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2021 SECOND CIRCUIT REVIEW

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MADOFF DECISION REGARDING GOOD FAITH DEFENSE UNDER §§ 548 AND 550

In the continuing litigation arising from the collapse of Bernard Madoff's Ponzi scheme in 2008, in ***Picard v. Citibank, N.A.* (*In re Bernard L. Madoff Inv. Secs. LLC*)**, 12 F.4th 171 (2d Cir. 2021), *cert. denied*, No. 21-1059, 2022 WL 585915 (Feb. 28, 2022), the United States Court of Appeals for the Second Circuit considered whether recipients of fraudulent transfers can assert a good faith defense when they had knowledge of facts that suggested the transferor, Madoff's fund, was engaged in fraudulent activity. The SIPA trustee, Irving Picard, appealed the dismissal of two avoidance actions against initial and subsequent transferees of Bernard L. Madoff Investment Securities LLC ("BLMIS"). In the first action, Picard alleged that Citibank received at least $343 million in subsequent transfers between 2005 and 2008 from an initial transferee (Prime Fund) to whom Citi had lent funds for Prime Fund to invest with BLMIS, despite that Citi "uncovered facts suggesting that BLMIS was engaged in fraudulent activity" as early as 2005. *Picard*, 12 F.4th at 182. In the second action, Picard sued the Legacy fund to recover over $213 million in initial transfers from BLMIS, as well as Khronos (a related entity that provided accounting services to Legacy) which received approximately $6.6 million in subsequent transfers from Legacy, while each transferee harbored serious concerns about the risk of fraud at BLMIS. *Picard*, 12 F.4th 183-84.

In the consolidated appeal, the Second Circuit addressed the good faith defense under §§ 548(c) and 550(b)(1) and the burden of pleading.[1] Joining all other circuits that have addressed the issue,[2] *Picard*, 12 F.4th at 189. the Second Circuit held "that a lack of good faith under Sections 548 and 550 of the Bankruptcy Code encompasses an inquiry notice standard." *Picard*, 12 F.4th at 192. The Second Circuit enumerated a three-step inquiry for courts to use to approach the good faith defense:

- "First, a court must examine what facts the defendant knew" as a subjective matter. *Picard*, 12 F.4th at 191.
- "Second, a court determines whether these facts put the transferee on inquiry notice of the fraudulent purpose behind a transaction—that is, whether the facts the transferee knew would have led a reasonable person in the transferee's position to conduct further inquiry into a debtor-transferor's possible fraud." *Picard*, 12 F.4th at 191.
- "Third, once the court has determined that a transferee had been put on inquiry notice, the court must inquire whether 'diligent inquiry [by the transferee] would have discovered the fraudulent purpose' of the transfer." *Picard*, 12 F.4th at 191-92.

The court made clear that good faith is an affirmative defense under both §§ 548 and 550(b) of the Bankruptcy Code. "Although § 550(b) is written differently and affects a different class of transferees than § 548(c), the statutory structure, case law, and legislative history make clear that good faith under § 550(b) is an affirmative defense." *Picard*, 12 F.4th at 197.

More interesting, perhaps, than the Second Circuit's majority opinion in *Madoff* is Judge Menashi's concurrence, which invites a future challenge to the "Ponzi scheme presumption"—a judicially developed principle in which courts presume a transfer from a Ponzi scheme was made with

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"actual intent to hinder, delay, or defraud" under § 548(a)(1)(A) of the Bankruptcy Code *Picard*, 12 F.4th at 201 (Menashi, J., concurring). Citing to numerous courts and commentators that "have rejected the Ponzi scheme presumption on the ground that it improperly treats preferences as fraudulent transfers." *Picard*, 12 F.4th at 201. Judge Menashi argues that application of the Ponzi scheme presumption ignores the "normal principle" that "when a creditor receives a payment from a debtor—even if the creditor knows that the debtor is insolvent and the payment will prevent other creditors from being repaid—that payment is considered a preference, not a fraudulent transfer" and thus is not avoidable unless the payment is made within the 90 days immediately prior to the debtor's bankruptcy. *Picard*, 12 F.4th at 200.

In Judge Menashi's view, "[b]y treating debt repayments as fraudulent transfers and not as preferences, the Ponzi scheme presumption assumes that creditors of a Ponzi scheme are not owed a valid contractual antecedent debt like bona fide creditors," thus obscuring the line between preferential and fraudulent transfers. *Picard*, 12 F.4th at 202. Though characterizing the majority decision as "counterintuitive," Judge Menashi noted that no party raised the propriety of the Ponzi scheme presumption, leaving that issue to a future case. *Picard*, 12 F.4th at 200 & 204.

IMPUTATION OF ACTUAL FRAUDULENT INTENT UNDER § 548(a) IN *TRIBUNE*

In the continuing litigation arising out of the 2007 leveraged buyout of the Tribune Company (the "LBO"), in ***Kirschner v. Large Shareholders*** (***In re Tribune Co. Fraudulent Conveyance Litig.***), 10 F.4th 147 (2d Cir. 2021), *cert. denied*, No. 21-1006, 2022 WL 516021 (Feb. 22, 2022), the Second Circuit established the proper test for imputing "actual intent" under § 548(a)(1)(A) to a corporate transferor. Marc Kirschner, the Tribune bankruptcy litigation trustee, alleged that, after Sam Zell proposed to take Tribune private, a group of shareholders that held approximately 33% of Tribune's publicly-traded shares (the "Large Shareholders") "indicated that they would only vote for a two-step LBO that allowed them to cash out during the first step." *Tribune*, 10 F.4th at 156. The Special Committee of the Board of Directors, consisting of seven independent directors, to whom the board delegated authority to consider the transaction, voted unanimously to approve the LBO. *Tribune*, 10 F.4th at 155 & 160.

Among other causes of action, Kirschner sought to avoid the buyback of the Large Shareholders' equity as an intentional fraudulent transfer under § 548. To survive a motion to dismiss, Kirschner "was required to plead allegations that gave rise to a strong inference that the Special Committee had the 'actual intent to hinder, delay, or defraud' Tribune's creditors, as required by 11 U.S.C. § 548(a)(1)(A)." *Tribune*, 10 F.4th at 160. Kirschner contended not that the Special Committee had such "actual intent," but rather "that Tribune's senior management had the necessary fraudulent intent, and that this intent must be imputed to the Special Committee." *Tribune*, 10 F.4th at 160. The Second Circuit, deciding an issue of first impression, adopted the "control test" for imputation of fraudulent intent enumerated by the First Circuit—"a court 'may impute any fraudulent intent of [an actor] to the transferor . . . [if the actor] was in a position to control the disposition of [the transferor's] property.' " *Tribune*, 10 F.4th at 160-61 (citing *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983)). Applying this test, the Second Circuit concluded that Kirschner "failed to allege that Tribune's senior management controlled the transfer of the property, . . . inappropriately pressured the Independent Directors, . . . [or] any financial or personal ties between senior management and the Independent Directors." *Tribune*, 10 F.4th at 161. thus imputing the officer's intent to the Special Committee "would stretch the 'actual intent' requirement . . . to include the merely possible or conceivable or hypothetical as opposed to existing in fact and reality." *Tribune*, 10 F.4th at 161-62.

SOME STUDENT LOANS ARE DISCHARGEABLE, SOME ARE NOT—*TINGLING* AND *HOMAIDAN*

Although certain types of educational debt are presumptively nondischargeable, § 523(a)(8) provides that such debt may be discharged if repay-

ment would pose an "undue hardship" on the debtor and the debtor's dependents. To determine "undue hardship," many courts have adopted the "so-called *Brunner* test" under which a debtor must make a "specific factual showing" of three enumerated matters "by a preponderance of the evidence." In ***Tingling v. Educational Credit Management Corp. (In re Tingling)***, 990 F.3d 304 (2021), *cert. denied*, No. 21-1020, 2022 WL 827892 (Mar. 21, 2022), the debtor argued—joining a growing chorus—"that the *Brunner* test has, over time, become too high a burden for debtors to satisfy." *Tingling*, 990 F.3d at 308. The Second Circuit declined to revisit its *Brunner* decision and affirmed the bankruptcy court's finding that debtor failed to demonstrate "undue hardship." *Tingling*, 990 F.3d at 309.

To reach the *Brunner* test, though, the educational debt in question must be of a type enumerated in § 523(a)(8). In ***Homaidan v. Sallie Mae, Inc.***, 3 F.4th 595 (2d Cir. 2021), the Second Circuit considered whether the private educational loans that debtor obtained from Navient were "obligation[s] to repay funds received as an educational benefit" and thus nondischargeable under § 523(a)(8)(A)(ii). While attending Emerson College, Homaidan took out two direct-to-consumer loans totaling $12,567 from Navient's predecessor. The loans "helped underwrite Homaidan's college education" but were not made through his college's financial aid office nor, as Homaidan alleged, "were they made solely to cover Emerson's cost of attendance." *Tingling*, 990 F.3d at 309. Soon after graduating, Homaidan filed Chapter 7 and commenced an adversary proceeding against Navient.

Applying well-worn rules of statutory construction, the Second Circuit rejected Navient's argument "that a private loan is covered by § 523(a)(8)(A)(ii) if the debtor obtained the funds to pay for educational expenses." *Homaidan*, 3 F.4th at 601. The Second Circuit reasoned that interpreting the phrase "obligation to repay funds received as an educational benefit" to broadly refer to all student loans is unsupported by plain meaning; " 'no normal speaker of English . . . would say that student loans are obligations to repay funds received as an educational benefit.' " *Homaidan*, 3 F.4th at 601 (quoting *McDaniel v. Navient Sols. LLC* (*In re McDaniel*), 973 F.3d 1083, 1096 (10th Cir. 2020)). The Second Circuit found that Navient's interpretation improperly "attempts to read 'loan' into § 523(a)(8)(A)(ii)." *Homaidan*, 3 F.4th at 602. "offends the canon against surplusage" by "draw-[ing] virtually all student loans within [its] scope" and thus swallowing up the other parts of § 523(a)(8). *Homaidan*, 3 F.4th at 602. and clashes with the canon *noscitur a sociis* by giving the term "educational benefit" a broader meaning than the words ("scholarship" and "stipend") that surround it. *Homaidan*, 3 F.4th at 604.

ENDNOTES:

[1]In reversing the district court, the Second Circuit also rejected the "theory, which no court of appeals has ever adopted, that" the Bankruptcy Code yields to different, securities law-based definitions and policies. *Picard*, 12 F.4th 192.

[2]Specifically, the Fourth, Fifth, Seventh, Eighth, Ninth and Tenth Circuits.

