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The Death of a Defense: How Derivatives Spell the End of the Good Faith Defense to Fraudulent Transfer Actions in Business Bankruptcies

Caitlin Hall

Abstract: This article examines the “good faith defense” to fraudulent transfer actions in bankruptcy. It argues that investors who have hedged their equity interest in an investment will always qualify as good faith transferees, and thus will be effectively immune from the Bankruptcy Code’s fraudulent transfer provisions. It then argues that permitting such arbitrary application of the provisions will increase the cost of capital for solvent firms, a result the Bankruptcy Code is designed to avoid. It concludes that one workable solution to this problem is to eliminate the good faith defense altogether in the context of business bankruptcies.
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The Death of a Defense: How Derivatives Spell the End of the Good Faith Defense to Fraudulent Transfer Actions in Business Bankruptcies

INTRODUCTION

In the three decades since the last major domestic recession, the derivatives industry has grown by leaps and bounds—it has expanded from rudimentary swaps to innumerable instruments that allow parties to individually allocate each of the many risks associated with investment. As a result of thirty years of relative prosperity, however, many of these instruments have never been tested in bankruptcy—a historical anomaly that has no doubt run its course.

This Article will argue that derivatives—particularly derivatives that separate investment from investment risk—pose a serious problem for fraudulent transfer actions, an integral part of bankruptcy administration. Fraudulent transfers are pre-bankruptcy transfers that are made (1) with actual intent to defraud current or future creditors or (2) for less than reasonably equivalent value when the debtor is insolvent. Ordinarily, a trustee in bankruptcy may recover a fraudulent transfer unless the transferee can assert a good faith defense by claiming that the transfer was made for value and in good faith. This Article will argue that investors who hedge their investments with certain derivative instruments will almost always qualify as good faith transferees—and will thus effectively be immune from fraudulent transfer actions. It will conclude that the best response to this problem may be to eliminate the good faith defense altogether in the context of business bankruptcies.

Part I of this Article explores fraudulent transfer actions from a theoretical perspective, by evaluating the Bankruptcy Code’s provisions through a cost-of-capital framework. Part II briefly summarizes the peculiar application of the provisions to debtors that operate as Ponzi schemes. Part III analyzes a recent case, In re Bayou Group, LLC, which illustrates the problem posed by the intersection of certain derivatives and the fraudulent transfer provisions. Part IV examines the problem in depth and analyzes its consequences from a cost-of-capital perspective. Finally, Part V advocates the elimination of the good faith defense in business bankruptcies in response.

I. THEORETICAL FOUNDATIONS OF THE FRAUDULENT TRANSFER PROVISIONS

Before examining the operation of the Bankruptcy Code’s fraudulent transfer provisions in specific contexts, it will be useful to articulate a set of principles that justify and animate the provisions and that should guide a
A. Avoidance Actions and the Cost of Capital

It is increasingly acknowledged that the primary goal of business bankruptcy law should be to reduce the cost of capital for solvent firms. Cost of capital has two components: a risk-free interest rate, which is firm-independent, and a risk premium, which is a function of, among other things, the likelihood of firm insolvency and creditors’ expected payoffs in the event of insolvency. The cost of capital decreases as investors’ insolvency state payoffs increase.

Alan Schwartz, discussing preference actions in bankruptcy, has differentiated between two methods of increasing the value of the bankruptcy estate, and thus the insolvency state payoffs of a firm’s general creditors: (a) increasing the value of the insolvent firm; or (b) transferring assets from other claimants to the general creditors. Schwartz contends that:

The first method is desirable because when firm value increases, it is possible to increase the bad state payoff of at least one creditor without decreasing the payoff of any other creditors. Thus, the effective pursuit of method (a) will reduce the cost of capital. The second method, on the other hand, is undesirable because when the estate is defined as the set of assets available to general creditors, the trustee and other parties are encouraged to reduce the payoffs to those claimants who are not general creditors. Since these efforts are costly, the consistent pursuit of method (b) necessarily reduces the total value available for distribution to all claimants, and so necessarily increases the cost of capital.

Schwartz concludes that a mandatory rule permitting avoidance of pre-bankruptcy preferences—such as section 547 of the Bankruptcy Code—cannot

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1. See, e.g., Alan Schwartz, A Normative Theory of Business Bankruptcy, 91 VA. L. REV. 1199, 1200 (2005); see also id. at 1220 (“A lower [cost of capital] is efficient for two related reasons. First, the set of economically viable and socially desirably projects that firms will pursue becomes larger as the interest rate falls. Second, the effort that firms exert in pursuit of debt-funded projects increases toward the optimal level as the interest rate falls.”).

2. Id. at 1212.

3. Subject to certain limitations, the Bankruptcy Code permits a trustee in bankruptcy to avoid any transfer by the debtor (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) made while the debtor was insolvent; (4) made within 90 days before the filing of a bankruptcy petition; and (5) that enables the creditor to receive more than it would in a pro-rata distribution under Chapter 7. 11 U.S.C. § 547(b) (2000). The Code’s preference provisions have traditionally been justified on the grounds that they (1) prevent creditors from picking apart firms that face surmountable difficulties, and thus permit the rehabilitation of viable businesses, and (2) promote equality of distribution among creditors. See generally Thomas H. Jackson, Avoiding Powers in Bankruptcy, 26 STAN. L. REV. 725 (1984) (describing and criticizing justifications for preference law).

4. The bankruptcy estate is the set of assets available for distribution by the trustee to the firm’s general creditors. See 11 U.S.C. § 541.

5. For example, avoidance of a pre-bankruptcy transfer will usually increase the value of the insolvent firm if the transfer was made for less than reasonably equivalent value.

6. Schwartz, supra note 1, at 1221.

7. Id.
be justified because it does not increase the value of insolvent firms.  

Schwartz’s analysis with respect to method (a) is technically correct—an avoidance that increases the value of the insolvent firm will always increase the value of the bankruptcy estate. I contend that his analysis with respect to method (b), however, is subject to a limitation, because under certain conditions, transfers to general creditors from other claimants may decrease the cost of capital. In addition to the size of creditors’ insolvency state payoffs, the risk premium investors demand is a function of the uncertainty of insolvency state payoffs. Under certain circumstances, the “cost-of-capital gains” from reducing payoff uncertainty for general creditors will eclipse the “cost-of-capital losses” from enforcement actions that decrease the value of insolvent firms because they are costly to pursue. Specifically, in situations where there is substantial uncertainty as to the direction (that is, the recipient) and magnitude of avoidable transfers, imposing a rule that improves the predictability of expected payoffs can lower the cost of capital. This is especially true (1) where the rule promotes low collection costs by creating a high degree of certainty as to the avoidability of transfers and (2) where those who would otherwise benefit from avoidable transfers do not know that they will so benefit ex ante, and thus their required rate of return does not account for higher insolvency state returns.

B. Actual and Constructive Fraud

The Bankruptcy Code differentiates between two types of fraudulent transfers—those that are constructively fraudulent and those that are actually fraudulent. “Constructively fraudulent transfers” are those made by the debtor (1) in exchange for less than “reasonably equivalent value” and (2) while the debtor was, or by virtue of which the debtor became, insolvent, undercapitalized, or unable to pay its debts as they came due. “Actually fraudulent” transfers are those made “with actual intent to hinder, delay, or defraud” current or future creditors of the debtor.

8. See id. at 1225-27.
9. Note, however, that not every avoidance of a transfer made for less than reasonably equivalent value will increase the value of the bankruptcy estate, owing to collection costs.
10. This analysis assumes that many business creditors will not be completely diversified. See infra note 98. However, even if creditors are well-diversified, a bankruptcy system that lowers the standard deviation of returns for all firms will lower the cost of diversification (because investors will be able to achieve sufficient diversification through fewer investments), which should also lower the cost of capital.
11. The “bankruptcy policy” of equality of distribution among creditors might be viewed in this light as an acknowledgment that avoidance actions can lower the standard deviation of creditors’ returns, decreasing the cost of capital for solvent debtors.
13. 11 U.S.C. § 548(a)(1)(A). Note that all fraudulent transfers—including constructively fraudulent ones—must additionally be (1) of an interest of the debtor in property or an obligation incurred by the debtor; and (2) made or incurred within two years before the date of the filing of a
Fraudulent transfers increase the cost of capital for solvent firms in three ways. First, constructively fraudulent transfers decrease the value of the bankruptcy estate by transferring assets away from the firm on the eve of insolvency for less than equivalent value. The Bankruptcy Code's constructive fraudulent transfer provision, section 548(a)(1)(B), permits a trustee to recover the value of the transferred property, net of any value received in return, which increases the aggregate value of the insolvent firm. The rule should thus prompt creditors to revise upward their estimates of the insolvency state value of the firm, and accordingly their own expected insolvency state returns, lowering the cost of capital.\(^{15}\)

Second, actually fraudulent transfers increase solvent firms' cost of capital by increasing creditors' uncertainty as to their insolvency state payoffs, because the magnitude and direction of such transfers are difficult for creditors to predict. Cost of capital should be sensitive not only to mean returns, but also to the standard deviation of returns. Hence, the fact that creditors cannot anticipate whether they will be benefitted or harmed by fraudulent transfers, and by how much, implies that the cost of capital for all creditors should rise if fraudulent transfers are permitted. In contrast to the beneficiaries of pre-bankruptcy preferences,\(^{16}\) the recipients of transfers that are "actually fraudulent" typically do not know, ex ante, that they will later profit. Recipients do not price this information into their required rate of return to lower the average cost of capital.

Finally, actually fraudulent transfers allow debtor firms to perpetuate fraud as they decline into insolvency, reducing the likelihood that a given creditor will receive a solvency state payoff. Fraudulent transfer actions are non-punitive—they are not designed to, and presumably do not, deter debtors from propagating fraud. Fraudulent transfer actions, however, should decrease the incidence and duration of successfully perpetrated fraud by eliminating a major incentive for creditors to knowingly participate in the debtor's scheme. In the absence of a bankruptcy rule setting aside actually fraudulent transfers, creditors will demand higher interest rates to compensate them for this risk. The Bankruptcy Code's actual fraudulent transfer provision, section 548(a)(1)(A), should lower the cost of capital both by lowering the standard deviation of insolvency state returns and by increasing the likelihood of a creditor's receiving a solvency state return.

\(^{14}\) 11 U.S.C. § 550(a) provides for the recovery of avoided transfers.

\(^{15}\) Note, however, that actions to set aside constructively fraudulent transfers cannot reduce the cost of capital to the level that would exist if no constructively fraudulent transfers occurred in the first place, because enforcement actions are costly. A bankruptcy system that permits a trustee to settle claims will approach the minimum cost of capital more nearly than a bankruptcy system that does not. Under current rules, a bankruptcy court may approve a settlement requested by a trustee after notice and a hearing. See Fed. R. Bankr. P. 9019.

\(^{16}\) See Schwartz, supra note 1, at 1228.
C. The Good Faith Defense

Section 548(c) of the Bankruptcy Code provides a limited defense to actions by a trustee to recover a fraudulent transfer: a transferee that takes (1) for value and (2) in good faith may retain any interest transferred to the extent of the value given.\(^7\) Structurally, this "good faith defense" hews closely to the cost-of-capital analysis, because it bars avoidance of transfers that (a) do not leach value from the debtor firm (because they are taken for value) and (b) do not reward a creditor's complicity in a debtor's fraudulent scheme (because they are taken in good faith).

The closeness of the relationship between the good faith defense and the cost-of-capital analysis depends, however, on the meaning of "good faith," a term that the Bankruptcy Code does not define and which is virtually absent from its legislative history.\(^8\) Courts have likewise generally declined to offer a precise definition of "good faith."\(^9\) Nonetheless, courts interpreting the Bankruptcy Code's fraudulent transfer provisions in particular have frequently employed two standards of good faith. Under a "subjective" standard, courts measure a creditor's good faith by attempting to determine what the creditor actually knew.\(^20\) Under an "objective" standard, courts ask whether a transferee knew or should have known of facts that would lead a prudent investor in the transferee's position to investigate further\(^21\)—that is, whether the transferee was on inquiry notice of the fraud.\(^22\) A transferee on inquiry notice may not avail himself of the good faith defense unless (1) he conducted a diligent investigation that allayed his concerns\(^23\) or (2) a diligent investigation would not have uncovered the fraud.\(^24\)

\(^{17}\) 11 U.S.C. § 548(c).
\(^{19}\) See, e.g., Jobin v. McKay (In re M & L Bus. Mach. Co.), 84 F.3d 1330, 1335 (10th Cir. 1996) ("[C]ourts applying § 548(c) have generally refused to formulate precise definitions."); Brown v. Third Nat'l Bank (In re Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995) ("Good faith ... is determined on a case-by-case basis."); Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group), 916 F.2d 528, 536 (9th Cir. 1990) ("Courts have been candid in acknowledging that good faith 'is not susceptible of precise definition.'"); see also 4 COLLIER ON BANKRUPTCY ¶ 548.07[2], at 548-72 (Lawrence P. King ed., 1996) ("The unpredictable circumstances in which courts may find its presence or absence render any definition of 'good faith' inadequate, if not unwise.").
\(^{20}\) See Mark A. McDermott, Ponzi Schemes and the Law of Fraudulent and Preferential Transfers, 72 AM. BANKR. L.J. 157, 167 (1998). A subjective standard is typically used by courts when determining whether a defrauded investor "gave value" for purposes of the constructive fraud provision and good faith defense. An investor will be deemed to have given value to the extent that he would have otherwise had a claim for restitution that was extinguished by the debtor's transfer. Good faith is an element of such a claim. See infra note 45 and accompanying text.
\(^{21}\) See, e.g., In re Sherman, 67 F.3d at 1355; In re Agric. Research, 916 F.2d at 535-56.
\(^{22}\) See, e.g., In re Sherman, 67 F.3d at 1355; HBELeasing Corp. v. Frank, 48 F.3d 623, 626 (2d Cir. 1995); see also COLLIER ON BANKRUPTCY, supra note 19, at 548-73.
\(^{23}\) See, e.g., In re M & L, 84 F.3d at 1338; In re Agric. Research, 916 F.2d at 536.
\(^{24}\) See In re Agric. Research, 916 F.2d at 536 (citing In re Polar Chips Int'l., Inc., 18 B.R. 480
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The two standards reflect different judicial goals, which should be examined from a cost-of-capital perspective. An actual knowledge standard suggests a desire to prevent transferees from profiting from fraud in which they were complicit or which they deliberately ignored. Because removing incentives for creditors to facilitate fraud is a cost-of-capital-reducing goal of the fraudulent transfer provisions, fraudulent transfers that fail to meet a subjective standard of good faith are appropriately carved out of section 548(c).

Courts might favor a more demanding inquiry notice standard, however, for one of two reasons. First, it may often be prohibitively difficult for a court to determine whether a defendant subjectively lacked good faith. If an actual knowledge standard substantially under-captures culpable behavior by creditors, an inquiry notice standard may prove to be the only workable method of probing creditors’ actual knowledge. Second, if courts want to encourage creditors to actively root out fraud, a duty-imposing inquiry notice standard may be preferable to an actual knowledge standard. On the other hand, innocent creditors who know they will be subjected to an objective standard have no reason to disclose the results of a diligent investigation that uncovers fraud, since an investigation that does not allay a creditor’s concerns provides no basis for a good faith defense. Rather, creditors may have an incentive to quietly disentangle themselves from the debtor, hoping that the statute of limitations on the Code’s fraudulent transfer provisions will run before the firm becomes insolvent. Moreover, it is not clear that expanding the scope of liability for creditors will actually induce them to more closely scrutinize their investments; given that the objective standard asks what a “prudent investor” would do, many creditors would have to behave imprudently, were it not for the provision, in order for it to have any bite.

Neither approach enjoys an obvious advantage from a cost-of-capital perspective. Imposing an inquiry notice standard is likely to capture a larger proportion of culpable behavior by creditors, but also risks being over-inclusive: it decreases the likelihood that a given creditor will receive the benefit of the good faith defense, and increases uncertainty as to what behavior

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25. Because the terms “subjective standard” and “objective standard” sometimes obscure the content of the good faith requirement, see discussion infra Section III.C, this Article will at times use the terms “actual knowledge standard” and “inquiry notice standard” in their place.

26. See Section I.B, supra.

27. Cf. In re Sharp Int’l Corp., 403 F.3d 43, 56 (2d. Cir. 2005) (discussing the difficulty of proving actual intent for purposes of § 548(a)(1)(A)).

28. Courts often speak sternly of a defendant “putting his head in the sand,” see In re Bayou, 396 B.R. at 847, or “putting on blinders,” see In re Manhattan Inv., 359 B.R. at 524—language which seems implicitly to support this justification.
will remove the creditor from its ambit, both of which should increase the cost of capital relative to an actual knowledge standard. Additionally, an inquiry notice standard may require a higher level of diligence from creditors, the costs of which must be offset by a higher interest rate. Conversely, an inquiry notice standard may reduce litigation costs in a case in which a trustee seeks to avoid transfers to multiple defendants based on a common factual background, by eliminating the need to litigate the issue of individual defendants' actual knowledge. Reducing enforcement costs in this manner increases the value of the bankruptcy estate, and thus lowers cost of capital.

As an initial matter, then, the fraudulent transfer provisions of section 548 find strong normative support under a cost-of-capital analysis. Neither standard of good faith that courts have employed, however, is clearly preferable to the other on purely normative grounds.

II. APPLICATION OF THE FRAUDULENT TRANSFER PROVISIONS TO PONZI SCHEMES

In the sections that follow, this Article will examine the difficulties that arise from fraudulent transfers to hedged investors—those that hold no economic stake in their investments. A hedged investor will typically hold an equity interest in the debtor, and thus will be considered a creditor only to the extent that it holds a claim against the debtor arising from its investment. Such claims will usually be claims for rescission based on fraud in the inducement—claims that ordinarily arise from Ponzi schemes. Because Ponzi schemes are expressly created to defraud investors, the courts treat fraudulent transfers in the context of such schemes differently than they do plain vanilla fraudulent transfers. It will thus be helpful, before proceeding, to briefly consider the application of the fraudulent transfer provisions to Ponzi schemes.

A Ponzi scheme is a fraudulent investment enterprise in which returns to old investors are paid out of funds collected from new investors, rather than from profits generated by a legitimate business venture. Ponzi schemes typically offer outsized returns in order to attract a steady stream of capital from which their promoters siphon funds. They eventually collapse when they are no longer able to attract enough new capital to maintain returns to old investors. To prove that a putative business was a Ponzi scheme, the trustee of the resultant bankruptcy estate must show: (1) that deposits were made by

29. See infra Section III.A.
30. Id.
31. See infra Section II.B.
32. In re Lake States Commodities, 253 B.R. 866, 869 n.2 (Bankr. N.D. Ill. 2000); see also Danning v. Bozek (In re Bullion Reserve of N. Am.), 836 F.2d 1214, 1219 n.8 (9th Cir. 1988).
33. In re Lake States Commodities, 253 B.R. at 869 n.2 ("A Ponzi scheme cannot last forever because the investor pool is a limited resource that will eventually run dry.").
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investors; (2) that the debtor conducted little or no legitimate business operations as represented to investors; (3) that the purported business operations of the debtor produced little or no profits or earnings; and (4) that the source of the payments to investors was from cash infused by new investors. In a bankruptcy proceeding, investors in a Ponzi scheme are general creditors of the estate, and investors become transferees when they redeem all or a portion of their investment.

A. Actual Fraud

Most courts apply a strong "Ponzi scheme presumption" that transfers made to investors in the course of a Ponzi scheme were made with actual intent to hinder, delay, or defraud creditors because they "could have been made for no other purpose." Falsified returns are designed (1) to conceal losses so that old investors (current creditors) will maintain their investments and (2) to give the illusion of profits so that additional investors (future creditors) will make new ones. Even in the unusual case where a court declines to apply a presumption of fraudulent intent, intent is rarely difficult to prove, given the criminal fraud proceedings that normally attend the collapse of a Ponzi scheme. Accordingly, if a trustee is able to demonstrate that a debtor operated as a Ponzi scheme, he will generally be able to avoid any transfer made to an investor within two years of commencement of the bankruptcy proceeding.

B. Constructive Fraud

The typical Ponzi scheme is insolvent from its inception. Accordingly,


35. See infra Section II.B. Under the Bankruptcy Code, the term "creditor" is defined expansively to include any "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10) (2000).

36. In re Manhattan Inv., 397 B.R. at 8; see also In re Canyon Sys. Corp., 343 B.R. at 636-37 ("Actual intent to hinder, delay, or defraud may be established as a matter of law in cases in which the debtor runs a Ponzi scheme or a similar illegitimate operation.").


40. In re Taubman, 160 B.R. 964, 978 (Bankr. S.D. Ohio 1993). The rare Ponzi scheme that operates for a substantial period as a legitimate business venture but becomes fraudulent in order to disguise losses poses unique challenges for a court applying the constructive fraud provisions. The difficulties arise from many investors' lack of a claim for restitution. See infra notes 45-50 and accompanying text. This highly atypical situation is beyond the scope of this Article.
many courts treat a debtor operating a Ponzi scheme as presumptively insolvent for purposes of the constructive fraud provision. Courts will thus hold transfers made by the debtor within two years of bankruptcy constructively fraudulent to the extent they were made for less than "reasonably equivalent value." Bankruptcy Code section 548(d)(2)(A) defines "value" as "property, or satisfaction or securing of an antecedent debt of the debtor." "Debt" is defined elsewhere as "liability on a claim," "claim" is in turn defined broadly as encompassing a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, disputed, legal, equitable, secured, or unsecured" and a "right to an equitable remedy for a breach of performance."

A defendant who is fraudulently induced to invest has a claim for rescission of his contract and restitution of his investment from the moment he enters into the agreement, regardless of whether it promised a return of principal. Because the amount of the claim for restitution is reduced by any amount returned to the investor, courts hold that a defendant has exchanged "reasonably equivalent value" for purposes of section 548(a)(1)(B) to the extent that a transfer represents a return of the defendant's initial investment. Thus, in contrast to an avoidance action based on actual fraud, in an action based on

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43. 11 U.S.C. § 101(5).

44. 11 U.S.C. § 101(12).

45. See Jobin v. Cervenka (In re M & L Bus. Mach. Co., Inc.), 84 F.3d 1330, 1341 (10th Cir. 1996) (citing In re Indep. Clearing House, 77 B.R. at 857). The claim for restitution arises under state law, but in cases of fraud is "almost universally recognized as appropriate." 66 AM. JUR. Restitution and Implied Contracts § 20 (2008); see also 17A AM. JUR. 2D Contracts § 588. Note, however, that a party seeking rescission of a contract must have entered into the contract in good faith; thus, a trustee seeking to show that a transfer was not made for reasonably equivalent value may do so by demonstrating that the defendant lacked good faith at the time of its initial investment. See McDermott, supra note 20, at 167. The standard of good faith applied in the context of a reasonably equivalent value inquiry under section 548(a)(1)(B) is subjective. See, e.g., Jobin v. Cervenka (In re M & L Bus. Mach. Co., Inc.), 194 B.R. 496, 501-02 (D. Colo. 1996). In determining the good faith of a defendant who has made multiple investments with the debtor at different times, courts typically will examine the defendant's knowledge solely at the time of the first investment, though this appears to be a byproduct of the "netting" approach, see infra note 49, rather than a deliberate strategy. See In re Lake States, Commodities, Inc., 253 B.R. 866, 872 (Bankr. N.D. Ill. 2000).

46. See In re M & L, 84 F.3d at 1341 (citing Wyle v. Rider (In re United Energy Corp.), 944 F.2d 589, 596 (9th Cir. 1991)). A suit for rescission is not brought under the contract, but to void the contract—thus, its content is irrelevant to the outcome. See 17A AM. JUR. 2D Contracts § 584.

47. See, e.g., In re M & L, 194 B.R. at 501 ("[C]ases addressing the issue have held that a defrauded investor in a Ponzi scheme gives 'value' to the debtor in the form of a dollar-for-dollar reduction in the investor's restitution claim against the Ponzi scheme."); aff'd, 84 F.3d 1330; In re Lake States, 253 B.R. at 872 ("Since investors' rights to restitution are proportionately reduced by payments received from a Ponzi scheme, to the extent of invested principal, payments from the debtor are deemed to be made in exchange for reasonably equivalent value."); In re United Energy, 944 F.2d at 595 (same).


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constructive fraud, the trustee typically may not recover any amount that represents the redemption of principal. Transfers of fictitious profits, on the other hand, are always avoidable under the constructive fraud provision because a claim for restitution is limited to the amount of the initial investment and thus any excess given by defendant does not qualify as “value” under 548(a)(1)(B). Moreover, courts have resisted efforts to characterize any portion of a redemption in excess of principal as pre-judgment interest on a restitution claim.

C. The Good Faith Defense

A defendant may escape liability for a fraudulent transfer to the extent he gave value in return by availing himself of the good faith defense in section 548(c). The determination of value given is identical to the inquiry under the constructive fraud provision; because the value requirement will usually be met, whether an investor is permitted to retain redeemed principal (fictitious profits will never be saved) ordinarily turns on whether the investor requested the redemption in good faith.

Courts considering the issue of good faith in this context have universally applied an objective, or inquiry notice, standard: they will find good faith lacking if an investor was on inquiry notice of fraud and failed to conduct a diligent investigation that allayed his concerns. Inquiry notice exists if the investor knew, or should have known, of facts that would lead a prudent investor to inquire further. While no court has directly addressed the content of the “prudent investor” standard, there is strong evidence to suggest that it is a payments made by a debtor in furtherance of a Ponzi scheme are made with actual fraudulent intent.”)

49. See, e.g., In re United Energy, 944 F.2d at 595 n.6; In re Lake States, 253 B.R. at 872. The courts have eschewed a nuanced view of the distinction between profit and principal in favor of a “netting” approach. “If a defendant received less than his [initial investment], the amounts received should be considered return of principal, regardless of how the parties may have designated them. On the other hand, to the extent all transfers to a defendant exceeded his undertaking (fictitious profits will never be saved) ordinarily turns on whether the investor requested the redemption in good faith.

49. See, e.g., In re United Energy, 944 F.2d at 595 n.6; In re Lake States, 253 B.R. at 872. The courts have eschewed a nuanced view of the distinction between profit and principal in favor of a “netting” approach. “If a defendant received less than his [initial investment], the amounts received should be considered return of principal, regardless of how the parties may have designated them. On the other hand, to the extent all transfers to a defendant exceeded his undertaking (fictitious profits will never be saved) ordinarily turns on whether the investor requested the redemption in good faith.

50. McDermott, supra note 20, at 165.

51. Section 548(c) technically says that a defendant may avoid liability for a transfer taken (1) “for value” and (2) in good faith. However, the provision later stipulates that the defendant is off the hook only “to the extent . . . [it] gave value to the debtor in exchange.” Courts have construed this in the same way as the “reasonably equivalent value” language of subsection (a)(1)(B). See, e.g., In re AFI Holding, Inc., 525 F.3d 700, 707 (9th Cir. 2008) (“Both the prima facie case for constructively fraudulent transfers . . . and the affirmative defense to actually fraudulent transfers . . . require the determination of whether ‘reasonably equivalent value’ was transferred from the transferee to the debtor.”); In re Lake States, 253 B.R. at 878 (“As has been noted in connection with the discussion of constructive fraud, the reduction of a transferee’s claim for restitution can constitute ‘value.’”); McDermott, supra note 20, at 176 n.75. Because, under this reading, every transfer that meets the “value” requirement of subsection (c) will fail to be avoidable in the first place under subsection (a)(1)(B), the good faith defense is essentially inapplicable to constructively fraudulent transfers.

52. See supra notes 20–23 and accompanying text.

context-specific standard—that is, a court will consider an investor to be on inquiry notice if an investor in his position would have investigated further.  

III. THE BAYOU CASE

A recent case, In re Bayou Group, LLC, provides an illustration of fraudulent transfer actions arising from a Ponzi scheme—and of trouble ahead for the good faith defense. Bayou involved a hedge fund, Bayou Group, LLC (Bayou), operated by Sam Israel and two co-conspirators from 1996 through 1996 ("[A] reasonably prudent investor in [the defendant's] position should have known of [the debtor's] fraudulent intent and impending insolvency and ... was therefore not entitled to the good faith defense established by § 548(c)."). With Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 536 (9th Cir. 1990) ("At least one court has held that if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent.") (citing In re Polar Chips Int'l, Inc., 18 B.R. 480 (Bankr. S.D. Fla. 1982)).

54. Some courts have explicitly stated the test by reference to the defendant's position. See In re M & L, 84 F.3d at 1339 ("[A] reasonably prudent investor in [the defendant's] position should have known of [the debtor's] fraudulent intent." (emphasis added)), In re Lake States, 253 B.R. at 878-79 ("[The defendant] has presented no evidence concerning his prior experience as an investor, and the record contains no competent evidence supporting his allegation that the returns indicated on his account statements would have seemed reasonable to similarly situated investors." (emphasis added)). Others explicitly consider the defendant's position, but more obliquely. See In re Manhattan Inv. Fund Ltd., 397 B.R. 1, 23 (S.D.N.Y. 2007) ("In this case, the best evidence of what a prudent prime broker would have done is what [the defendant] actually did. In other words, the support for a finding of inquiry notice is found in [the defendant's] own reaction: the actions it took ... clearly show that it had cause to and did investigate further."). Still others consider the defendant's education and experience when making the good faith determination—"a futile exercise if the "prudent investor" is an immutable standard. See, e.g., In re Bayou Group, LLC, 396 B.R. 810, 845 (S.D.N.Y. 2008) ("Whether a transferee was on 'inquiry notice' may also be informed by, inter alia, the experience or sophistication of the transferee.").

Jobin v. Cervenka (In re M & L Bus. Mach. Co., Inc.), 194 B.R. 496, 503 (D. Colo. 1996) ("[T]hese factors, coupled with the fact that [the defendant] had satisfied the minimal educational requirements to qualify as a doctor of chiropractic, when measured by an objective standard, put [him] on constructive notice of the fraud."); In re Tiger Petroleum Co., 319 B.R. 225, 236 (Bankr. N.D. Okla. 2004) ("Factors which have been considered by the Tenth Circuit to be relevant include the defendant's experience as an investor ... "); Gill v. Maddalena (In re Maddalena), 176 B.R. 551, 556 (Bankr. C.D. Cal.) ("In summary, it appears defendant was inexperienced, unsophisticated and largely uninformed, and consequently, his motives in buying the note for the funds he had available seem bona fide to the Court. Defendant acted in good faith ... "); see also McDermott, supra note 20, at 178 ("Courts have considered a host of factors in applying the objective good faith standard, including the investor's level of business knowledge and experience, including education, other investments made, [and] the returns earned on such investments ... "). By contrast, the courts that have made no allusion to these factors have, by and large, summarily stated the rule of a nineteenth-century case interpreting a state fraudulent conveyance statute:

While the plaintiff was not bound to act upon mere suspicion as to the intent with which his brother made the sale in question, if he had knowledge or actual notice of circumstances sufficient to put him, as a prudent man, upon inquiry as to whether his brother intended to delay or defraud his creditors, and he omitted to make such inquiry with reasonable diligence, he should have been deemed to have knowledge of such fact, and therefore such notice as would invalidate the sale to him, if such sale was in fact made with the intent upon the part of the vendor to delay or defraud other creditors.


55. 396 B.R. at 810.

56. In 2003, the original Bayou fund was reorganized into three funds—Bayou Accredited Fund, LLC, Bayou No Leverage Fund, LLC, and Bayou Superfund, LLC. Id. at 821-22. The four funds will be
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2005. The fund sustained heavy trading losses early in its operation. To conceal those losses its principals began manufacturing false financial statements and fraudulently misrepresenting their investment performance. Recognizing that the fund would not be able to survive an independent audit, the fund’s managers terminated its auditor, and the fund’s chief financial officer created a fictitious accounting firm to pose as the independent auditor. Under a cover of fabricated audits, the managers used new investments to pay modest returns to existing investors, all the while continuing to lose money. By the time the scheme collapsed in 2005, the managers had extracted at least $120 million in cash, and $250 million was missing from customer accounts owing to a combination of embezzlement, trading losses, and transfers of “profits” to investors who had redeemed their investments. Each of the fund’s managers pled guilty to multiple counts of mail fraud.

A. The DBSP-Sterling Swap

After Bayou filed for bankruptcy, its trustee brought suit against dozens of investors to recover fraudulent transfer redemption payments made in the year prior to bankruptcy. Of particular interest were the proceedings against two investors: DB Structured Products (DBSP), a subsidiary of Deutsche Bank (Deutsche), and Sterling Stamos Capital Management, L.P. (Sterling), a “fund of funds.” Sterling held several direct investments in Bayou that it redeemed in February 2005, six months before Bayou’s collapse, for reasons still being litigated: the trustees of the bankruptcy estate allege that Sterling redeemed when confronted with evidence of accounting irregularities and obfuscation by the fund’s principals; Sterling claims that it withdrew on account of Bayou’s decisions to expand its investments into more volatile asset classes and to quadruple its assets under management.

Sterling also held a synthetic position—a position that mimicked, but did not actually involve, an equity investment—in Bayou through a transaction with Deutsche called a total return swap. A total return swap is an agreement under which one party makes periodic interest payments and the other makes payments based on the return on an underlying asset. For instance, if Party X

treated as one for the purposes of this Article.

57. See id. at 822-24.
58. Id. at 828-31.
59. Id. at 821.
61. Id. at 861-64.
62. For additional information on total return swaps, see generally ANDREW M. CHISHOLM, DERIVATIVES DEMYSTIFIED (2004); and John D. Finnerty, The PricewaterhouseCoopers Credit Derivatives Primer: Total Return Swaps, THE FINANCIER, Mar. 22, 2000, at 66.
wants to invest in Company Z, instead of investing directly in Z, X can enter into an agreement with Party Y with the following terms:

- X will pay Y a periodic interest rate, which can be either fixed or floating.
- X will also pay Y for any decline in the value of its “investment”—that is, any drop in the market value of an equivalent direct investment.
- Y will pay X for any increase in the value of the “investment.”
- Y will also pay X the value of any income that would be generated through a direct investment—that is, the value of dividends and other distributions to investment holders.

The counterparty in a total return swap—here, Y—will often make a direct investment in the “reference asset”; that is, if X has purchased synthetic exposure to the common stock of Z, Y will purchase common stock with a value equal to X’s synthetic investment. Y does so in order to hedge its exposure to increases in the value of the stock (for which it will have to pay X).

After these transactions have been completed, Y—and Y alone—is the legal owner of an equity stake in Z. The economic reality, however, does not line up: Y has made an initial cash outlay in return for periodic interest payments, while X has gained exposure (both upside and downside) to the securities of Z. Y has, in effect, loaned X money to make an investment in Z.

There are a number of reasons why X might prefer a total return swap to a direct investment. First, a total return swap is a leveraged position; it allows a party such as X to gain exposure to a reference asset with a minimal cash outlay. Second, total return swaps are periodically marked to market, meaning that cash is exchanged based on the value of the reference asset. If X prefers its short-term cash flows to reflect rises and falls in the value of its investments, it may favor a total return swap over a direct investment, which must be liquidated in order to generate cash flows. Third, X may wish to keep its investment in Z off of its balance sheet; a total return swap accomplishes this goal because it does not give X a legal stake in Z. Finally, if Z is a public company, X may wish to acquire a large beneficial ownership stake in Z without being required to publicly disclose its position. Y, on the other hand, typically will be willing to serve as a swap counterparty because it will charge X an interest rate slightly above that at which it borrows to finance its hedge. Thus, Y will earn a small, periodic margin for a low-risk investment.

63. See CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 522-23 (S.D.N.Y. 2008). The legality of this practice, known as “hidden voting,” is hotly debated. See Floyd Norris, Hedge Funds Can Vote at CSX Meeting, N.Y. TIMES, June 12, 2008; Client Newsflash, Davis Polk & Wardwell, Court Requires Activist Hedge Funds To Disclose Swaps in CSX (June 13, 2008), http://www.dpw.com/1485409/newsflashes/06.13.08.SwapsinCSX.htm.

64. The primary source of risk for Y is that X will default on its obligations under the swap. To this end, X is often required to post collateral.
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In Bayou, Sterling was in X’s position—it made periodic interest payments to Deutsche in exchange for a synthetic exposure to Bayou. Although the agreement between Deutsche and Sterling specifically disclaimed any obligation by Deutsche to make a direct investment in Bayou, Deutsche decided to do so in order to hedge its position in the swap. It did so by directing its subsidiary, DBSP, to make a same-sized direct investment in Bayou. As a result, while DBSP was the only party with an investment in Bayou, Sterling was the only party with investment risk.

When Sterling requested redemption of its direct investments from Bayou, Sterling also notified Deutsche that it was terminating the total return swap, apparently for the same reasons. Because DBSP no longer needed to hedge its position in the swap, it also requested redemption.

B. The Bankruptcy Court’s Opinion

The bankruptcy court ruled that the Bayou trustee was entitled to summary judgment against all defendants under the Code’s actual fraud provision, subject to any affirmative defense under section 548(c). It also granted summary judgment with respect to fictitious profits under the constructive fraud provision. The court then proceeded to articulate a novel standard of good faith under section 548(c):

Recognizing that the burden is on the defendant to prove his 548(c) defense, I would hold that a defendant may establish his defense if he can prove by a preponderance of the credible objective evidence that his request for redemption was in fact the result of a good faith reason other than his knowledge of “red flags,” even if he was on inquiry notice and did not make inquiry before redeeming. By “objective evidence” I mean independent evidence of facts, as opposed to mere “subjective assertions of good faith” by the defendant himself or the testimony of others that cannot be objectively verified. Therefore, while I maintain that an objective standard must be applied to the good faith analysis, to disregard objective evidence of the transferee’s subjective good faith intent would fundamentally distort the concept of good faith.

The court dismissed cross-motions for summary judgment on Sterling’s section 548(c) defense, on the ground that material questions remained as to

68. In re Bayou, 396 B.R. at 855.
69. Id. at 843.
70. Id. The court held that “[r]edemption payments in respect of fictitious profits are not subject to the affirmative defense under section 548(c), because the 548(c) defense applies only ‘to the extent that such transferee . . . gave value to the debtor in exchange for such transfer.’” See supra note 51.
71. In re Bayou, 396 B.R. at 848-49.
Sterling's motivation for redeeming its investments.\textsuperscript{72} The court granted DBSP's motion for summary judgment, however, holding that DBSP had established that its redemption request was made in good faith under the court's modified standard:

> It is perfectly evident from the foregoing undisputed facts that DBSP made its investments in Bayou . . . solely as a hedge . . . and that DBSP requested redemption of its . . . investment because Deutsche Bank's risk exposure was terminated under the Total Return Swap. These facts would establish DBSP's good faith defense even if Deutsche Bank or DBSP had received knowledge of "red flags" putting them on inquiry notice with respect to the Bayou hedge funds . . . .\textsuperscript{73}

In effect, the court held that, by showing its redemption request was triggered by Sterling's decision to terminate the swap, DBSP could shield itself from liability under the fraudulent transfer provisions (at least with respect to redemption of principal). The court dismissed the trustee's argument that Sterling's inquiry notice should be imputed to DBSP as "frivolous as a matter of fact and law."\textsuperscript{74} The ultimate result, unacknowledged by the court, was that neither DBSP nor Sterling could be pursued by the trustee for the transfer from Bayou to DBSP—the court held that neither party's knowledge was relevant to DBSP's good faith defense.\textsuperscript{75} This result suggests that, under the standard promulgated by the bankruptcy court, a trustee may never avoid as fraudulent a redemption of principal when such redemption is coupled with the termination of an offsetting position by a counterparty.

\textbf{C. Bayou's Red Herring}

Before examining the consequences of this surprising result, it will be helpful to discuss the court's novel interpretation of the good faith requirement.\textsuperscript{76} The court's reading illustrates that the terms "objective" and "subjective" are at times misleading. "Objective" is frequently used in the law not in relation to inquiry notice, as in section 548(c), but in relation to external manifestations of internal (mental) phenomena.\textsuperscript{77} Focusing on the term "objective" thus may lead courts to search solely for external evidence that a defendant actually knew of a debtor's fraudulent intent, rather than to engage in

\begin{itemize}
\item \textsuperscript{72} \textit{Id.} at 863.
\item \textsuperscript{73} \textit{Id.} at 855 (emphasis added).
\item \textsuperscript{74} \textit{Id.} at 856.
\item \textsuperscript{75} This result is particularly striking in light of other sections of the \textit{Bayou} opinion, which reveal that, with respect to its direct investments in Bayou, Sterling "was certainly on inquiry notice of serious issues involving Bayou." \textit{Id.} at 863.
\item \textsuperscript{76} The court confirmed the novelty of its approach: "[I]t is important to set forth this Court's views on certain aspects of the law which have informed my conclusions as to each defendant, since my views may be thought to differ in some respects from the case law (e.g., the 'objective/subjective' dichotomy discussed below)." \textit{Id.} at 847.
\item \textsuperscript{77} See, for example, Black's Law Dictionary, which defines "objective" as "1. Of, relating to, or based on externally verifiable phenomena, as opposed to an individual's perceptions, feelings, or intentions." or "2. Without bias or prejudice; disinterested." \textit{BLACK'S LAW DICTIONARY} (8th ed. 2004).
\end{itemize}
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a broader inquiry of whether the defendant “knew or had reason to know” of facts demanding further investigation, as required by the good faith defense.\textsuperscript{78}

Given that one possible justification of an objective good faith standard is that subjective intent is difficult to prove,\textsuperscript{79} a standard that allows objective evidence to prove, as well as disprove, an assertion of good faith may at first seem to have some appeal. The problems with such an approach, however, are evident from the \textit{Bayou} opinion itself. After preliminary hearings, the trustee agreed to settle several claims it determined would not meet the court’s modified good faith approach. Among those the court singled out for discussion as “representative . . . of good faith defenses under \textsection 548(c) established by objective evidence”\textsuperscript{80} were cases against a defendant who requested redemption to pay for private school tuition for a child and a couple who requested redemption to purchase a new home.\textsuperscript{81} The court’s endorsement of these justifications for redemption is troubling because the defendants’ expenditures were purely discretionary. An “objective” standard is supposed to tell investors they cannot “bury their heads in the sand,”\textsuperscript{82} but the court’s modified standard virtually instructs them to do just that—or, more cynically, to buy a yacht. Under the standard, defendants are given a strong incentive not only to ignore fraud but, once alerted to it, to manufacture pretenses for a quiet withdrawal—a scheme that not only immunizes the worst offenders from liability, but minimizes the likelihood of regulators and other investors being alerted. The \textit{Bayou} court’s interpretation of the good faith defense should thus be expected to increase, rather than decrease, the duration of fraud, a result that would be normatively indefensible\textsuperscript{83} even if it were justifiable by reference to prior case law.

IV. THE TROUBLE AHEAD FOR THE GOOD FAITH DEFENSE

This obvious error in \textit{Bayou} disguises a deeper problem. Even if the correct standard had been applied, it is unlikely that DBSP, or any similarly situated party, could have been held liable under the Bankruptcy Code’s fraudulent transfer provisions—a situation which might have drastic consequences from a cost-of-capital perspective.

\textsuperscript{78} In contrast to the definition of “objective,” see id., Black’s Law Dictionary defines good faith as “a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.” BLACK’S LAW DICTIONARY (8th ed. 2004).
\textsuperscript{79} See supra note 27 and accompanying text.
\textsuperscript{80} In re Bayou, 396 B.R. at 853.
\textsuperscript{81} Id.
\textsuperscript{82} See supra note 28 and accompanying text.
\textsuperscript{83} See supra Section I.C.
A. The Problem Posed by Hedged Investors

As discussed above, courts have uniformly applied an objective standard in analyzing a defendant’s good faith, and under this standard, a defendant will be found to have acted in good faith if it was not on inquiry notice of fraud. A defendant is on inquiry notice when it knows, or should know, of facts that would lead the prudent investor in its position to investigate further. But a prudent investor in DBSP’s position—that is, an investor that has eliminated its investment risk through an offsetting position—will be unlikely to investigate further. Its returns will be the same regardless of whether the value of its direct investment rises or falls. In fact, it would be imprudent for an investor who has hedged away its investment risk to expend resources to investigate fraud. A subjective theory of good faith fares no better—precisely because a hedged investor has no reason to monitor its investments, it will rarely, if ever, have actual knowledge of fraud. Thus, under either standard of good faith previously articulated by the courts, a hedged investor should usually be able to avoid liability under the fraudulent transfer provisions for a redeemed investment.

Nor is there any way to hold a “synthetic” investor liable for the transfer. As an initial matter, any possible theory of recovery must be strained by the fact that the synthetic investor is not in privity with the debtor. Moreover, a synthetic investment is not equivalent in any real sense to a direct investment effected by a third party. The agreement between Deutsche and Sterling expressly provided that Deutsche was not required to hedge its position by making a direct investment in Bayou, and that any decision to do so would be made solely upon consideration of its own interests. That language was true to Sterling’s intent—though Deutsche apparently had an institutional policy of

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84. See supra Section II.C.
85. See supra note 54 and accompanying text.
86. This logic extends not only to total return swaps, but to all situations in which an investor has eliminated its investment risk by entering into an offsetting position—for example, where an investor holds a short forward position or has sold short against the box. Moreover, under an objective standard, it is not relevant whether a request for redemption was “in fact the result of a good faith reason other than his knowledge of ‘red flags,’” In re Bayou, 396 B.R. at 848. Thus, it shouldn’t matter whether the request was motivated by another party’s investment decision (as in Bayou) or by the investor’s own, at least as long as the investor lacked actual knowledge of the debtor’s fraud.
87. In Bayou, Sterling was not in privity with DBSP—its contract was with Deutsche, DBSP’s corporate parent. See In re Bayou, 396 B.R. at 854.
88. The agreement provided:
This Master Confirmation and each Transaction hereunder does not create any obligation on the part of Party A [Deutsche Bank] or any of its affiliates to hedge or otherwise make an investment in the Reference Fund related to a Transaction. To the extent that any such investment in a Reference Fund is made by Party A or any of its affiliates, such investment will be on its own behalf only and each of Party A [Deutsche Bank] and Party B [Sterling Levered] acknowledges that neither this Master Confirmation nor any Transaction hereunder will create either a direct or indirect obligation of any Reference Fund owing to Party B.
Statement of Undisputed Material Facts, supra note 65, ¶ 29.
hedging its positions in swap transactions to eliminate investment risk, Sterling was truly indifferent as to whether Deutsche elected to do so. Given that Sterling had no interest in Deutsche's investment, it would be a strange result if Sterling could be held liable on account of it.

The case law on best-fit legal theories supports this intuition. The only court that appears to have addressed the issue ruled in an analogous case that neither party in a swap transaction acted "for or on behalf of any other person"—an interpretation that would bar a court from finding an agency relationship. The result is unsurprising, given that the hallmark of an agency relationship is consent by one party to act on behalf of another and subject to its control—consent which both sides to a swap transaction would surely disclaim. In fact, the parties to a swap transaction have opposing interests: any subsequent hedging aside, one party to a swap profits if the value of the reference asset falls, while the other profits if it rises.

Courts have sometimes held parties that manage investments for others to be "mere conduits" for purposes of the fraudulent transfer provisions—rather than hold such parties liable, trustees are permitted to pursue the ultimate recipients of funds. In order to be adjudged a "mere conduit," however, a defendant must demonstrate that it lacked "dominion over the money or other asset, the right to put the money to one's own purposes." An investor in DBSP's position clearly does not meet that test: regardless of whether it has hedged its position, it plainly has the right to control the funds it receives from a debtor.

B. Consequences for the Fraudulent Transfer Law

It thus appears that under current law a trustee will never be able to recover amounts transferred to hedged investors. This represents a major departure from past precedent when one considers the parties who are likely to use complex financial instruments like total return swaps. Parties with an appetite for highly leveraged, complex derivatives are disproportionately likely to be

92. See supra Section III.A.
93. See Christy v. Alexander & Alexander of N.Y. Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey), 130 F.3d 52, 57 (2d Cir. 1997) (“Every Court of Appeals to consider this issue has squarely rejected a test that equates mere receipt with liability, declining to find ‘mere conduits’ to be initial transferees.”).
94. Id.
95. Interestingly, “a transferee who does not act in good faith can never be deemed a ‘mere conduit.’” In re Model Imperial, Inc., 250 B.R. 776 (Bankr. S.D. Fla. 2000) (citing Huffman v. Commerce Sec. Corp. (In re Harbour), 845 F.2d 1254, 1258 (4th Cir. 1988)). One might wonder at the fact that a principal such as DBSP is arguably held to a lower standard than a mere conduit.
sophisticated investors like hedge funds and investment banks. The very reason the objective good faith standard is keyed to an investor’s position is so that experienced investors may be held to a higher standard than other parties—so it is surprising that the most sophisticated investors may be able to avoid liability altogether. If neither hedged investors nor their counterparties are liable for fraudulent transfers under the Bankruptcy Code, those most likely to be able to detect fraud will be permitted to evade the reach of the law.

This result has serious consequences from a cost-of-capital perspective. First, it eviscerates the good faith requirement by eliminating sophisticated investors’ duty to monitor their investments, which should increase the duration of fraud, making a solvency state payoff less likely for all creditors. It should also raise the cost of capital by increasing investors’ uncertainty as to their insolvency state payoffs, because investors cannot determine whether and to what extent a debtor is capitalized by investors who hold no investment risk and who therefore will effectively be immune from fraudulent transfer actions.

The situation is all the more troubling in today’s context. The world is currently experiencing the first major economic downturn since the proliferation of derivatives, and it appears that a major section of the Bankruptcy Code is incapable of dealing with arrangements whereby investment risk is severed from the other risks incident to ownership. The picture that emerges is one of a bankruptcy law incapable of taking cognizance of the economic realities of modern investment, precisely at the moment when those investments are first being tested.

V. POSSIBLE RESPONSES

There are two possible approaches to the problem outlined in the previous section: standardize the objective good faith requirement, or eliminate the good faith defense altogether. This Part will examine each in turn.

96. See Finnerty, supra note 62.
97. See supra Section I.B.
98. The assumption that creditors are not completely diversified, see supra note 10, is admittedly weak where creditors are in fact sophisticated investors in hedge funds, including funds of funds, investment in which is presumed to carry with it the benefits of diversification. However, diversification is costly, and there is evidence that complete diversification, even in this context, is rarely achieved. See generally Francois-Serge Lhabitant & Michelle Learned, Hedge Fund Diversification: How Much is Enough? (FAME Research Working Paper No. 52, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=322400 (finding a trade-off between profit potential and reduced probability of loss for fund of funds investments).
99. There are efficiency costs associated with both approaches, given that each would require holding defendants liable for failure to scrutinize investments in which they have no stake. Doing so will not compel them to monitor their investments, but it will require them to contract with their counterparties for a right of recoupment if redemptions are avoided by a trustee, or to increase the rate of return they demand on their offsetting positions, dependent on the investment’s bankruptcy risk. There are also substantial one-time equity costs associated with each approach. Changing the standard under
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One approach to the problem presented by hedged investors would be to eliminate the requirement that a defendant behave as a prudent investor in its position—that is, to hold all investors to the standard of an economically invested defendant. Courts could do so by holding all investors to the same standard, or by holding each class of investor—for example, hedge funds or individuals—to the same standard, regardless of the nature of the investment.

Even assuming standards could be agreed upon, however, serious problems would remain. Under an objective standard, investors wishing to avail themselves of section 548(c)’s good faith defense generally must demonstrate that they lacked inquiry notice of a debtor’s fraud. Inquiry notice exists when an investor “knew or should have known” of facts that would lead a prudent investor to investigate further. Yet construing the phrase “knew or should have known” is no easier than interpreting the “prudent investor” language discussed above. Hedged investors have no incentive to monitor their investments, and so in many cases will not actually be aware of troubling facts. The question will then often be what the defendant should have known—one that is not easy to answer when asked about a defendant without an economic stake in its investment. It is not clear, for instance, that a hedged investor should know facts appearing in a debtor’s financial statements, as other investors presumably should. Here, as before, the problem is not just semantic. It seems unreasonable to expect such a debtor to expend resources to monitor its investment. Nonetheless, this difficulty could be overcome using another blunt instrument—for example, by deeming all investors to know, as a matter of law, what an economically interested investor would know.

An alternative approach would be to legislatively eliminate the good faith defense altogether in the context of business bankruptcy. Doing so would render all fraudulent transfers effected within two years of bankruptcy automatically avoidable by the bankruptcy trustee.

A comprehensive analysis of the relative merits, from a cost-of-capital perspective, of eliminating the good faith defense is beyond the scope of this article. Nonetheless, there are reasons to suspect that elimination of the defense altogether is the superior alternative.

First, this approach has the advantage of simplicity: it would nullify completely the difficult questions, discussed above, that are raised by derivative

which current contracts will be interpreted will entail a costly one-time wealth transfer from hedged investors to other creditors of the bankruptcy estate. It will also mean that such investors will have contracted for a risk-inappropriate interest rate, lowering the value of their derivative contracts.

100. See supra note 55 and accompanying text.
101. See supra note 22 and accompanying text.
102. See supra note 21 and accompanying text.
103. See supra Section V.A.
instruments in bankruptcy, by permitting the trustee to recapture all wealth that may have been transferred through fraud.

Second, eliminating the defense should be expected to substantially lower litigation costs, which always decrease the value of the estate available for distribution to general creditors. In many large business bankruptcies, determination of individual defendants' good faith is doubtless a significant part of the expense of fraudulent transfer actions, given that many other relevant issues need only be litigated once, rather than for each transferee. For example, in the context of Ponzi schemes, a court will presume (a) that a debtor acted with intent to hinder, delay, or defraud current or future creditors, as required by 11 U.S.C. § 548(a)(1)(A), and (b) that a debtor was insolvent at the time the transfers were made, as required by § 548(a)(1)(B).

Eliminating the good faith defense altogether should thus be expected to substantially reduce the expense to the bankruptcy estate of litigating individual fraudulent transfer actions. Moreover, even in cases that do not proceed in court, a mandatory avoidance rule will lower settlement costs and increase overall returns to the bankruptcy estate. Lowering enforcement costs in this manner should increase the value of the insolvent firm, lowering the cost of capital.

Of course, this approach is not without its disadvantages, which would need to be weighed against its benefits. Its major disadvantage is that it throws the baby out with the bathwater—i.e., it mandates recovery of some transfers that are unquestionably the product of blameless transferee conduct. Some creditors who take a transfer for value and in good faith will be forced to return the property received, and in exchange will only be awarded a general unsecured claim against the bankruptcy estate. A full examination of the magnitude of this problem is beyond the scope of this article. Nonetheless, it is significant that, at present, it appears that the good faith defense is unsuccessful in a majority of the cases in which it is asserted by a transferee. Specifically, a review of two decades of case law reveals that, in 58 percent of business bankruptcy cases, the trustee was able to recover the entire amount of a challenged transfer from the transferee, and in 87 percent of cases, the trustee was able to recover a portion of the transfer. As a consequence, there is at least some reason to believe that the effect of a mandatory avoidance rule would be relatively limited from the standpoint of transferees.

CONCLUSION

This Article makes three major claims. First, the Bankruptcy Code’s fraudulent transfer provisions reduce the cost of capital for solvent firms in three ways: they increase the value of assets available for distribution to general creditors.
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creditors in bankruptcy; they decrease the likelihood that a given investor will receive an insolvency state payoff; and they decrease the standard deviation of investors' insolvency state payoffs. While the good faith exception to the provisions enjoys some normative support, neither standard of good faith thus far articulated by the courts enjoys a strong advantage from a cost-of-capital perspective.

Second, this Article argues that derivative instruments pose serious problems for the application of the fraudulent transfer provisions, and especially the good faith defense of section 548(c). Specifically, it argues that no standard of good faith can accommodate the unique position of an investor who has eliminated its investment risk—the risk that the value of its investment will fall (or rise)—by entering into an offsetting position. This result has serious consequences: it should decrease the likelihood of a solvency state payoff for all investors, and increase investors' uncertainty as to the size of their insolvency state payoffs, both of which should raise the cost of capital for solvent firms.

Finally, this Article argues that an appropriate response to this development would be to eliminate the good faith defense entirely in the context of business bankruptcies. Doing so would nullify the difficult issues raised by derivatives in fraudulent transfer actions, and would decrease litigation costs. The importance—and exigency—of achieving these goals should be readily apparent, given the flood of business bankruptcies just over the horizon.

APPENDIX

The table that follows summarizes case law since 1990 on the good faith defense to the Bankruptcy Code's fraudulent transfer provisions. It examines business bankruptcy cases where the good faith defense was actually litigated and decided. The data show that in 58% of such cases the challenged fraudulent transfer was avoided in its entirety, and in 87% a portion was avoided. By contrast, in only 13% of cases did a defendant prevail under 548(c) with respect to the full amount of a fraudulent transfer. The data also show that in 19% of cases, the last decision available was the denial of a motion for summary judgment—indicating a probable settlement.

Cases were originally located through a Westlaw search for “548(c) & bankruptcy & 'fraudulent transfer,” which generated 275 cases. The results were then narrowed to business bankruptcy cases in which good faith was actually litigated and decided.106 Cases prior to 1990 were excluded on the ground that the First Circuit court opinion addressing the scope of the defense

106. Because this Article asserts that the In re Bayou Group, LLC interpretation of good faith is indefensible by reference to prior law, it is omitted from the data.
was issued that year;\textsuperscript{107} prior cases adopted variable approaches to the good faith inquiry.\textsuperscript{108}

In the table, the following notation is used:

\begin{itemize}
  \item Y: The defendant was permitted to retain the entire contested transfer.
  \item N: The trustee was permitted to recover the entire contested transfer.
  \item P: The trustee was permitted to recover a portion of the contested transfer.
  \item ND: No decision was entered with respect to the avoidability of the transfer (typically, because a request for summary judgment was denied.)
\end{itemize}

<table>
<thead>
<tr>
<th>No.</th>
<th>Defense allowed?</th>
<th>Case</th>
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<tr>
<td>1</td>
<td>Y</td>
<td>Frontier Bank v. Ronald G. Brown (\textit{In re} Northern Merch., Inc.), 371 F.3d 1056 (9th Cir. 2004)</td>
<td>&quot;[T]he [bankruptcy appellate panel] erred in holding that Frontier was not protected under 11 U.S.C. § 548(c).&quot;</td>
</tr>
<tr>
<td>2</td>
<td>Y</td>
<td>\textit{In re} Hannover Corp., 310 F.3d 796 (5th Cir. 2002), \textit{reh'g denied}, 54 Fed. Appx. 593 (5th Cir. 2002); \textit{cert. denied}, 538 U.S. 1032 (2003)</td>
<td>&quot;[T]his court holds that JSM satisfied the terms of § 548(c) . . . .&quot;</td>
</tr>
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<td>3</td>
<td>N</td>
<td>Jobin v. McKay (\textit{In re} M &amp; L Bus. Mach. Co., Inc.), 84 F.3d 1330 (10th Cir. 1996), \textit{cert. denied}, 519 U.S. 1040 (1996)</td>
<td>&quot;[I]t was not clearly erroneous for the bankruptcy court to conclude that . . . Mr. McKay . . . was therefore not entitled to the good faith defense established by § 548(c).&quot;</td>
</tr>
<tr>
<td>4</td>
<td>N</td>
<td>Wilson v. Carman (\textit{In re} Blazo Corp.), 73 F.3d 361 (6th Cir. 1995)</td>
<td>&quot;The defendants failed to ‘designate’ facts showing a genuine issue with respect to the $ 548(c) defense.”</td>
</tr>
<tr>
<td>5</td>
<td>P</td>
<td>Clark v. Sec. Pac. Bus. Credit, Inc. (\textit{In re} Wes Dor, Inc.), 996 F.2d 237 (10th Cir. 1993)</td>
<td>Defendants acted in good faith, but only gave value for approximately 30 percent of avoided transfer.</td>
</tr>
</tbody>
</table>

\textsuperscript{107} See Hayes v. Palm Seedlings Partners-A (\textit{In re} Agric. Research & Tech. Group), 916 F. 2d 528, 536 (9th Cir. 1990).

### The Death of a Defense

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<td>6</td>
<td>Y</td>
<td>Covey v. Commercial Nat’l Bank of Peoria, 960 F.2d 657 (7th Cir. 1992)</td>
<td>Bankruptcy court did not clearly err in finding that defendants acted in good faith for purposes of § 548(c).</td>
</tr>
<tr>
<td>7</td>
<td>N</td>
<td>Hayes v. FPI Nursery Partners 1984-I, 936 F.2d 577 (9th Cir. 1991)</td>
<td>“FPI 1984-I itself did not take in good faith . . .”</td>
</tr>
<tr>
<td>8</td>
<td>N</td>
<td>Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248 (1st Cir. 1991)</td>
<td>“Dade and Bristol cannot qualify as ‘good faith’ transferees.”</td>
</tr>
<tr>
<td>9</td>
<td>N</td>
<td>Hayes v. Silver Queen Project I, 922 F.2d 844 (9th Cir. 1991)</td>
<td>“SQI and SQIII themselves did not take in good faith . . .”</td>
</tr>
<tr>
<td>10</td>
<td>ND</td>
<td>In re Student Finance Corporation, 382 B.R. 212 (D. Del. 2007)</td>
<td>Summary judgment denied.</td>
</tr>
<tr>
<td>11</td>
<td>ND</td>
<td>In re Manhattan Inv. Fund Ltd., 397 B.R. 1 (S.D.N.Y. 2007)</td>
<td>“In sum, we find that there are genuine issues of material fact as to whether the proactive steps taken by Bear Stearns demonstrated diligence in its investigation of the Fund. Thus, trial will be necessary on this issue.”</td>
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<tr>
<td>14</td>
<td>N</td>
<td>In re Rosen Automatic Leasing, Inc., 346 B.R. 798 (B.A.P. 8th Cir. 2006)</td>
<td>“[T]he bankruptcy court’s determination that Mr. Gratton is entitled to the transfer for value and in good faith defense of [s]ection 548(c) is reversed.”</td>
</tr>
<tr>
<td>16</td>
<td>N</td>
<td>In re Nat’l Century Fin. Enter., Inc., 341 B.R. 198 (Bankr. S.D. Ohio 2006)</td>
<td>“Biomar’s assertion that it is entitled to a good faith defense lacks merit.”</td>
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<td>17</td>
<td>N</td>
<td><em>In re</em> Canyon Sys. Corp., 343 B.R. 615 (Bankr. S.D. Ohio 2006)</td>
<td>“[T]he Defendants . . . may not avail themselves of the good faith defense afforded by § 548(c) . . . .”</td>
</tr>
<tr>
<td>18</td>
<td>N</td>
<td><em>In re</em> Enron Corp., 2005 WL 6237551 (Bankr. S.D. Tex. 2005)</td>
<td>“[Section] 548(c) is not available to Defendants as a defense because . . . Defendants did not prove a good faith defense under § 548(c) or the extent of any alleged value given.”</td>
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<td>19</td>
<td>N</td>
<td><em>In re</em> McCook Metals, L.L.C., 319 B.R. 570 (Bankr. N.D. Ill. 2005)</td>
<td>“Lynch . . . has no affirmative defense under § 548(c) reducing the trustee’s recovery.”</td>
</tr>
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<td>22</td>
<td>N</td>
<td><em>In re</em> H. King &amp; Assoc., 295 B.R. 246 (Bankr. N.D. Ill. 2003)</td>
<td>“Joe has not asserted any viable defense to the recovery of these fraudulent conveyances.”</td>
</tr>
<tr>
<td>27</td>
<td>N</td>
<td><em>In re</em> Paramount Citrus, Inc., 268 B.R. 620 (M.D. Fla. 2001)</td>
<td>The court below found that the defendant did not meet the requirements of § 548(c).</td>
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<td>28</td>
<td>Y</td>
<td>Balaber-Strauss v. Lawrence, 264 B.R. 303 (S.D.N.Y. 2001)</td>
<td>Affirmed bankruptcy court’s determination that § 548(c) was met.</td>
</tr>
<tr>
<td>29</td>
<td>N</td>
<td><em>In re</em> Adler, Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001)</td>
<td>“[T]his Court finds no basis for Appellants’ § 548(c) defense.”</td>
</tr>
<tr>
<td>31</td>
<td>ND</td>
<td>Moglia v. Universal Auto., Inc. (<em>In re</em> First Nat’l Parts Exch., Inc.), 2000 WL 988177 (N.D. Ill. 2000)</td>
<td>“Because the language of the bankruptcy court’s holding suggests a possible disregard for the objective component of the good faith inquiry under § 548(c), that portion of the judgment is reversed, and this case is remanded.”</td>
</tr>
<tr>
<td>33</td>
<td>N</td>
<td><em>In re</em> Bennett Funding Group, Inc., 232 B.R. 565 (Bankr. N.D.N.Y. 1999)</td>
<td>“Wager . . . is excluded from the protection of Code § 548(c).”</td>
</tr>
<tr>
<td>34</td>
<td>N</td>
<td>Hays v. Jimmy Swaggart Ministries, 263 B.R. 203 (M.D. La. 1999)</td>
<td>“Thus, this Court concludes JSM was on notice of the debtors [sic] insolvency and was not in good faith at the time it received the payments.”</td>
</tr>
<tr>
<td>35</td>
<td>N</td>
<td><em>In re</em> Am. Way Serv. Corp., 229 B.R. 496 (S.D. Fla. 1999)</td>
<td>Because no transfers were received in good faith, defendants were each ineligible for protection under § 548(c).</td>
</tr>
<tr>
<td>36</td>
<td>P</td>
<td><em>In re</em> Nat’l Liquidators, 232 B.R. 99 (Bankr. S.D. Ohio 1999)</td>
<td>“11 U.S.C. § 548(c) does not preclude the Plaintiff from recovering the false profit, as the Defendant has not alleged that she received the false profit in exchange for value.”</td>
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<td>38</td>
<td>Y</td>
<td>Durkin v. Shields <em>(In re Imperial Corp. of Am.)</em>, 1997 WL 808636 (S.D. Cal. 1997)</td>
<td>“Accordingly, because Fabiano took in good faith and for value, he is entitled to summary judgment . . . .”</td>
</tr>
<tr>
<td>40</td>
<td>N</td>
<td>Jobin v. Ripley <em>(In re M &amp; L Bus. Mach. Co., Inc.)</em>, 198 B.R. 800 (D. Colo. 1996)</td>
<td>District court reaffirmed the bankruptcy court’s conclusion that “Ripley was not entitled to the good-faith defense under § 548(c).”</td>
</tr>
<tr>
<td>42</td>
<td>N</td>
<td>Jobin v. Cervenka <em>(In re M &amp; L Bus. Mach. Co., Inc.)</em>, 194 B.R. 496 (D. Colo. 1996)</td>
<td>“I uphold the court’s findings that Cervenka was not entitled to a § 548(c) defense . . . .”</td>
</tr>
<tr>
<td>45</td>
<td>P</td>
<td>Sender v. Hannahs <em>(In re Hedged Inv. Assoc., Inc.)</em>, 176 B.R. 214 (D. Colo. 1994)</td>
<td>Reversed and remanded lower court’s decision in favor of defense on basis that estoppel principles were inappropriately applied.</td>
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<td>49</td>
<td>N</td>
<td>Wilson v. Sheely (In re Blazo Corp.), 1994 WL 92403 (Bankr. N.D. Ohio 1994)</td>
<td>“Sheely asserts the good faith defense provided under [section 548(c)] but has shown the court nothing which demonstrates that he ‘gave value . . . .’”</td>
</tr>
<tr>
<td>50</td>
<td>N</td>
<td>Richardson v. Fed. Deposit Ins. Corp. (In re M. Blackburn Mitchell Inc.), 164 B.R. 117 (Bankr. N.D. Cal. 1994)</td>
<td>“Therefore, the Court concludes that the FDIC, as transferee, cannot invoke the protections of § 548(c) . . . .”</td>
</tr>
<tr>
<td>51</td>
<td>P</td>
<td>In re Naomi M. Taubman, 160 B.R. 964 (Bankr. S.D. Ohio 1993)</td>
<td>“Thus, to the extent that the trustee seeks to avoid false profits, § 548(c) does not provide a defense for any defendant.”</td>
</tr>
<tr>
<td>52</td>
<td>N</td>
<td>Dicello v. Jenkins (In re Int’l Loan Network), 160 B.R. 1 (Bankr. D.D.C. 1993)</td>
<td>“[S]ection 548(c) does not apply, even if the defendants acted in good faith” (because no value given).</td>
</tr>
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