actual intent to hinder or defraud" elements of § 548 and N.J.S.A. 25:2–25 et seq. The Trustee's task to establish intent focuses on proving Debtor's business scheme equates to a Ponzi Scheme. Upon demonstrating successfully the Salzano Scheme qualifies as a Ponzi Scheme, the actual intent to hinder, delay, or defraud creditors will be inferred. In re Bayou Group, LLC., et al., 362 B.R. 624, 633 (Bankr. S.D.N.Y.2007) (citing numerous cases in support); In re Slatkin, 310 B.R. 740, 748; In re Cohen, 199 B.R. 709, 717 (9th Cir. BAP 1996).

A resolution to the question whether the Trustee can employ the "Ponzi scheme route" to establish the intent prong for Count I and II of the Complaint based on the facts of this case requires a finding of facts exceeding the scope of this motion. The court found that more discovery was required on this issue. The Court was satisfied that Count I and Count II of the Trustee's Complaint stated claims for relief "plausible on its face" and dismissal of Count I and Count II was denied.

6. C.F. Foods, L.P., 280 B.R. 103 (Bankr. E.D. Pa. 2002). Plaintiff has the burden of proof on all elements. Intent can be inferred based on a Ponzi scheme. Good faith and fair value are *defenses*. Numerous courts have decided that a debtor's actual intent to hinder, delay or defraud creditors may be inferred from the Debtor's active participation in a Ponzi scheme. One can infer an intent to defraud future investors from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. Knowledge to a substantial certainty constitutes intent in the eyes of the law, and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them. The Transfers at issue were charitable contributions. Although Campus Crusade was not an investor in the Ponzi scheme, *neither § 5104(a)(1) nor § 548(a)(1)(A) requires that the transfers be made to defraud the transferee, but only that they are made with actual intent to hinder, delay or defraud any creditor of the debtor* (12 Pa.C.S.A. § 5104(a)(1)) or any entity to which the debtor was or became indebted (11 U.S.C. § 548(a)(1)(A)).

The court found that it was also reasonable, and, in this case, appropriate, to infer that, except for transfers to a person who took in good faith and for a reasonably equivalent value, as described in § 5108(a) of PUFTA or in § 548(c) of the Bankruptcy Code, all other transfers made by the debtor during an on-going Ponzi scheme are part of the overall fraud. The "good faith" exceptions found in § 5108(a) of PUFTA and § 548(c) of the Bankruptcy Code are not applicable to the transfers at issue here, because, in its answer to the trustee's interrogatories, Campus Crusade admitted that the Transfers were not in return for "the delivery of goods, services or loans of money or other reasonably equivalent value delivered by [Campus Crusade] to the Debtor." Based upon the foregoing, the Transfers to Campus Crusade were made by the Debtor with actual intent to defraud creditors. The Third Circuit Court of Appeals has held consistently that the plaintiff must prove each of the elements of a constructive fraud claim brought under Bankruptcy Code § 548.

III. LITIGATION ISSUES

A. Evidentiary Issues

1. Relevant Rules of Evidence

a. FRE 602 – Lack of Personal Knowledge

A witness may not testify to a matter unless evidence is introduced sufficient to support a finding that the witness has personal knowledge of the matter. Evidence to prove personal knowledge may, but need not, consist of the witness' own testimony. This rule is subject to the provisions of rule 703, relating to opinion testimony by expert witnesses.

b. FRE 703 – Bases of Opinion Testimony by Experts

The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.

c. FRE 705 – Disclosure of Facts or Data Underlying Expert Opinion

The expert may testify in terms of opinion or inference and give reasons therefor without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination.

d. FRE 901 – Authenticating Documents

(a) General provision.—The requirement of authentication or identification as a condition precedent to admissibility is satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims.

e. FRE 1002 – Requirement of Original

To prove the content of a writing, recording, or photograph, the original writing, recording, or photograph is required, except as otherwise provided in these rules or by Act of Congress.

f. FRE 1003 – Admissibility of Duplicates

A duplicate is admissible to the same extent as an original unless (1) a genuine question is raised as to the authenticity of the original or (2) in the circumstances it would be unfair to admit the duplicate in lieu of the original.

g. FRE 1004 – Admissibility of Other Evidence

The original is not required, and other evidence of the contents of a writing, recording, or photograph is admissible if—
(1) Originals lost or destroyed.—All originals are lost or have been destroyed, unless the proponent lost or destroyed them in bad faith; or
(2) Original not obtainable.—No original can be obtained by any available judicial process or procedure; or
(3) Original in possession of opponent.—At a time when an original was under the control of the party against whom offered, that party was put on notice, by the pleadings or otherwise, that the contents would be a subject of proof at the hearing, and that party does not produce the original at the hearing;
or
(4) Collateral matters.—The writing, recording, or photograph is not closely related to a controlling issue.

2. Evidentiary Issues That May Arise in a Ponzi Case

When a debtor that has been orchestrating a Ponzi scheme files bankruptcy, a host of evidentiary issues arise. The vast majority of these issues are related to foundation issues and the authenticity of certain of the debtor's documents, especially its books and records. Because the perpetrator of the Ponzi scheme is usually facing criminal charges (or is already in jail), the person with the best knowledge of the debtor's business is likely to be unavailable to testify as a witness. Even if the perpetrator is available to testify, he/she would likely refuse to do so, either by being generally uncooperative or by invoking the protections of the Fifth Amendment.

Assuming the Ponzi scheme had been uncovered prior to the bankruptcy, a chapter 11 trustee is likely to be appointed very early in the case. If the Ponzi scheme had not yet been discovered, the committee or other parties in interest will likely quickly discover that something is amiss and will seek the appointment of an examiner or a chapter 11 trustee. Under either scenario, the debtor will be under new management, and the trustee will likely come in and terminate any insiders who may have knowledge of the Ponzi scheme. Because the persons most knowledgeable about the debtor's financial situation will have been replaced, the trustee is likely to rely heavily on his professionals to manage the debtor's operations and maintain its books and records.

Of course, any successful Ponzi scheme relies on misinformation and deception. That deception most often arises in connection with the maintenance of the Debtor's books and records. Often, the perpetrator of the Ponzi scheme is the only person with knowledge of the debtor's true books and records, and other times the books and records are intentionally so misleading and complex that a snapshot of the debtor's books at any given time is impossible.

Typically, the trustee's professionals will need to recreate the debtor's records by using complex accounting principles that rely on scattered information within the debtor's records as well as certain information that can be obtained from third parties, such as bank account statements.

When the trustee needs to prove certain information about the debtor's books and records to satisfy its burden of proof—proving the debtor's insolvency for example—the trustee has several options. All of these options, however, are likely to face scrutiny under the Federal Rules of Evidence.

First, the trustee can offer information from the debtor's actual books and records. To do so, however, the trustee will need a witness with personal knowledge to testify as to the documents authenticity under FRE 602. Unless the trustee has been personally involved in the maintenance and creation of those records, however, the trustee will not possess the requisite personal knowledge to attest to their authenticity. Moreover, because the trustee has likely terminated any employees of the debtor who may be able to verify the authenticity of the documents, those employees likely will not agree to testify for the trustee willingly. Even if they were subpoenaed to testify, their knowledge of, and possible role in, the Ponzi scheme could cause them to, at a minimum, be subject to cross-examination by character evidence, or, even worse, to assert their Fifth Amendment rights. Similarly, the perpetrator of the Ponzi scheme, who would surely have the necessary personal knowledge will make for a very poor witness.

Second, assuming the trustee is unable to offer someone with personal knowledge to verify the debtor's documents, the trustee would likely try to have the documents admitted through the use of expert testimony. Although FRE 703 permits an expert to base his or her opinion on inadmissible evidence, if the trustee has no other evidence but the testimony of his hired expert, he will likely be unable to satisfy his burden of proof. See the discussions in Barber and Fisher below.

Third, if the trustee is unable to offer a witness with personal knowledge of the debtor's documents (or if no relevant documents exist), the trustee will be forced to offer recreated books and records as proof. FRE 1004 permits the use of other evidence of a writing in certain situations. If the records do not exist, or were destroyed prior to the trustee's appointment, the trustee may be able to offer third-party records and forensic accounting documents as evidence of the original books and records. Once again, this testimony will almost always require the use of expert testimony. Depending on the methods utilized by the expert in recreating the books and records, the expert's testimony could be subject to a Daubert challenge. Even if the testimony survives such a challenge (or is admitted without objection), the court will ultimately determine the weight to be afforded to the expert's testimony. If the expert did not take steps to independently verify or sample the evidence used in reaching the expert's conclusions, the court may assign little weight to the testimony and ultimately decide that the trustee failed to satisfy the requisite burden of proof.

3. Applicable Cases

a. Brinco v. Rio Props., Inc. (In re Nat'l Consumer Mortg., LLC), Case No. 10–cv–00930, 2011 WL 1300540 (D. Nev. 2011).

Plaintiff, chapter 11 trustee, filed adversary complaint against defendant casino as subsequent transferee of a fraudulent transfer allegedly made by debtor to a Ponzi scheme operator (a relative of the Debtor's owners), who used the proceeds to gamble at the casino. Casino filed a motion for sanctions for spoliation of evidence, alleging that the trustee allowed all of the Debtor's business records to be destroyed. Given the alleged importance of the lost evidence to Defendant's case, it also sought dismissal of the adversary or, in the alternative, an adverse instruction to the jury.

Plaintiff testified at his deposition that, upon the trustee's appointment, one of the Debtors' employees, Martinez, destroyed most of the Debtor's relevant records. The Trustee produced his "reconstructed financial records" based on incomplete third-party records in support of his case. Defendant alleges that the destroyed records were key to its defense against the Trustee's *prima facie* case on important issues such as the solvency of the Debtor, the initial transferee's role at the Debtor, and his intent (or lack thereof) to defraud creditors of the Debtor.

Trustee responded that the Debtor's records were scant when he took over and that Debtor's counsel had previously issues a litigation hold and seized the available records. While Martinez may have deleted some audio and surveillance files on his computer, the trustee was not sure when he did so and terminated Martinez within hours of learning that he may be an insider.

Ultimately, the Court found that Defendant did not provide sufficient evidence to warrant the imposition of sanctions against the Plaintiff trustee. Given the steps taken by Debtor's bankruptcy counsel to take control over the Debtor's financial records prior to the Petition Date, and the trustee's swift action in removing insiders and reinforcing the litigation hold, the Court determined that even if Martinez did destroy some of the Debtor's records, those records were unlikely to be relevant to the present dispute.

b. Fisher v. Sellas (In re Lake States Commodities, Inc.), 272 B.R. 233 (Bankr. N.D. Ill. 2002)

Plaintiff, chapter 7 trustee sued an investor in a Ponzi scheme to recover an alleged fraudulent conveyance. Trustee retained KPMG Peat Marwick, LLP to provide accounting services on behalf of the estates. At trial, the trustee offered three means of evidence: (i) his testimony, (ii) four documents, and (iii) expert testimony and the expert's report. The defendant challenged the admissibility of all three types of evidence.

First, the Court sustained the Defendant's challenge to the trustee's testimony regarding the debtors' business operations, finding that the trustee did not have personal knowledge. Second, the trustee tried to introduce a report prepared by KPMG and certain business records of the Debtors. The business records were sent directly to KPMG for analysis and the trustee was not involved in the preparation or maintenance of the business records, so the Court refused to admit the testimony under FRE 602 because the trustee lacked personal knowledge. Third, the trustee introduced an expert report and testimony in an effort to establish that the Debtors were insolvent and running a Ponzi scheme. The expert formed his opinion

based on a review of the KPMG Report and the business records, but he did not speak to any of the Debtors former employees. The Defendants did not challenge the admissibility of the report, but they did make a hearsay objection to the KPMG Report.

The trustee also initially planned to introduce the federal indictment of the orchestrator of the Ponzi scheme, Edward Collins, along with a copy of the criminal case docket. Presumably, he intended to use these documents to establish Collins's unavailability to lay the foundation for the business records. After the Defendants argued that the plaintiff should have supplemented his discovery responses with relevant documents used by the government in the criminal case, however, he withdrew his efforts to seek admission of these documents.

After the close of the trustee's case, Defendants moved for judgment on partial findings pursuant to Bankruptcy Rule 7052(c). Because the trustee had the burden of proof and all other evidence had been excluded, the Court turned to the issue of what weight to give the expert report and testimony. Because no other evidence had been admitted into the record, the Court ascribed no weight to the expert report. "If there are no facts in evidence, it is difficult to discern how an expert can assist the trier of fact." Id. at 244. Moreover, the Court also ascribed no weight to the expert report because (a) he did not perform a statistical sampling of the information on which he relied, (b) he did not interview anyone with personal knowledge of the business records on which he relied, and (c) he did not perform a forensic analysis with respect to the debtors' solvency. The Court acknowledged that had the Defendants raised a Daubert challenge, he might have excluded the expert testimony as well.

The bankruptcy court's decision was affirmed on appeal to the District Court in Fisher v. Page, 2002 WL 31749262 (N.D. Ill. 2002).

c. Barber v. Production Credit Servs. of W. Cent. Ill. (In re KZK Livestock, Inc.), 290 B.R. 622 (Bankr. C.D. Ill. 2002).

Mr. Knowles, Debtor's sole shareholder and director was operating a check kite. Prior to bankruptcy Debtor repaid a loan Knowles had with Defendant. Trustee sought to avoid the payment as a fraudulent transfer. After a series of prior rulings, the only remaining issue was whether the Debtor was insolvent at the time of the transfer. Both parties cross-moved for summary judgment.

The Trustee relied on affidavits of two experts, a retired FBI agent specializing in financial crimes and a CPA, as well as the deposition of one of Defendant's employees. The CPA, Neil Gerber, attempted to establish that the Debtor became insolvent prior to the transfer at issue and never became solvent again. This method of proving insolvency has been labeled "retrojection" by the courts.

The Defendant challenged the introduction of Gerber's testimony under Daubert, but the bankruptcy court permitted it, finding that the alleged shortcomings in the methodology may affect the weight attributed to it at trial. The Defendant also challenged Gerber's failure to meet with the Trustee or any of the Debtor's employees or examine certain corporate documents.

Ultimately, the Court found that the problem with Gerber's opinion was not the methods he used in arriving at his opinion but rather a lack of foundation for his analysis. This lack of foundation was largely attributable to the Debtor's failure to keep proper records. While the Court acknowledged that the Trustee did "the best he could with what he had," ultimately, the Trustee was unable to satisfy his burden of proof that the Debtor was insolvent at the time of the transfer.

B. **In Pari Delicto**

"It is well settled that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself." Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) (citing, inter alia, Caplan v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972)). However, a bankruptcy trustee also lacks standing to sue third parties where the debtor itself participated in the fraud.

In pari delicto comes from a longer Latin phrase: "In pari delicto potior est condition defendentis" In English: Where the wrong of both parties is equal, the defendant's position is stronger. This is an equitable defense, where plaintiff is prohibited from maintaining a claim where he bears fault for injury. In other words, a participant in the fraud cannot claim to be a victim of its own fraud. "A plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim." Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 354 (3d Cir. 2001).

This arises in tort claims, claims of violations of state partnership laws, claims of breach of fiduciary duty, and professional negligence claims.

- Lancelot Investors Fund (Petters Fraud)
    - Winston & Strawn: Peterson v. Winston & Strawn, LLP, 2012 U.S. Dist. LEXIS 147653 (N.D. Ill. Oct. 10, 2012) – bankruptcy of two hedge funds
    - auditors: Peterson v. McGladrey & Pullen, LLP, 676 F.3d 594 (2012) (Easterbrook, J.)
- Madoff
    - Judge McMahon: Picard v. JPMorgan Chase & Co., 460 B.R. 84, 92-83 (S.D.N.Y. 2011) ("Here, in pari delicto would preclude Madoff from recovering against Defendants, and, under general principles of agency law, his wrongdoing as BMIS's [the debtor] agent is imputed to BMIS itself. The acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their principals. The result is that (1) BMIS could not have sued Defendants for the alleged scheme, and (2) the Trustee—standing the shoes of BMIS—cannot do so either. Because management's misconduct is imputed to the corporation, and because a trustee stands in the shoes of the corporation, the Wagoner rule bars a trustee from suing to recover for a wrong that he himself essentially took part in."(citations, internal quotation marks, and alterations omitted)).

- Judge Rakoff: Picard v. HSBC Bank PLC, 454 B.R. 25, 37 (S.D.N.Y. 2011) ("Here, given that the Trustee's own complaint is replete with allegations of Madoff's role as the "mastermind[ ]" of the fraud, see, e.g., Am. Compl. ¶ 1, the Wagoner rule bars the Trustee as "successor in interest" to Madoff and Madoff Securities, from bringing common law fraud claims. Thus, the Trustee has no standing to pursue on behalf of the estate his common law claims against the HSBC Defendants and the UCG/PAI Defendants."

A dismissal of bankruptcy trustee's claims based on in pari delicto does not prevent investors from suing these third parties. See, e.g., MLSMK v. JP Morgan Chase & Co., 431 F. App'x 17 (2d Cir. 2011) (individual customers suing bank in connection with Madoff fraud). Avoidance actions not barred by in pari delicto. McNamara v. PFS (The Personal & Business Ins. Agency), 334 F.3d 239 (2003). In re The Pers. & Bus. Ins. Agency, 334 F.3d 239, 245-46 (3d Cir. 2003) (holding in pari delicto inapplicable to actions brought under § 548 of Bankruptcy Code because § 548 does not contain limiting language of § 541

C. **11 U.S.C. § 546(e)**

In enacting 546(e) Congress sought to reduce the ripple effect that a bankruptcy can cause in the securities market. It provides, in pertinent part, that the trustee may *not* avoid "a transfer that is a . . . settlement payment . . . made by or to . . . a . . . stockbroker." As part of the Financial Netting Improvements Act of 2006, Congress expanded Section 546(e) to include "a transfer made by or to (or for the benefit of) a [Stockbroker] in connection with a securities contract, as defined in section 741(7)." In other words, the trustee may not be able to claw back a payment made by the debtor prior to bankruptcy if the payment was made to a stockbroker as a settlement payment, or made to a stockbroker in connection with a securities contract. The Code's definition of "stockbroker" requires that one be "engaged in the business of effecting transactions in securities," and that one have a "customer" as defined by § 741(2). As for "settlement payment," the stockbroker safe harbor provision incorporates § 741(8)'s definition: "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The definition of "securities contract" comes from § 741(7). Courts have concluded that the language "in connection with" means that the transfer must be "related to" that securities contract. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 12 MC 115 (JSR), 2013 U.S. Dist. LEXIS 56042, at *47 (S.D.N.Y. Apr. 15, 2013).

Section 546(e), by its express terms, only protects transfers from avoidance by "the trustee." Thus, it does not apply as a defense to causes of action asserted by individual creditors seeking recovery of property. See In re Tribune Co. Fraudulent Conveyance Litig., 499 B.R. 310, 320 (S.D.N.Y. 2013) ("[T]he Court concludes that Congress said what it meant and meant what it said; as such, Section 546(e) applies only to the trustee and does not preempt the Individual Creditors' SLCFC claims"). However, one a representative of the estate has commenced an avoidance action, under whatever theory, a court might find that individual creditors thereafter lack standing to seek the avoidance of the same transfers. See id. at 325 ("Unless and until the Committee actually and completely abandons those claims, the Individual

Creditors lack standing to bring their own fraudulent conveyance claims targeting the very same transactions.").

Importantly, the stockbroker safe harbor provision does not apply to *all* settlement payments made by or to a stockbroker. In fact, the provision explicitly excludes from its purview avoidance actions brought under § 548(a)(1)(A). That section allows the trustee to avoid transfers made "with actual intent to . . . defraud" in other words, fraudulent transfers.

But § 548(a)(1)(A)—the section to which the stockbroker safe harbor does not apply—is limited. Under that section the trustee may avoid only those fraudulent transfers made less than two years before the bankruptcy filing. This two-year "lookback period" is relatively short. To avoid earlier fraudulent transfers, trustees often bring § 544(b)(1) actions. Section 544(b)(1) allows the "trustee [to] . . . avoid any transfer . . . voidable under applicable [state] law." Generally, state fraudulent-transfer laws' lookback periods exceed § 548(a)(1)(A)'s two years. Although the stockbroker safe harbor explicitly excludes from its purview avoidance actions brought under § 548(a)(1)(A), the safe harbor does not comparably exclude actions brought under § 544(b)(1). That is to say, while the trustee can use § 548(a)(1)(A) to avoid fraudulent transfers made less than two years before the bankruptcy filing, the stockbroker safe harbor prevents the trustee from using § 544(b)(1) to avoid fraudulent transfers made more than two years before the bankruptcy filing.

At first glance, it might appear that the stockbroker safe harbor would not shelter transfers from a brokerage firm that operated a Ponzi scheme before bankruptcy. After all, under the Ponzi scheme presumption, a court would presume that the firm made transfers "with actual intent to . . . defraud," which would enable the trustee to avoid them under § 548(a)(1)(A)81—the section to which the stockbroker safe harbor provision explicitly does not apply. Though Congress wanted to minimize systemic risk in the securities market, it recognized the competing need to remedy fraud. But Congress did not go far enough. The stockbroker safe harbor provision exempts from its purview only § 548(a)(1)(A) avoidance actions, which are limited to transfers made less than two years before the bankruptcy filing. As such, the stockbroker safe harbor prevents avoidance of—or, to state it positively, protects—fraudulent transfers that the trustee seeks to avoid under § 544(b)(1), which incorporates state laws' longer lookback periods. Specifically, the safe harbor can shelter false profits that a Ponzi scheme distributed more than two years before it filed for bankruptcy. This inevitably leads to inequity. The trustee's avoidance actions cannot reach those who invested early enough to be paid false profits more than two years before the scheme collapsed. These early investors retain their "profits" at the expense of the many net losers who—because they invested later—recover less than their principals from the Ponzi scheme's insufficient estate. Though enacted for the commendable purpose of reducing systemic risk in the securities market, the stockbroker safe harbor produces this unintended and undesirable result.

Recognizing the inequity that results from the protection of certain Ponzi scheme transfers, some courts have attempted to exclude all Ponzi scheme transfers from the protection of the stockbroker safe harbor. However, each of the attempted methods proves inadequate.

1. Textualist Approaches To Narrow the Stockbroker Safe Harbor. — Since the stockbroker safe harbor provision shelters (i) "settlement payments" between a (ii) "stockbroker" and (iii) "customer," some courts have narrowly interpreted each of these three terms to exclude Ponzi scheme transfers from the safe harbor's protection.

a. A Narrow Reading of the Term "Settlement Payment." — In In re Grafton Partners, 321 B.R. 527 (9th Cir. BAP 2005) the Ninth Circuit Bankruptcy Appellate Panel excluded Ponzi scheme transfers from the protection of the stockbroker safe harbor by narrowly interpreting the term "settlement payment." In that case, the trustee assigned to liquidate the estate of a firm that had operated a Ponzi scheme brought an avoidance action to claw back some of the money that the firm had paid to an investor that ultimately withdrew almost all of its investment before the scheme collapsed. The investor, a trust company that provided fiduciary services to clients, argued that these payments were settlement payments, and that the stockbroker safe harbor protected them from avoidance. The court disagreed.

The stockbroker safe harbor provision incorporates § 741(8)'s definition of "settlement payment": "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The Grafton court noted the circularity of this definition, which uses the term "settlement payment" five times. The court avoided this circularity by reading the phrase "commonly used in the securities trade" to modify *all* of the preceding terms and not just the immediate antecedent, "any other similar payment." In other words, the court read the definition such that common usage in the securities trade became a necessary condition of a "settlement payment." Recognizing that fraudulent transactions are not *commonly used* in the securities trade, the court held that Ponzi scheme transfers do not qualify as "settlement payments." In support of this reading of § 741(8), the Grafton court cited other cases. It stated that "[a]lthough the rhetoric of decisions describes the § 741(8) definition of 'settlement payment' as being 'broad' or 'extremely broad,' reality is different . . . [in that] decisions that actually have found protected settlement payments to exist have involved publicly traded securities in public markets in which an intermediary played a role." For the Grafton court, this apparent pattern in the case law confirmed that "settlement payment" should be interpreted to apply only to transactions common in the securities trade.

But the Grafton court's interpretation of "settlement payment" is not compelled. In fact, the Grafton court's textualist analysis is arguably flawed, as evidenced by the Second Circuit's reasoning in Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011) a more recent case that reached a different result. Indeed, a comparison of the courts' textualist analyses is revealing despite the cases' factual differences, the most notable of which is that the debtor in Enron did not operate a Ponzi scheme prior to bankruptcy. In Enron, the trustee brought an avoidance action not to claw back fraudulent profits, but to recover payments the debtor had made to redeem its commercial paper prior to maturity. The recipients of these payments were financial institutions that argued that the stock- broker safe harbor shielded the payments from avoidance. The Second Circuit agreed.

Like the Grafton court, the Second Circuit noted the circularity of § 741(8)'s definition of "settlement payment." Because establishing the limits of that definition presented

an issue of first impression in the Second Circuit, the court looked to other circuits. It, like the Grafton court, noted that the rhetoric of the cases favored a broad interpretation of the definition. However, unlike the Grafton court, the Second Circuit determined that this rhetoric captured reality. In fact, without referencing Grafton or any Ninth Circuit decision, the Second Circuit stated that "[s]everal circuits . . . have *rejected* limitations on the definition that would exclude transactions in privately held securities or transactions that do not involve financial intermediaries"—the precise limitations the Grafton court *embraced.* Looking at the text of § 741(8), the Second Circuit held that the grammatical structure indicates that the phrase "commonly used in the securities trade" modifies only the immediately preceding term. The court relied on the "rule of the last antecedent," under which a phrase limits only its immediate antecedent. Since no comma separates the phrase "commonly used in the securities trade" from the antecedent terms, the court found that the "rule of the last antecedent" applied rather than a corollary rule under which a modifier separated from an antecedent series by a comma modifies each antecedent in the series. Based on this statutory construction and the apparent agreement among other circuits, the Second Circuit concluded that the modifier "commonly used in the securities trade" does not *limit* the definition of "settlement payment," but rather makes the final term in the definition's series a residual one, underscoring the breadth of the stockbroker safe harbor.

The Second Circuit Court of Appeals also broadly interpreted the section 546(e) safe harbor in Official Committee of Unsecured Creditors of Quebecor World (USA) Inc. v. American United Insurance Co. (In re Quebecor World (USA) Inc.), 719 F.3d 94 (2d Cir. 2013). There, the unsecured creditors sought to avoid a preference payment to noteholders in exchange for private placement notes that had been issued to those noteholders by one of the debtor's affiliates. The defendants maintained that the payment was protected under 546(e). The Second Circuit agreed, holding that the payments fit "squarely within the plain wording of the securities contract exemption, as it was a 'transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract." Id. at 98. Under a plain-language interpretation, the court reached this conclusion notwithstanding that the financial participant in the transactions acted only as a passive intermediary and had no real interest in the notes.

Because the Enron and Quebecor courts' textual analysis is based on a well-settled rule of statutory construction, it is more defensible than the Grafton court's competing textual analysis, which enjoys no such support. And although Enron and Quebecor did not involve a Ponzi scheme, the Second Circuit's interpretation of the Code's definition of "settlement payment" binds courts in the circuit, even in cases involving Ponzi schemes. Indeed, a New York district court presiding over the Madoff bankruptcy cited Enron in holding that the stockbroker safe harbor protected Ponzi scheme transfers. Thus, courts in the Second Circuit, and other courts that— defensibly—interpret the definition of "settlement payment" under the "rule of the last antecedent," need a different strategy to exclude Ponzi scheme transfers from the stockbroker safe harbor.

b. A Narrow Reading of the Term "Customer." — In Wider v. Wootton, 907 F.2d 570 (5th Cir. 1990), the Fifth Circuit excluded Ponzi scheme transfers from the stockbroker safe harbor's protection by narrowly interpreting the term "customer." In that case, an investment advisor operated an unusual Ponzi scheme. Typically, Ponzi scheme operators

collect deposits from investors and purport to use this reservoir of deposits to purchase securities for these investors. But in Wider, the investors did not provide the operator a reservoir of cash from which to "purchase" securities; instead, an investor selected in advance the securities he wanted the operator to purchase and did not pay until the operator sent a (fabricated) slip confirming that the securities had been "purchased." After the scheme collapsed, the trustee assigned to liquidate the estate brought an avoidance action to claw back "proceeds" paid to an investor as the result of a fabricated securities transaction. The investor argued that, because he was the customer of a stockbroker, the stockbroker safe harbor sheltered these payments from avoidance. The court disagreed.

To be a "stockbroker" under the Code, one must, among other things, have a "customer" as defined by § 741(2). That section offers two alternative definitions of "customer." The first refers to an "entity . . . that has a claim against [a] person on account of a security received, acquired, or held by such person in the *ordinary course of such person's business*." The second refers to an "entity that has a claim against a person arising out of . . . a deposit . . . with [a] person *for the purpose of purchasing* . . . a security." The Wider court narrowly interpreted the first definition of "customer" to exclude Ponzi scheme investors. The court reasoned that Ponzi scheme operators do not receive, acquire, or hold securities in the *ordinary course* of business, as required by that definition, because the "business" of a Ponzi scheme is not to actually trade in securities but to fraudulently appear to do so. Additionally, the court held that the second definition of "customer" did not apply to the facts of Wider. That definition requires one to place with the stockbroker a deposit *for the purpose of purchasing* a security, which implies that the deposit must be placed *before* the security is purchased. In Wider, the Ponzi scheme's clients paid the operator *after* receiving (fabricated) confirmation of "transactions." If most Ponzi schemes operated like the one in Wider, the second definition of "customer" would be inapplicable and a narrow reading of the first definition would successfully exclude Ponzi scheme investors from "customer" status. But, as the Ninth Circuit noted in a later case, the facts of Wider are exceptional: In the case of *most* Ponzi schemes, investors deposit cash in advance for the purpose of purchasing a security. Thus, the second definition of "customer" will apply to most Ponzi scheme investors, and the Wider court's narrow reading of the first definition will be of little use to courts seeking to exclude Ponzi scheme transfers from the stockbroker safe harbor. The Wider approach, in other words, is inadequate.

c. A Narrow Reading of the Term "Stockbroker." — In In re Slatkin, 525 F.3d 805 (9th Cir. 2008), the Ninth Circuit excluded Ponzi scheme transfers from the protection of the stockbroker safe harbor by narrowly interpreting the term "stockbroker." In that case, an investment advisor who was not a licensed broker-dealer purported to rely on licensed broker-dealers to execute transactions for his clients. In reality, he transferred hardly any investments to licensed broker-dealers and instead operated a Ponzi scheme. The bankruptcy trustee brought an avoidance action to claw back false profits that the operator had paid to net winners, who argued that the stockbroker safe harbor sheltered these transfers because the operator had been a stockbroker. The court disagreed.

The Code's definition of "stockbroker," in addition to requiring that one have a customer, requires that one be "engaged in the business of *effecting* transactions in securities." Citing Black's Law Dictionary's definition of "effecting," the Slatkin court interpreted the

Code's definition of "stockbroker" to require that one be "in the business of making securities transactions happen." In Slatkin, most of the securities transactions that the investment advisor claimed to have effected were fictitious, but even the few transactions that actually occurred were not effected by the investment advisor. Since he was not a licensed broker-dealer, he transferred investments along to other people who made these securities transactions happen. The Slatkin court, however, limited the applicability of its holding. While ruling that this particular investment advisor was not in the business of making securities transactions happen, the court approvingly cited a case in which the Sixth Circuit held that a firm *was* "engaged in the business of effecting transactions in securities" *despite* the fact that the firm relied on other broker-dealers to conduct some of its transactions. In other words, as long as a firm conducts *some* of its own transactions, reliance on broker-dealers for other transactions will not preclude the firm from "stockbroker" status under Slatkin's reasoning. The investment advisor in Slatkin did not conduct any of his own transactions, but Slatkin was an unusual case. Many Ponzi scheme operators are licensed broker-dealers who actually do effect *some* securities transactions (even if the bulk of the transactions they claim to effect are fictitious). Under the Slatkin approach, those operators—such as Madoff—will generally qualify as "stockbrokers," making their transfers eligible for the stockbroker safe harbor's protection. This fact makes the Slatkin approach inadequate.

2. Intentionalist Approach To Narrow the Stockbroker Safe Harbor. — The textualist methods of narrowing the stockbroker safe harbor encounter a number of obstacles. But a statute's text does not always provide a complete answer. Parties sometimes argue that a particular application of a statute is contrary to Congress's intent in enacting the statute. This argument can prompt a court to attempt to discern that congressional intent. The statute's text is the best indicator of congressional intent, and if the text reveals such intent, the inquiry ends. But if a court cannot discern congressional intent from the text, the court may consider extra-textual materials, such as legislative history. Once the court discerns congressional intent, the court may apply the statute in a way that serves that intent, even if such an application strays from the statute's text.

Some bankruptcy courts have argued—though only in dicta—that sheltering Ponzi scheme transfers with the stockbroker safe harbor provision is contrary to Congress's intent in enacting the provision, even if allowed by its text. These courts have resorted to the legislative history, which explains that the stockbroker safe harbor was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." According to this intentionalist argument, the goal of minimizing displacement in the securities market has nothing to do with sheltering Ponzi scheme transfers, and so the stockbroker safe harbor should not be read to protect such transfers.

However, district courts reviewing the decisions of bankruptcy courts have rejected this intentionalist argument for two reasons. First, some higher courts argue that Congress's intent in enacting the stockbroker safe harbor can be discerned from the statutory text alone, making extratextual considerations unnecessary. In one of the Madoff cases (Picard v. Katz, 462 B.R. 447 (S.D.N.Y. 2011), a New York district court (reviewing a bankruptcy court's decision) used this argument to reject the bankruptcy trustee's invocation of the legislative history. The district court disapproved of resorting to legislative history because the court found

the statutory text to be clear and controlling. Recognizing that "to deviate from what Congress has clearly and constitutionally decreed is a power the judiciary does not possess," the court concluded that there was "neither a need nor a basis" to consider the legislative history of the stockbroker safe harbor.

A second objection to the intentionalist argument concedes that Congress intended the stockbroker safe harbor to minimize displacement in the securities market (as indicated by the legislative history), but concludes that this intent can be served by protecting certain Ponzi scheme transfers. Congress intended the stockbroker safe harbor to shelter transfers from Ponzi schemes—the argument goes—if doing so would minimize displacement in the securities market. In the Madoff case, the New York district court raised this objection in addition to the one discussed above. The bankruptcy trustee had argued that, because avoiding BLMIS's transfers would not cause displacement in the securities market, the stockbroker safe harbor should not protect those transfers. The district court conceded for the sake of argument that the stockbroker safe harbor was intended to minimize displacement in the securities market, but reasoned that avoidance of BLMIS's transfers *could* cause such displacement. Indeed, the trustee's own complaint alleged that Madoff's scheme involved approximately sixty-eight billion dollars and forty-nine hundred customers, so the court found "'*no* reason to think that undoing' such large transfers involving so many customers from so long ago as 2002 'would *not* . . . have a substantial . . . negative effect on the financial markets.'" To the contrary, the court supposed that avoidance actions of such magnitude would cause displacement in the market.

The Eighth Circuit has taken a similar position. See Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009). That court responded as follows to the contention that a particular application of the stockbroker safe harbor was contrary to congressional intent:

> [B]ecause so much money [$26.5 million] is at stake, we question [plaintiff's] assertion that the reversal of the payments—at least a portion of which were probably reinvested—would in no way impact the nation's financial markets. At the very least, we can see how Congress might have believed undoing similar transactions *could* impact those markets, and why Congress might have thought it prudent to extend protection to payments such as these.

Thus, this intentionalist approach, like its textualist counterparts, is inadequate. In conclusion, while courts have attempted various strategies— both textualist and intentionalist— to exclude Ponzi scheme transfers from the protection of the stockbroker safe harbor, each strategy is inadequate.

D. **11 U.S.C. § 550 Issues**

Topic: Initial Transferee Defenses

- Contractual obligation to pass along monies
    - Multiple tests employed by Ct. but problem arises with Ponzi Schemes

- Broker v. Financing Institution
    - Issue typically looks to relationship or past relationship
        - Dominion & Control or Mere Conduit
        - Following basic assumption as in schemes to reduce debt
    - Reconciliation difficulties
        - Just because a broker may not be a mere conduit doesn't mean that it would lack the dominion and control over funds
        - Mere conduit relies heavily on third parties but in broker cases money may not be passed along
        - Problems with what satisfies control
    - Cases
        - In re Derivium Capital, LLC, 437 B.R. 798 (2010)
        - In re Manhattan Inv. Fund Ltd., 397 B.R. 1 (2007)
        - Bonded Financial Services, Inc. v.European American Bank, 838 F.2d 890 (7th Cir. 1998)
        - In re Lancelot Investors Fund, L.P., 08 B 28225, 2012 WL 718631 (Bankr. N.D. Ill. Mar. 2, 2012)
        - Brian A. Abramson & Kyung S. Lee, Hurdles Trustees Face in Asserting Fraudulent-Transfer Claims Against Brokers in Short-Sales, Am. Bankr. Inst. J., February 2010, at 50
- Ethics topics Ponzi
    - Section 550 extended to trustees looking to recover from spouses
        - Good faith implicit in transfers?

- Ruth Madoff or even Kimberly Rothstein two examples

Testimony of Hon. Christopher S. Sontchi

United States Bankruptcy Judge for the District of Delaware

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

United States House of Representatives

Washington, D.C.

March 26, 2014

Chairman Bachus, Ranking Member Johnson and Members of the Committee:

Thank you for inviting me to testify today. My name is Christopher Sontchi and I am a sitting United States Bankruptcy Judge for the District of Delaware. I have presided over a number of cases involving the safe harbors for financial contracts, derivatives and repurchase agreements. Most notably, I presided over the *American Home Mortgage* case. At the time of its filing in 2007, American Home Mortgage was the 10th largest home mortgage originator in the country and was in the business of originating, securitizing, selling and servicing "Alt-A" home mortgage loans, a step above the now infamous subprime market. As part of its origination and securitization business the company was a party to numerous repurchase agreements involving billions of dollars. In addition, commencing in late 2007, I presided over the case of *Delta Financial Corporation*, which was a somewhat smaller version of American Home Mortgage, albeit in the riskier subprime market. I have presided over numerous other cases and issued numerous opinions involving repurchase agreements, tri-party setoffs and swaps. Finally, I have had the honor of serving as a member of the *Committee on Financial Contracts, Derivatives and Safe Harbors* of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Today, I would like to discuss two important issues related to the "safe harbors" for derivatives, repurchase agreements and other similar contracts. The first is narrow in scope and, I think, for the most part uncontroversial. I believe Congress should consider amending section 546(e) of the Bankruptcy Code to significantly narrow its scope. As set forth more fully below, Section 546(e) exempts from avoidance as

preferences or fraudulent conveyances "settlement payments" and transfers made to a class of financial institutions. I believe Congress's intent was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

The second issue is broader and significantly more controversial. I believe Congress should consider scaling back the scope of the safe harbors for repurchase agreements. The original 1984 safe harbor for "repurchase agreements" or "repos" encompassed repos on U.S. government and Agency securities and other highly liquid assets. In 2005 and 2006, the definition of "repurchase agreement" and "securities contract," under which certain repos had been afforded safe harbor treatment, were expanded to include a broader range of potentially less liquid assets, including mortgage loans and interests in mortgage loans. The current safe harbors for repurchase agreements allow for "runs" on financial institutions by counterparties who are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its

liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually impossible to reorganize companies with significant repo exposure such as American Home Mortgage.

Section 546(e) of the Bankruptcy Code

As written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts and other transactions, even if the securities were privately issued. Absent the safe harbors, these payments – often made to the directors, officers and other company insiders that led the company into bankruptcy - would be potentially voidable as fraudulent or preferential transfers. The safe harbor of section 546(e) should protect the *securities transfer system*, if and when the financial institutions are acting as conduits for payment, regardless of whether the securities involved are public or private. This safe harbor for the securities industry is important because the initial transferee is not accorded a good faith defense under section 550, potentially exposing the securities industry to large and inappropriate liability for acting as mere intermediaries in securities transactions.

However, section 546(e) should not protect settlement payments or other transfers with respect to the beneficial owners of *privately* placed debt securities or of equity securities of a closely held entity. With regard to *publicly* traded securities, section 546(e) should only protect transfers to the beneficial owners of public securities holders that have acted in good faith.

Section 546(e) of the Bankruptcy Code provides as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

"Settlement payment" is defined in section 741(8) in a circular fashion as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." Because of this broad and circular language, courts have interpreted it to include many kinds of transactions regardless of whether it advances the legislative intent/policy behind enactment of the safe harbor, i.e., protection of the securities transfer system. These have included transfers to insiders owning private and public securities and LBO's that would otherwise have been fraudulent transfers.

Courts have applied section 546(e) literally and shielded from avoidance transfers involving little or no impact on the functioning of the public securities market. For example, in the case of *In re Quebecor World (USA), Inc.*, 719 F.3d. 94 (2d Cir. 2013), *aff'g*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), the Second Circuit affirmed the holding of the bankruptcy court that payments made to repurchase *privately-placed notes* were both "settlement payments" and transfers made in connection with a securities contract that

were protected under the safe harbor.[1] I propose narrowing the scope of section 546(e) to make it clear that the safe harbor only protects the securities transfer system and settlement payments made in connection with publicly traded securities.

Section 546(e) has also been successfully invoked to protect leveraged buyouts or LBO's. In cases involving LBO transactions, the issue is whether a payment made to the shareholders of the target company in exchange for their securities is a settlement payment entitled to protection. There is a split in authority in cases interpreting the safe harbor in the LBO context. A minority of courts have held that the safe harbor only applies to LBO's involving publicly traded securities or involving the public system of intermediaries and guarantees typical of the securities industry[2] but a majority of courts have increasingly found that the safe harbor protects the beneficial recipient even if the transaction involved private securities and regardless of the involvement of a financial intermediary.[3] My proposal supports the minority position and calls for revising the statute to specifically exclude private transactions from the safe harbor.

Section 546(e) can also impact LBO's of public companies. If the LBO leaves the firm with an unreasonably small capital or if it renders the firm insolvent, then the payments to shareholders are potentially recoverable in a subsequent bankruptcy, for the benefit of the target firm's pre-transaction creditors, if the other elements of a

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[1] *See also Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. 2011); and *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[2] *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996); *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (S.D.N.Y. 2012); and *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68 (E.D.N.Y. 2007).

[3] *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re Kaiser Steel Corporation*, 952 F.2d 1230 (10th Cir. 1991); and *AP Services LLP v. Silva*, 483 B.R. 63 (S.D.N.Y. 2012).

fraudulent transfer are in place. Section 546(e) as written, however, can immunize transfers made in connection with LBO's involving public companies, including those that render the target firm insolvent, even if the target's insiders acted in bad faith.[4] I propose that shareholders of public companies would not be automatically immunized, *per se*, by section 546(e). Rather they would only be protected if they have acted in good faith.

Again, I believe Congress's intent in implementing the safe harbor in section 546(e) was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

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[4] *Compare Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D.Ill. 1988) (With respect to fraudulent conveyance claim against insider shareholders of a public company, the court "collapsed" the LBO transaction so that insiders were considered to have received property of the debtor in the transaction but did not collapse the transaction with respect to non-insider shareholders and, therefore, dismissed the actions against the non-insiders); and *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71 (D. Del. 2002). (In a fraudulent conveyance action against insider shareholders resulting from an LBO of a public company, the court concluded that the distinction between insider and non-insider status was "not one that [held] legal significance under section 546(e)" and the insider shareholders were protected by the safe harbor).

I respectfully recommend that Section 546(e) of the Bankruptcy Code be amended (1) to affirm the current statutory protections in section 546(e) to security industries participants who act as conduits in both public and private securities transactions, (2) to remove the section 546(e) protection from avoidance actions for beneficial owners of privately-issued securities, and (3) to continue to safe harbor public securities holders from avoidance actions, if the public securities holder acted in good faith.

More specifically, without providing precise statutory language, section 546(e) should be amended as follows:

> (1) If the settlement payment or transfer is made to (or a securities contract is made with) a stockbroker, bank, clearing agency such as the DTC or a similar financial institution obligated to forward what has been paid or transferred, then, to the extent that the institution received such settlement payment or transfer for the benefit of a client or customer of the transferee and is obligated to forward that payment or transfer, then the institution shall receive the benefit of the existing section 546(e).
>
> (2) The first beneficial recipient of the transfer chain in question will be deemed to have received the relevant settlement payment or transfer directly from the debtor.
>
> (3) Parties receiving payments or transfers as beneficial owners of non-public securities shall not be protected by section 546(e).
>
> (4) Parties receiving payments or transfers as beneficial owners of public securities shall be protected by section 546(e) from constructive fraudulent transfer actions, as well as preferences under section 547, provided they acted in good faith without knowledge of the avoidability of the underlying transaction.

I have and continue to be faced with a flurry of motions to dismiss and for summary judgment filed by insiders of bankrupt companies seeking shelter from liability through the section 546(e) safe harbor. The "secret" is out and defense

attorneys are seeking to take advantage of the safe harbor to the fullest extent possible. I believe these changes would align the statutory language and the courts' interpretation of the statute with Congress' original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith.

I respectfully urge Congress to act quickly to close this unintended loophole in the otherwise necessary safe harbor for the securities transfer system.

The Scope of the Safe Harbors for Repurchase Agreements

The second subject I would like to discuss is more controversial: what is the proper scope of the safe harbors governing mortgage repurchase agreements?

For the reasons discussed below, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A). The effect would be to remove "mortgages" and "interests in mortgages" from the safe harbors of sections 555 and 559 (and 561 under Chapter 15).

The genesis of my request is my experience in the *American Home Mortgage* bankruptcy case filed in 2007. It became quickly apparent to me during that case that mortgages simply do not fit into one of the primary purposes behind protecting repurchase agreements, i.e., preservation of liquidity of investments. In fact, mortgages and interests in mortgages are not liquid assets. This is due in large part to the fact that mortgages are sold by the originators to investors or securitization trusts in bundles

containing as many as thousands of mortgages as well as the unique nature of mortgages. Every mortgage is secured by a unique piece of real property and involves a buyer that has a unique credit profile and payment history. In order to address the uncertainty arising from the individual nature of mortgages, sales often include lengthy look back periods where the buyer can return some mortgages in a portfolio to the seller if there is an early default or representations regarding the loans turn out to be inaccurate. In fact, it can take several months to complete the sale of a portfolio of mortgages.[5] These are not United States government securities. The reality is that the counterparties to repurchase agreements, i.e., the lenders, are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The current safe harbors for repurchase agreements allow for "runs" on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually

[5] While the same argument may be applied to "mortgage related securities" and "interests in mortgage related securities" there can be no question that these agreements are much more liquid than the underlying mortgages themselves and, thus, I do not recommend their removal from the protections of the safe harbors.

impossible to reorganize companies with significant repo exposure such as American Home Mortgage.[6]

The business of originating mortgages requires access to a huge amount of capital. For example, when a new homeowner buys a house for $100,000 with 20% or $20,000 down and borrows the remainder of the purchase price through a mortgage, the mortgage company must deliver $80,000 in cash at the closing of the sale. As of the end of 2013, there were approximately $9.9 trillion in home mortgage loans outstanding, every penny of which came from a mortgage lender. [7] In most cases, the mortgage lender providing the cash at closing obtained that money from a counterparty to a repurchase agreement or through a secured loan.

Traditionally, a mortgage lender would borrow the money necessary to originate mortgage loans through a warehouse secured line of credit or loan. That warehouse loan would be for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come from the warehouse lender (either directly or through the mortgage lender). The amount of the balance under the warehouse loan would increase by the amount of the mortgage loan and the mortgage itself would automatically become the warehouse lender's collateral. However, the mortgage would remain property of the

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[6] There is a persuasive argument to be made that the current scope of the repo safe harbors increases systematic risk for the financial system as a whole and exacerbated the financial crisis of 2007-09. Although I support that position, I am not addressing it in today's testimony. Rather, I am limiting my comments to the adverse effect that allowing the termination of repurchase agreements, notwithstanding the automatic stay, has on a company's ability to reorganize.

[7] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MORTGAGE DEBT OUTSTANDING (March 6, 2014), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

mortgage lender. When the mortgage lender later sold the mortgage loan to another financial institution or a securitization trust, the cash received from the sale would be used to pay down the warehouse secured loan (plus interest) and the mortgage loan would automatically be removed from the warehouse lender's collateral pool. In the event of a bankruptcy by the mortgage lender, the mortgage loans that had been originated but not yet sold would become property of the bankruptcy estate, the automatic stay would prevent the warehouse lender from taking control of the mortgage loans, and the warehouse lender would both have a secured claim against the estate collateralized by the mortgage loans and be entitled to adequate protection.

Starting in the late 1990's, master repurchase agreements began to replace warehouse secured loans. The prevalence of mortgage repos increased slowly until, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include mortgages.[8] Since 2005, the bulk of lending to mortgage originators has been through repurchase agreements. Mortgage repurchase agreements are virtually identical to warehouse secured loans except for the fact that, under a repo, the mortgage belongs to the repo counterparty/lender rather than to the mortgage lender. As discussed below, this difference is of huge import.

[8] Prior to 2005, mortgage repurchase agreements proceeded under the theory that they were protected by the safe harbors governing securities contracts. The number of repos under that theory were limited by the litigation risk that courts might not agree the safe harbors were applicable and the transaction was, in fact, a loan.

The procedure for originating mortgage loans under a master repurchase agreement and a warehouse secured loan are virtually identical. The mortgage lender and the repo counterparty/lender would enter into a master repurchase agreement for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come either directly from the repo counterparty or the mortgage lender. Simultaneously with the mortgage loan closing (or very shortly thereafter), the mortgage lender would sell the mortgage loan to the counterparty with an agreement that the mortgage lender would repurchase the mortgage loan within a specified period of time (usually between thirty and ninety days) for the original purchase price plus a fee. The mortgage lender would use the time of the repurchase agreement to arrange to sell the mortgage to a "permanent" investor or a securitization trust. At the time of the closing of the ultimate sale or securitization of the mortgage loan (or immediately prior), the mortgage lender would repurchase the mortgage from the repo counterparty and flip it to the buyer. As mortgage loans were sold to the repo counter party the balance of loans subject to the master repurchase agreement would increase and as they were repurchased it would decrease. I hope it is readily apparent that warehouse secured loans and repurchase agreements are virtually identical except for the ownership of the mortgage loans themselves.

Under a repurchase agreement, the mortgage loan is property of the repo counterparty. In the event of a default or bankruptcy by the mortgage lender, the repo counterparty has the right to declare a default and require the mortgage lender to

immediately repurchase the mortgages (in secured creditor parlance this would be the equivalent of calling the loan). In the event the mortgage lender could not immediately repurchase the loan, the repo counterparty would obtain permanent ownership over the mortgage loans and would be able to immediately sell them directly to permanent investors, securitization trusts or any other third party willing to buy the loans. Alternatively, the repo counterparty could maintain ownership over the mortgages. In any event, the mortgage loans would not be property of the estate and the automatic stay would not be applicable. The structure discussed above and the safe harbor from the rules governing warehouse secured loans such as the automatic stay have been codified by the repo safe harbors.[9]

The ability of a repo counterparty/lender to be able to immediately sell the mortgage loans to a third party and, thus, limit its exposure to the risks inherent in the mortgage itself, i.e., liquidity, is asserted as one of the primary bases for the repo safe harbors. The argument is that without the liquidity supplied by the safe harbors the cost of lending would increase and, in the event of a default, there could be a cascading series of defaults that might spread to the repo counter party/lender and parties to other agreements with the repo counterparty.

So far, so good. But, in my experience, the repo counterparty may not be interested in having the ability to preserve liquidity by selling the mortgages but, rather, is likely to hold the loans for later disposition, especially in a crisis such as in 2007-2009 where the value of the mortgage was artificially low. Indeed, as described

[9] See Exhibit A attached hereto for a brief recitation of the relevant safe harbor provisions.

above, mortgage loans are illiquid assets and, thus, the counterparty may have no choice but to hold the loans. The safe harbors allow the repo counterparty rather than the debtor to hold the mortgage and obtain the upside of any increase in value. In the event the transaction was treated as a loan, the debtor would be able to retain ownership and control over the mortgage loans, subject to providing adequate protection, and preserve the upside for the estate as a whole. As applied to mortgages, the safe harbors allow for the repo counter party/lender to grab what otherwise would be its collateral and prevent the mortgage lender/debtor from maximizing the value of those loans for the benefit of the bankruptcy estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Bankruptcy Code on its head. The economic reality is that a mortgage lender such as American Home Mortgage can be stripped of its assets in days or even hours, leaving no ongoing business and denying its creditors in general of the value of its assets, i.e., its mortgage loans.[10] While these safe harbors make sense in the context of assets that are actually liquid such as U.S. Treasuries, they do not in the context of an illiquid asset such as mortgages.

Let me close my discussion of mortgage repurchase agreements with a real world example. In the *American Home Mortgage* case, the debtor was a party to a master repurchase agreement with Calyon Bank. At the time of the bankruptcy filing in 2007,

[10] Generally speaking, a debtor would not be able to force a lender under a warehouse secured loan or a repurchase agreement to continue funding future mortgages. 11 U.S.C. §365(c)(2). But, at the very least, the debtor would still own its portfolio. In addition, forcing a debtor and a secured lender to deal with each other often results in continued lending.

the outstanding principal amount of the mortgage loans subject to the master repurchase agreement was approximately $1 billion. Immediately prior to the bankruptcy filing, Calyon declared a default under the master repurchase agreement and took ownership of the mortgage loans. If a repo counterparty such as Calyon takes ownership of the mortgages subject to the repurchase agreement and the value of those mortgages is less than the outstanding principal balance of the loans, the counterparty, *i.e.*, Calyon, can assert an unsecured claim for the deficit. They are, in effect, an undersecured creditor asserting a claim for unsecured portion of their loan.

I conducted a trial over two related issues: (1) at what time does the court value the mortgage loans for considering whether there is a deficit and, thus, a claim; and (2) how does the court calculate the value of the loans. I ultimately issued an opinion on those issues that was affirmed by the Third Circuit.[11] I raise the issue here, however, for a different reason. It became clear in trial that Calyon never had any intention of selling the mortgage loans in the foreseeable future. Rather, its strategy was to hold the mortgages until value rebounded and in the interim its credit exposure was minimized because the mortgage borrowers, i.e., the homeowners, were continuing to make principal and interest payments.

There is nothing morally wrong with Calyon's strategy to hold on to the loans. Indeed, it makes perfectly valid economic sense. The problem is that it should have been in the debtor's purview – not Calyon's - to make the decision whether to hold the

[11] *In re American Home Mortgage Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

loans for the benefit of the bankruptcy estate and the debtor's creditors rather than just for Calyon. With virtually every other type of asset that serves as collateral for a secured loan control rests in the debtor. But secured creditors are not without protection. For example, they may be entitled to adequate protection. The law governing the rights of secured creditors and the balance of those rights with other considerations are well developed. The repo safe harbors remove what would otherwise be considered a secured loan from the bankruptcy estate, depriving the debtor with any control over what would otherwise be its property and the lender's collateral. The asserted reason for exempting mortgages from the rules governing virtually every other type of collateral is that those protections are necessary to preserve liquidity in the system and, more particularly, for the repo counterparty's exposure. But, that asserted basis for extraordinary treatment is fallacious because mortgage loans are not liquid, especially in times when there is likely to be a default under the loans such as in 2007-2009. There is no reason to exempt mortgage loans and interests in mortgage loans from the ordinary, well established rules governing secured lending.

I am cognizant that the application of the safe harbors to mortgages and interests in mortgages is a complicated and controversial subject and any amendment to the safe harbors should be carefully weighed. It is not my intention to address the entirety of the issues. Rather, I have attempted to pass on my conclusions as to one issue based on my experience as a bankruptcy judge overseeing several cases involving repurchase agreements governing mortgages, especially the *American Home Mortgage* case.

Based on my experience, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A).

In closing, thank you very much for inviting me to testify on these important issues. I do not envy this committee's task in addressing these complicated issues. Nonetheless, I believe there are important, discrete changes that can be quickly addressed such as amending section 546(e) to align the statutory language and the courts' interpretation of the statute with Congress's original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith. In addition, I think the committee should take a step back and reconsider the scope of the repo safe harbors, especially as they apply to mortgages. While there are a number of issues and arguments that should be considered in such an examination, I think one thing is clear – the assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages. They should be returned to whence they came and be subject to the normal, long-standing, well-developed law governing secured lending.

Thank you again.

Exhibit A

Since 1982, Congress has enacted a number of amendments to the Bankruptcy Code that work in concert to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions such as the automatic stay:

- Sections 555, 559 and 561, which protect the exercise of certain contractual rights to liquidate, terminate and accelerate repurchase agreements from stays, avoidance and other limitations;
- Sections 362(b)(7) and 362(o), which exempt from the automatic stay and all other Bankruptcy Code stays setoffs under repurchase agreements and the realization against collateral for repurchase agreements;
- Sections 546(f) and 548(d), which provide exemptions from preference and fraudulent transfer avoidance for settlement and margin payments; and
- Portions of sections 101 and 741, which define the key terms repurchase agreement, margin payment, settlement payment, repo participant and financial participant.

Section 559 and its exclusion of repurchase agreements from the automatic stay are of primary significance. Collier explains that "[m]ost repurchase agreements afford a non-defaulting party the right to 'close-out' or 'liquidate' the agreement upon the other party's default.[1] Furthermore, virtually all repurchase agreements contain *ipso facto* clauses which authorize repo participants to terminate "for cause" (or otherwise forfeit or modify rights) if the other party becomes bankrupt, insolvent, or fails to maintain contractually specified conditions.[2] "In almost all instances, commencement of a Bankruptcy Code case by a party ... will constitute a default triggering the availability of such rights."[3] Such clauses permit termination of the repurchase

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[1] 5 COLLIER ON BANKRUPTCY ¶¶ 559.04 (Alan N. Resnick and Henry J. Sommer eds. 15th ed. rev. 2007).

[2] *Id.* at ¶¶ 559.04 and 559.LH.

[3] *Id.*

agreement simply because of the other party's distressed financial condition. Section 559 protects rights triggered by a condition of the kind specified in section 365(e)(1), i.e., *ipso facto* clauses or bankruptcy defaults.[4] Thus, "section 559 allows protected parties to act upon *ipso facto* clauses."[5]

In addition, section 555 of the Bankruptcy Code provides the tool for the non-defaulting repo participant to exercise its contractual right to close-out, terminate or accelerate a "securities contract."[6] "Such a close-out or liquidation typically entails termination or cancellation of the contract, fixing of the damages suffered by the non-defaulting party based on market conditions at the time of the liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages."[7]

Finally, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include the transfer of "mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans."[8]

Section 101(47) of the Bankruptcy Code contains the definition of a repurchase agreement. A repurchase agreement is an agreement, including related terms, which (i)

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[4] *Id.*

[5] *Id.*

[6] As defined in 11 U.S.C. § 741.

[7] 5 COLLIER ON BANKRUPTCY ¶ 555.04.

[8] 11 U.S.C. § 101(47).

provides for the transfer of one or more mortgage loans or interests in mortgage loans; (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage loans; (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests mortgage loans; (iv) at a date certain not later than 1 year after such transfer or on demand; and (v) against the transfer of funds.[9] No other criteria are set forth in the statute for a contract to be considered a repurchase agreement under the Bankruptcy Code.

The definition of repurchase agreement is incorporated into section 559 of the Bankruptcy Code. As noted earlier, since 1982, Congress has enacted a number of amendments to the Bankruptcy Code to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions of the Bankruptcy Code. Section 559 and its companion statute, section 555, preserve market liquidity by providing a "safe harbor" for non-defaulting repo participants "to terminate, liquidate or accelerate . . . repurchase agreements with the bankrupt or insolvent party."[10] Indeed, the legislative history of the 2005 amendments specifically provides that:

> The reference to "repurchase and reverse repurchase transactions" is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. Repurchase and reverse repurchase transactions meeting certain criteria are already covered under the definition of "repurchase agreement" in the Bankruptcy Code.[11]

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[9] *Id.*

[10] H.R. Rep. 109-31, pt. 1, at 133 (2005).

[11] *Id.* at 130.