NOTE

"FRAUD AND DECEIT ABOUND" BUT DO THE BANKRUPTCY COURTS REALLY BELIEVE EVERYONE IS CROOKED: THE *BAYOU* DECISION AND THE NARROWING OF "GOOD FAITH"

INTRODUCTION

"Fraud and deceit abound in these days more than former times."
- Sir Edward Coke

On December 11th 2008, Bernard Madoff was arrested and charged with securities fraud for allegedly operating a massive Ponzi scheme.[1] Subsequently, Madoff plead guilty to masterminding the largest Ponzi scheme in history, at the cost of nearly $50 billion to those who trusted him with their money.[2] The size of Madoff's fraud shocked the investment community, and the public at large, and produced front-page news for months after his arrest. However, despite being the biggest, Madoff's fraud was only one of many Ponzi schemes that have been discovered during the past year. For example, Mark Stanford operated an $8 billion, worldwide Ponzi scheme.[3] And authorities have uncovered many smaller Ponzi schemes across the country. In fact, the Federal Bureau of Investigations has reportedly opened investigations on more than 500 additional possible Ponzi schemes during the past year.[4] Ultimately, the Bankruptcy Courts will be responsible for a large portion of the work required to untangle these Ponzi schemes and attempt to provide a fair distribution for investors of the remaining assets.

Ponzi schemes present unique problems for bankruptcy courts. One of the most prevalent of these problems is how to deal with pre-bankruptcy investor redemptions made within the fraudulent transfer or conveyance recovery periods. In the Madoff fraud, it is estimated that nearly half of the Madoff investors actually

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[1] *The Madoff Case: A Timeline*, WALL ST. J., Mar. 12, 2009, http://online.wsj.com/article/SB112966954231272304.html.

[2] Reports of the size of Madoff's fraud vary, but $50 billion is a number that is commonly used and actually on the low end of the figures, which range from $50 to $78 billion. *See* David Voreacos & David Glovin, *Madoff Confessed $50 Billion Fraud Before FBI Arrest*, BLOOMBERG, Dec. 12, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aYzclQY1HkVE&refer=home.

[3] *See* Charles Paikert, *$8B Stanford Fraud Case Will Take Years To Clean Up: Burned Investors, Trapped Advisers, Frozen Assets Spell Trouble*, INVESTMENTNEWS, Feb. 22, 2009, www.investmentnews.com/article/20090222/REG/302229957.

[4] *See* FBI Investigating 500 Alleged Ponzi Schemes?, http://www.fa-mag.com/blog/evan-simonoff/3916-fbi-investigating-500-alleged-ponzi-schemes.html (February 26, 2009); *see also* Abigail Goldman, *Toast this Recession Loser: Ponzi Schemes*, LAS VEGAS SUN, June 16, 2009, http://www.lasvegassun.com/news/2009/jun/16/toast-recession-loser-ponzi-schemes/.

turned a profit by investing in the Ponzi scheme.[5] However, these profits came at the expense of other Madoff investors who lost everything. In Ponzi schemes, early investors are simply paid from the investments of later investors. These later investors generally lose the entirety of their investments. Because of these inequitable results, bankruptcy courts overseeing the liquidation of Ponzi schemes are forced to decide what is the most equitable way to divide the remaining money between the defrauded investors. Should earlier investors be allowed to keep their profits, or should they be forced to give it back? Should earlier investors be allowed to keep the return of their principal, or should they be forced to return some of this to ensure that all investors receive an equal recovery from the fraud?

The Bankruptcy Code ("Code") provides some answers. Under the Code, investors who received a profit from a Ponzi scheme must return the amount of profit they made under the theory of constructive fraud. A transfer is held to be constructively fraudulent if the transferor is insolvent and does not receive reasonably equivalent value.[6] In a Ponzi scheme, the debtor is always insolvent and any profits given to an investor are illusory. Thus, any transfer of profits to an investor is constructively fraudulent. And, any transfer made by the debtor with an actual intent to defraud must be returned. However, the Code protects a transferee who takes a transfer from a debtor, even from an insolvent debtor, "for value and in good faith."[7] The question becomes: When does an investor take a transfer from a debtor operating a Ponzi scheme for value and in good faith?

Recently, in *In re Bayou Group*,[8] The Bankruptcy Court for the Southern District of New York—the very same court, although a different judge,[9] currently handling the Madoff liquidation—adopted an extremely narrow view of the definition "good faith" as used in section 548(c).[10] There, the court held that to satisfy the "good faith" requirement of 548(c), a transferee must satisfy at least one prong of a two part disjunctive test; meaning the transferee must demonstrate either: (1) the transferee was not on inquiry notice, as evidenced by its lack of knowledge of any "red flags"; or (2) the transferee could prove by objective evidence that it made its request for redemption for a reason other than its knowledge of "red flags."[11] The court then used this test to avoid several transfers to investors that redeemed their investments.

This Note contends that the court in *Bayou* overly narrowed the definition of good faith to extreme levels by applying an objective notice-based good faith standard when good faith should take a subjective standard. Part I briefly discusses

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[5] Associated Press, *'Victims' of Madoff Scandal Do Math, Realize They Profited*, Jan. 9, 2009, http://www.foxnews.com/story/0,2933,47826,00.html.

[6] 11 U.S.C. § 548(a)(2) (2006).

[7] 11 U.S.C. § 548(c).

[8] 396 B.R. 810 (Bankr. S.D.N.Y. 2008).

[9] Judge Hardin wrote the *Bayou* decision while Judge Lifland is handling the Madoff Case. *See In re* Bernard L. Madoff Inv. Sec. LLC, 418 B.R. 75, 75 (Bankr. S.D.N.Y. 2009); *see also In re Bayou Group*, 396 B.R. at 820.

[10] *Id.* at 848–49.

[11] *Id.*

the statutory basis for fraudulent transfer actions in the Code, including the good faith defense of 548(c). Part II discusses the Bankruptcy Court's findings and holding in the *Bayou* case. Part III discusses the historical development of fraudulent conveyance law from the early English Common Law through the modern Code. Moreover, Part III argues that *Bayou* creates a new and distinct line of case law that cannot be reconciled with past precedent, despite adopting similar language. Part IV explores the possible intended meanings of good faith in 548(c) by analyzing the operation of good faith in other sections of the Bankruptcy Code, primarily section 550(b), and other prominent statutes, mainly the Uniform Commercial Code ("UCC"). Also, Part IV considers section 547 of the Bankruptcy Code, the preference provision of the Code, and draws a distinction between preferences and fraudulent transfers. That analysis will demonstrate that *Bayou* incorrectly applied a highly objective standard to the term good faith when good faith requires a subjective analysis.

I. THE STATUTORY FOUNDATION OF FRAUDULENT TRANSFERS IN THE BANKRUPTCY CODE

The controversy created by fraudulent transfers in Ponzi scheme bankruptcies originates in sections 548(a) & (c) of the Code.[12] Section 548(a)(1)(A) allows a trustee to avoid transfers that were made within two years of the petition date with the intent to "hinder, delay or defraud" creditors.[13] Section 548(a)(1)(B) allows a trustee to avoid any transfer made by an insolvent debtor that is not supported by consideration.[14] Section 548(c) protects a transferee who receives a fraudulent transfer by allowing the transferee retain value equivalent to the value the transferee exchanged for the transfer in "good faith."[15] When faced with a Ponzi scheme, judges generally invoke the "Ponzi scheme presumption," which presumes that every transfer a debtor made was intended to "hinder, delay or defraud" creditors.[16] Under the "Ponzi scheme presumption," a bankruptcy trustee has the ability to avoid nearly every transfer made by the debtor as actual fraud including pre-bankruptcy redemption payments made to investors.[17] Thus, the transferee who

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[12] 11 U.S.C. §§ 548(a), (c) (2006).

[13] § 548(a)(1)(A).

[14] § 548(a)(1)(B); *see* Wyle v. C.H. Rider & Family, (*In re* United Energy Corp.), 944 F.2d 589, 597 (9th Cir. 1991) (construing federal fraudulent transfer provision to direct courts to determine whether debtor received reasonably equivalent value); *see also In re* M & L Bus. Mach. Co., 164 B.R. 657, 667 (D. Colo. 1994) (rejecting trustee's argument suggesting transferee did not give value because transferee lacked good faith).

[15] § 548(c).

[16] *See* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 174 (1998) (explaining Ponzi scheme presumption); Paul Sinclair, *The Sad Tale of Fraudulent Transfers: The Unscrupulous Are Rewarded and the Diligent Are Punished*, 28 AM. BANKR. INST. J., 16, 78 (April 2009) (explaining actual fraud is presumed for Ponzi schemes in bankruptcy).

[17] *See In re* Manhattan Inv. Fund Ltd., 359 B.R. 510, 517–18 (Bankr. S.D.N.Y 2007) ("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 enterprise, because transfers made in the course of a Ponzi operation could

redeemed investments from the debtor must seek the shelter of the 548(c) "good faith" defense.

In order to be protected by section 548(c), a transferee must show that (1) he gave value in exchange for the transfer, and (2) he gave this value in "good faith."[18] A transferee who establishes both requirements is entitled to retain the value equal to the value exchanged for the transfer. In section 548(d)(2)(A) value is defined as including antecedent debts.[19] In a Ponzi scheme, an investor who redeems his initial investment always gives value because that investor has a tort claim for rescission/conversion the instant the Ponzi scheme steals the investor's money.[20] A Ponzi scheme investor will always satisfy the first prong of the defense up to the amount he has invested in the fund—the investor's principal investment.[21] Thus, the primary issue in Ponzi scheme cases will be the redeeming investor's good faith. Unfortunately, neither the Code nor the Code's legislative history defines good faith. Recently, In *In re Bayou*, the Bankruptcy Court for the Southern District of New York adopted a very strict objective definition of good faith.

II. THE BAYOU CASE

A. Factual background of Bayou

Bayou resulted from the discovery that Samuel Israel III, James Marquez and Daniel Marino were running an approximately $250 million Ponzi scheme out of their Bayou hedge fund family.[22] The family of hedge funds run by Israel, Marquez and Marino employed a somewhat complex structure. The group of funds was at all times managed by Bayou Management, LLC, a company owned by Israel.[23] Israel created the management company in 1996 and, until the discovery of the fraud in 2005, acted as the company's Chief Executive Officer ("CEO").[24] Marino served as

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have been made for no purpose other than to hinder, delay or defraud creditors."); *see also* McDermott, *supra* note 16, at 174 (observing intentional fraud can reasonably be inferred from debtor's Ponzi scheme); Sinclair, *supra* note 16, at 78 (acknowledging "actual fraud presumed in a Ponzi case under [section] 548(a)(1)(A)").

[18] 11 U.S.C. § 548(c) (providing good faith transferee who takes for value has lien on or may retain estate property to extent of value given).

[19] 11 U.S.C. § 548(d)(2)(A) (describing "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor").

[20] *See* Jobin v. McKay (*In re* M & L Bus. Mach. Co.), 84 F.3d 1330, 1340–44 (10th Cir. 1996) (holding reduction in claim for rescission is value and satisfaction of antecedent debt); *see also* Wyle v. C.H. Ryder & Family (*In re* United Energy Corp.), 944 F.2d 589, 595 (9th Cir. 1991) (concluding value was exchanged when investors' restitution claims were reduced by debtor's "power payments" to them); McDermott, *supra* note 16, at 166 (reasoning investor holds claim for restitution upon initial payment of principal to debtor and debtor's subsequent return of principal amount to investor reduces restitution claim and constitutes value).

[21] *See* McDermott, *supra* note 16, at 165 (discussing "rule of value only for a return of principal investments").

[22] *See In re* Bayou Group, LLC, 396 B.R. 810, 823 (Bankr. S.D.N.Y. 2008) (describing collapse of Bayou hedge funds' Ponzi scheme).

[23] *Id.* at 822.

[24] *Id.*

the company's Chief Financial Officer ("CFO") from the company's inception until the discovery of the fraud.[25] The Bayou Management Company operated a series of fund operations beginning with The Bayou Fund, which was created in 1996.

The Bayou Fund was originally conceived as a legitimate trading operation; however, the fund immediately began to lose money, and thereafter, operated as a Ponzi scheme.[26] In 2003, The Bayou Fund was liquidated as part of a non-bankruptcy reorganization. In its place, Bayou Management created four new funds.[27] These funds also operated as Ponzi schemes, and never earned a profit. Further, Bayou's principals misappropriated millions of dollars of clients' money.[28] To hide these loses and thefts, The Bayou Fund, until its demise, and its four legacy funds almost immediately began to create fraudulent financial disclosures to conceal their true financial condition.[29] Further, Marino, a CPA, created a fictitious accounting firm to produce false audit reports for Bayou Funds, which Bayou and Bayou's principals represented to investors as independent audits.[30] The Bayou Funds were discovered to be a Ponzi scheme in the summer of 2005 when the funds collapsed. While many investors were caught off guard by the discovery of Bayou's fraud, there were warning signs that the fund was not legitimate.

On March 26, 2003, Paul T. Westevelt and his son Paul T. Westervelt III filed a lawsuit ("The Westervelt Complaint") in Louisiana against the Bayou Companies, Dan Marino and Samuel Israel III.[31] The Westervelts were former employees of Bayou, and the father was a former shareholder in Bayou Management LLC.[32] Paul T. Westervelt, the father, was originally recruited by Israel because of his experience and reputation as an investor in the New Orleans area.[33] Westervelt and his son started their employment at Bayou in September of 2002.[34] However, the Westervelts employment was short lived and riddled with problems. The Westervelt Complaint resulted. The Westervelt Complaint alleged four counts: (1) Israel repeatedly denied the Westervelts access to business and financial information that the father was entitled to as a partner; (2) Israel did not grant the Westervelts information and records necessary to evaluate perceived S.E.C. and ethical violations; (3) Israel depleted Bayou's capital trading account by more than $7 million; and, (4) Israel fired the Westervelts when they tried to address their concerns with Israel.[35]

Aside from the Westervelt Complaint, Bayou investors also discovered several other warning signs of Bayou's fraud. Most notably, Bayou's employment of

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[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.* at 867.
[32] *Id.*
[33] Westervelt was enticed to join Bayou by the promises of a large salary and equity in the firm. *Id.*
[34] *Id.*
[35] *Id.* at 867–69.

Richmond-Fairfield as an independent auditor indicted that Bayou was a fraud.[36] As mentioned above, Richmond-Fairfield was an accounting firm Marino created solely for the purposes of creating fake independent audits of Bayou.[37] Marino was the registered agent for the firm, which revealed the firm's lack of independence.[38] Further, Bayou created its own net asset values ("NAVs") rather than entrusting this calculation to an independent agent.[39] Bayou's off-shore administrators verified that all information regarding NAVs was provided by Marino.[40] After Bayou's collapse, Bayou's trustee would use this information to attempt to recover fraudulent transfers from the parties who discovered the information.

The Bayou trustee filed several adversary complaints in an attempt to recover transfers made to Bayou investors by Bayou within the statutory period.[41] The trustee argued that all payments made by the fund to investors were made with the intent to "hinder, delay, or defraud creditors" using the Ponzi scheme presumption.[42] Further, the trustee contended that the investors could not establish the "good faith" defense of section 548(c) because, based on the available objective evidence, each investor should have known that the Bayou Funds were frauds.[43]

B. The Bayou Decision

In *Bayou*, the court held that all redemption payments made by the Bayou Funds were made with an actual fraudulent intent and addressed the investor defendants' assertion of the section 548(c) value in good faith defense.[44] First, the court found that the debtor committed actual fraud in making all transfers to redeeming investors.[45] The court applied the Ponzi scheme presumption to hold that at all times the Bayou Funds were operating as a Ponzi scheme and therefore every redemption payment it made was with the actual intent to "hinder, delay or defraud creditors."[46] Next, the court recognized that each investor who received transfers from the debtor gave value to the extent of their original principal investment because each investor held a claim for rescission against debtor.[47] Therefore, the defendant investors were entitled to keep their principal investment if the investor could establish their good faith.[48]

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[36] *Id.* at 822, 865.
[37] *Id.* at 865.
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.* at 812.
[42] *Id.* at 825.
[43] *Id.*
[44] *Id.* at 841–43.
[45] *Id.* at 842–43.
[46] *See generally id*. at 828–42 (describing evidence used to determining Bayou was operating as Ponzi scheme including guilty pleas of its officers).
[47] *Id.* at 844.
[48] *Id.*

The court began its good faith analysis by explaining that the term had a different meaning within the law of fraudulent transfers than it did in other contexts of the law.[49] According to the *Bayou* court, "[i]t should be noted first that the concept of "good faith" embodied in section 548(c) is somewhat different from the traditional notion of good faith as the term is customarily used by laymen."[50] The court continued by holding that good faith is a question of inquiry notice, which should be defined by an objective standard, rather than a subjective honest belief standard.[51] The court concluded that this standard was appropriate because the fraudulent transfer sections of the Bankruptcy Code were meant to promote the concept of equality among creditors.[52]

In *Bayou*, an investor's good faith was not a matter of guilt, mala fides or bad faith.[53] Rather, an investor's good faith hinged on whether the investor's actions were consistent with concepts of equality among creditors.[54] The *Bayou* court explained, "The good faith requirement was not designed by Congress nor has it been interpreted by the courts to deter or sanction misconduct. Like section 547, which requires innocent creditors to refund payments of money owed to them within ninety days of a bankruptcy filing, section 548 seeks to promote a limited degree of equality of treatment among creditors."[55] Thus, an objective notice standard for determining good faith is appropriate. Under this standard despite an investor's lack of intent to harm other creditors or participate in a debtor's fraud, an investor lacks good faith if it is on notice of an array of infirmities with its investment.

The *Bayou* court posited that "good faith" in the fraudulent transfers context does not lend itself to an exact definition and should be determined on a case-by-case basis.[56] An investor could prove its good faith in multiple ways through objective evidence that its actions were not based on inquiry notice of an infirmity in its investment.[57] An investor, however, cannot act on notice of an infirmity in its investment and then give value in good faith. In a good faith analysis, notice takes many forms. Applying this objective standard, the court held that an investor's objective good faith is satisfied when the investor can prove by objective factual evidence that either: (1) it was not on inquiry notice of any problem with the debtor; or, (2) it did not act on notice of an infirmity but another objective reason that

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[49] *Id.* at 847 ("It should be noted first that the concept of 'good faith' embodied in Section 548(c) is somewhat different from the traditional notion of good faith as the term is customarily used by laymen.").

[50] *Id.* ("[T]o say that a person has not acted in 'good faith' might be thought to imply that the person's action in question was wrongful, improper or legally or ethically deplorable in some manner.").

[51] *Id.* at 848.

[52] *Id.* at 866–67.

[53] *Id.* at 848 ("Where the rule of law holds that an investor may not be able to establish his statutory good faith defense because he requested redemption of his investment after becoming aware of a 'red flag' putting him on 'inquiry notice' of possible infirmity in his investment, that does not necessarily entail a finding or carry an imputation that he was guilty of any sort of *mala fides* or otherwise deserving of opprobrium.").

[54] *Id.* at 866–67.

[55] *Id.* at 866.

[56] *Id.* at 846.

[57] *Id.* at 849.

demonstrates the investor's subjective good faith. This test was used to determine the good faith or to approve settlements for all of the fraudulent transfer adversary proceedings brought by the *Bayou* trustee.

Using the second prong of this test, the *Bayou* Court granted summary judgment to several unsuspecting investors.[58] In the adversary proceedings where the court granted summary judgment for the investors, the investor transferees demonstrated what the Court considered objective evidence of subjective good faith.[59] The objective evidence required by the court usually took the form of non-investment related events that caused the transferee to seek redemption.[60] These events included an investor's liquidation of its investments to comply with ERISA, liquidation of the fund to pay for a home, liquation of the fund to administer an estate, and a change of investment strategy.[61] The court held that these investors had taken their redemptions in good faith because they had not acted on any knowledge of the instability of their investment. In other words, the *Bayou* court rewarded those investors who were either too stupid or lazy to do enough diligence with respect to their investments to discover signs of Bayou's fraud and who, through dumb luck, decided to redeem their money from Bayou before its collapse.[62]

With respect to diligent investors, the *Bayou* court held that an investor could not establish good faith if the investor had requested redemption because the investor had of knowledge of circumstances that would put a reasonable person on inquiry notice of an infirmity in their investment. The court focused on whether the defendant investors had any knowledge of "red flags." "Red flags" are any information that might put a reasonable person on notice that there might be a problem, any problem, with its investment or the firm.[63] The court did not merely limit its definition of a "red flag" to include indications of a funds underlying fraud. Rather, a "red flag" imputes inquiry notice on an investor if it signals one of many problems with either the debtor or the redemption transfer, including the fraudulent purpose of the transfer, the underlying fraud, the unfavorable financial condition of the transferor, the insolvency of the transferor or the improper nature of a transaction, or the violability of the transfer. Further, the court held that this was

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[58] *See generally id.* at 854–60 (describing factual basis and reasoning for granting defendants' summary judgment where court found either bad faith defense proven or uncontested *prima facie* bad faith defense).

[59] *Id.* at 849.

[60] *Id.* at 853–54.

[61] *Id.*

[62] *See* Sinclair, *supra* note 16, at 80 (positing Bayou court ruling rewards dumb luck rather than diligence); *cf.* Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495, 506–07 (1983) ("Focusing on the creditor's knowledge of the debtor's financial position is obviously unacceptable when preferences are involved. To allow a preference only when the creditor is unaware of his debtor's predicament is to place a curious premium on incompetency in creditors."). *See generally* Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1512 (1st Cir. 1987) ("To find a lack of 'good faith' where the transferee does not participate in, but only knows that the debtor created the other debt through some form of, dishonesty is to void the transaction because it amounts to a *kind* of 'preference'—concededly a most undesirable *kind* of preference.") (emphasis added).

[63] *See In re Bayou*, 396 B.R. at 848 ("[L]earning of a 'red flag' . . . under an 'objective' standard, should have put the defendant on 'inquiry notice' of some infirmity.").

not an exhaustive list. Thus, almost any piece of evidence that remotely suggests infirmities in an investment firm could be a "red flag," even if it does not suggest that the debtor is involved in a fraud.

The court explained that if an investor had knowledge of a "red flag" and if a diligent investigation could have revealed the fund's fraud, the investor could not establish good faith.[64] Thus, although the court seemed to assert that "good faith" was a question of inquiry notice,[65] the court took the inquiry notice analysis one step further. The court held that an investor with knowledge of any "red flag" must conduct a diligent investigation that actually dispels their worries about the firm.[66] If the investor is not able to dispel his worries despite conducting an investigation, the court held that the investor is not able to redeem in good faith.[67] Therefore, an investor who conducts a diligent investigation but is unable to confirm or dispel his worries about the fund is unable to establish the section 548(c) defense.[68] The court named an investigation that neither revealed nor disproved the fraud an "inconclusive diligent investigation" and soundly rejected this type of investigation as enough to reestablish good faith once an investor has notice of a red flag.[69] Thus, an investor who unknowingly invests in a Ponzi scheme and discovers any problems with his investment is stuck in the Ponzi scheme whether or not it conducts an investigation.

The court used this objective, inquiry-notice standard to reject the good faith for value defenses asserted by several investors. The facts and circumstances leading to the redemptions by two groups of investors, the Altegris Investors, and CSG and Centennial investors, whose 548(c) defenses were rejected by the court, will be particularity helpful in illuminating the *Bayou* court's reasoning and useful in demonstrating where the *Bayou* court makes a departure from past precedent.

1. The Altegris Investors

First, the court discussed the due diligence done by Altegris Investments.[70] Although the Altegris defendants all settled with the trustee before the second *Bayou* decision was entered, the court used the Altegris investors as an illustration of investors that could not establish good faith.[71] Altegris entered into a selling

[64] *In re Bayou*, 396 B.R. at 846 ("Once on inquiry notice, a transferee's failure to conduct a 'diligent investigation' is fatal to its 'good faith' defense.").

[65] *Id.*

[66] *Id.* ("In order to prove 'good faith' that 'diligent investigation' must ameliorate the issues that placed the transferee on inquiry notice in the first place."). The courts idea of a diligent investigation that actually dispels an investor's worries in the investment still baffles this author. The concept again suggests that if the Ponzi scheme operator is keen enough that the operator could actually defraud an incompetent investor back into a "good faith" defense. Once again, this idea seems like a protection for the incompetent more than a standard for determining the allocations of funds between sophisticated parties. *Id.*

[67] *Id.*

[68] *Id.* at 850.

[69] *Id.* at 851.

[70] *Id.* at 865–66.

[71] *Id.* at 866–67.

agreement with the original Bayou Fund. After the Bayou Fund's 2003 liquidation, Altegris sought to enter in to a new selling agreement with three of the newly created Bayou hedge funds.[72] Before finalizing the agreement, Altegris discovered that Bayou's offshore administrators were not calculating Bayou's NAV's.[73] Rather, Altegris discovered that Marino calculated all Bayou's NAV's and Bayou never received independent verification of this accounting. Upon learning of this information in June 2004, Altegris began further diligence into the stability of the Bayou Funds.[74]

Altegris' due diligence led to several unsettling discoveries about Bayou. First, Altegris discovered that Bayou was only independently audited once a year and only by Richmond-Fairfield.[75] Second, Altegris discovered that Marino was the registered agent for Richmond-Fairfield, which led Altegris to question if Richmond-Fairfield was actually independent of Bayou.[76] Altegris' diligence culminated in a letter to Marino demanding that he explain his connections to Richmond-Fairfield and why he was a registered agent for the firm.[77] After waiting two days for a response from Marino, Altegris advised its clients to immediately redeem their funds.[78] Altegris advised its clients to redeem their funds within a month of perceiving a problem with the Bayou firm and immediately after being stonewalled by Marino. There was no evidence that Altegris attempted to take advantage of other Bayou investors by attempting to profit with Bayou for as long as feasible. Moreover, Altergris never developed any knowledge of the actual fraud being committed by Bayou.[79]

In its decision, the court was clear that Altegris and its investors never committed any form of misconduct, fraud, or even acted in bad faith.[80] The court agreed that Altegris' actions were completely proper, and indeed prudent.[81] However, the court found that Altegris' diligence had put the investment advisor on inquiry notice.[82] Therefore, Altegris could not have made its redemptions in good faith, despite lacking any bad faith.[83] The court reasoned that Altegris's knowledge allowed it to take advantage of other creditors because its redemption reduced the pool of money that could be used to pay other creditors, notwithstanding that Altegris itself was owed a legitimate debt. The court explained, "[s]ection 548 is not a punitive provision designed to punish the transferee, but is instead an

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[72] *Id.* at 865.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.* at 866.
[78] *Id.*
[79] *Id.* ("These facts did not reveal the full scope or detail of the Bayou fraud.").
[80] *Id.* ("There is not a single element of 'bad faith' or misconduct of any sort on the part of Altergris or its clients.").
[81] *Id.* ("[T]he Altegris due diligence and the recommendation to its clients to divest their Bayou investments . . . were in every respect proper and entirely reasonable [under] the circumstances.").
[82] *Id.*
[83] *See id.* at 867.

equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive fraudulent conveyances."[84] Thus, if the Altegris investors had not settled with the trustee, they would not have been able to assert a successful defense under 548(c).

Further, the court used the Altegris diligence of an example of what a diligent investigation could reveal. Although Altegris was stonewalled by Marino, and, ultimately, never discovered the true nature of the Bayou fraud, the court explained Altegris had discovered enough to conclude that Bayou had fraudulent aspects. For example, Altegris was able to discover that Bayou lied about having independent auditing, that it determined its own NAVs, and that it would not allow a sales representative to view its records. Although it recognized that these facts did not reveal the full scope or detail of Bayou's fraud, the court used Altegris' investigation to reject any argument that an investigation would not reveal Bayou's fraud.[85]

2. CSG and Centennial

Centennial was a fund-of-funds that was partially owned and had very close relationship with CSG, which was an investment advisory service.[86] Both, Centennial and CSG had selling agreements with the Bayou Funds. Together, Centennial and CSG became aware of the Westervelt complaint and the allegations made during that litigation in early 2004.[87] The group's president, a friend of Israel's, inquired into the complaint with Bayou.[88] Israel assured CSG and Centennial that the complaint's allegations were simply fabrications made up by "disgruntled employees."[89] Concurrently, CSG and Centennial became concerned about the calculations of Bayou's NAV's; specifically, the funds discovered that Bayou's NAVs were not independently calculated.[90] In June 2004, the funds emailed Marino requesting a diligence meeting. The email also demanded explanations for the lack of independent NAV calculations and the allegations in the Westervelt complaint.[91] These requests were stonewalled by Bayou at the diligence meeting.[92]

Applying the same good business sense as Altegris, CSG and Centennial immediately advised their clients to redeem their accounts with Bayou after being stonewalled by Marino. The funds acted prudently to protect their investments rather than attempting to defraud other creditors. Recognizing this prudence, the

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[84] *Id.* at 827.

[85] *Id.* at 866 ("The Altergris due diligence . . . graphically undermines the contentions of a number of defendants . . . that no reasonable due diligence could have discovered the Bayou fraud.").

[86] *Id.* at 869.

[87] *Id.* at 870.

[88] *Id.* The group's president, Lee Giovannetti, had a long-standing relationship with Samuel Israel that dated back to at least 1999. *Id.* at 869.

[89] *Id.* at 870.

[90] *Id.*

[91] *Id.* at 870–71 (summarizing email sent requesting diligence).

[92] *Id.* at 871.

Court once again agreed that like Altergris, CSG and Centennial had not engaged in any misconduct, acted in bad faith or obtained actual knowledge of Bayou's fraud.[93] Yet, the court held that the funds clients did not act in "good faith" when they redeemed their accounts, and the court rejected the funds' inconclusive investigation defense.[94] The court reasoned that the funds had not gathered any information that would dispel their beliefs that there was a problem with Bayou, despite the fact that CSG and Centennial had been stonewalled from obtaining any information.[95] Therefore, CSG and Centennial could not have taken their redemption payments in good faith even though, despite their investigations, they never were able to discover the true nature of Bayou's fraud or its insolvency.[96]

The *Bayou* court's determination of good faith rests solely on a sensitive inquiry notice standard.[97] Under the *Bayou* logic, an investor who has any knowledge of facts and circumstances that would put any investor on notice of an infirmity in his investment cannot assert the good faith defense contained in section 548(c).[98] The investor who is on inquiry notice lacks good faith even if the investor refrains from using this knowledge to gain an advantage over other creditors beyond asking for repayment.[99]

The court justified this standard by reasoning that fraudulent conveyance law seeks to promote equity among creditors rather than correct wrongdoing. The *Bayou* standard dispels any notion that fraudulent transfer law should be based on fault or subjective inquiries. Rather, the *Bayou* court expressly states that the purpose of fraudulent transfer law is to ensure that all creditors are placed in the same position regardless of the knowledge of the creditors.[100] The standard amounts to nothing more than misapplication of previous case law and a distortion of the traditional purposes and goals of fraudulent transfer and conveyance laws.

III. THE CASE LAW OF FRAUDULENT CONVEYANCES

The term "good faith" in the context of fraudulent transfers and conveyances has a long history within case law.[101] Although there has certainly been much controversy over the operation of the term 'good faith', the history of fraudulent transfer and conveyance case law is informative as to what Congress meant when

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[93] *Id.* at 872–73.
[94] *Id.* at 852.
[95] *Id.*
[96] *Id.*
[97] *Id.* at 846.
[98] *Id.*
[99] *See id*.
[100] *In re Bayou*, 396 B.R. at 866–67.
[101] *See In re* Madrid, 725 F.2d 1197, 1199–200 (9th Cir. 1984) (providing historical review of law of fraudulent conveyances); *see also* GARRARD GLENN, THE LAW OF FRAUDULENT CONVEYANCES 7 (Baker Voorhis & Co. 1931) (describing history of fraudulent conveyance law as even pre-dating the Statute of Elizabeth and 1500s); Bruce A. Markell, *Following Zaretsky: Fraudulent Transfers and Unfair Risks*, 75 AM. BANKR. L.J. 317, 321–22 (2001) (describing deep-rooted history of American fraudulent transfer laws).

writing the term into the Code. First, and foremost, the history of fraudulent conveyance law indicates that the law is based on *fault*. Second, the standard for good faith has taken several forms. In early cases, the standard for good faith has nearly always been subjective. This early standard sought to prevent a debtor and creditor working in trust to allow the debtor to defraud his earlier creditors. However, the standard for good faith began to incorporate more objective characteristics in more modern case law.[102]

An overview of the case law on good faith demonstrates that there are at least two distinct ways of dealing with the questions of whether a transferee/grantee has given value in good faith. The first standard is completely subjective and asks whether the transferee/grantee participated in the debtor's fraud.[103] This first standard incorporates objective evidence but only to the extent that it demonstrates the subjective intent of the debtor and creditor to collude to defraud the debtor's other creditors. The second standard, which developed later and is employed by the majority of circuits in the bankruptcy context, has more objective aspects and asks whether the transferee should have had knowledge of the fraud.[104] The cases employing this standard have also involved egregious circumstances, mainly consisting of the transferee employing this knowledge to gain a benefit beyond redeeming his funds.[105] These courts' inquiries into what the transferee did with his knowledge serves as objective proof of a subjective intent to "hinder, delay or defraud" a debtor's other creditors. This inquiry also brings the two prominent standards more in line with each other. Although many of the major post-Code decisions minimize this inquiry, the transferees in every major case rejecting the good faith defense under the Code used their knowledge of the debtor's fraud to

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[102] *See* Hayes v. Palm Seedlings Partners (*In re* Agric. Research & Tech. Group, Inc.) [hereinafter *In re* Agretech], 916 F.2d 528, 535–36 (9th Cir. 1990) (noting courts apply objective rather than subjective standpoint in questions of good faith); *see also* Tacoma Ass'n of Credit Men v. Lester, 433 P.2d 901, 904 (Wash. 1967) ("[W]hether or not there has been good faith is to be determined by looking to the intent behind or the effect of a transaction, rather than to its form."); *Good Faith and Fraudulent Conveyances*, *supra* note 62 at 497 (describing how courts have reduced role of debtor's subjective intent and increased role of objective factors).

[103] *See, e.g.*, *In re* Sharp Int'l Corp., 302 B.R. 760, 781 (E.D.N.Y. 2003) (acknowledging participation necessary to find lack of good faith in fraudulent conveyance); Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1512 (1st Cir. 1987) (stressing transferee must participate in dishonesty to lack good faith and good faith "does not ordinarily refer to the transferee's knowledge of the *source* of the debtor's monies" because transferee's actual knowledge without participation is merely preference which is not fraudulent conveyance); English v. Brown, 229 F. 34, 41 (3d Cir. 1916) (finding participation in scheme is necessary for fraudulent conveyance and knowledge alone is insufficient).

[104] *See, e.g.*, Conroy v. Shott, 363 F.2d 90, 92–93 (6th Cir. 1966) (acknowledging lack of good faith requirement is met when defendant should have had knowledge of fraud); *Tacoma*, 433 P.2d at 904 (suggesting good faith includes "honest belief in the propriety of the activities in question" and "no intent to take unconscionable advantage of others . . . [or] no intent to, or knowledge of the fact that the activities in question will, hinder, delay, or defraud others"); Sparkman & McLean Co. v. Derber, 431 P.2d 585, 591 (Wash. Ct. App. 1971) (relying on three good faith factors listed by court in *Tacoma*).

[105] *See Sparkman & McLean Co.*, 431 P.2d 585, 591–92 (suggesting if transferee lacks "honest belief in the propriety of the activities in question" good faith requirement not met and conveyance fails); *see also Good Faith and Fraudulent Conveyances*, *supra* note 62, at 500 (describing *Tacoma* as case of egregious circumstances).

gain an advantage over the debtor's other creditors. Further, the courts' inclusion of discussions of the egregious circumstances in those cases indicates that the courts actually applied a subjective rather than objective analysis. This Note will demonstrate that the *Bayou* court ignored this second prong of the modern good faith standard.

This Section begins by examining the standards employed by courts from the early English Common Law and concludes by demonstrating that these early concepts still prevail—or should prevail—in the modern bankruptcy cases. The goal of the section is twofold. First, the section seeks to explore what Congress intended good faith to mean in the Code by looking to how previous case law interpreted the term. It should be assumed that Congress was content with the courts' previous definitions of good faith because Congress did not seek to expressly redefine the term within the Code.[106] Second, this section will seek to show that the standard used by the *Bayou* court is at odds with any standard used by previous courts. To accomplish this second goal, this section will provide a factual analysis of several major cases that construe the meaning of good faith under both older fraudulent conveyance laws and the Code.

A. The Statute of Elizabeth and the English Common Law

The modern law of fraudulent conveyances originates from The Statute of Elizabeth of 1571.[107] The common law of fraudulent conveyances formerly employed in all the states of the union, both the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act, and the fraudulent transfer sections of the Code developed from this early statute.[108] Under The Statute of Elizabeth, affected creditors could avoid conveyances made by debtors with the "end, purpose and intent to delay, hinder, or defraud creditors" as fraudulent.[109] The common law

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[106] *See* Field v. Mans, 516 U.S. 59, 69 (1995) ("It is . . . well established that '[w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.'" (quoting Community for Creative Non-Violence v. Reid, 490 U.S. 730, 739, (1989))); *see also* Nationwide Mutual Ins. Co. v. Darden, 503 U.S. 318, 322 (1992) (stressing Congress' content with accumulated settled meaning of term if Congress does not redefine term in statute); Perrin v. United States, 444 U.S. 37, 42 (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined words will be interpreted as taking their ordinary, contemporary, common meaning.").

[107] 13 Elz. Ch. 5 (1570). *But see* GLENN, *supra* note 101, at 7–8 (noting even though most consider modern law of fraudulent conveyances to date back to The Statute of Elizabeth, our law really stems from writings of Sir Edward Coke who interpreted statute); *In re* Goldberg, 277 B.R. 251, 295 (Bankr. M.D. La. 2002) (recognizing Professor Glenn does not think modern principles of fraudulent conveyances "flow directly from the Statute of Elizabeth or any modern substitute").

[108] *See* Eberhard v. Marcu, 530 F.3d 122, 130 (2d Cir. 2008) (noting legislature enacted Uniform Fraudulent Conveyance Act which had origin in The Statute of Elizabeth); *see also* Abell v. Devan, 350 B.R. 201, 203 (D. Md. 2006) (recognizing fraudulent transfer sections developed from The Statute of Elizabeth); GLENN, *surpa* note 101, at 7 (noting overall idea of fraudulent conveyance dates back to statues from Elizabethan period).

[109] *See* 13 Eliz. Ch. 5 (1570); *see also Eberhard*, 530 F.3d at 129 (recognizing "[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder,

under The Statute of Elizabeth did not provide for the constructive fraud provisions found in the Uniform Acts, Bankruptcy Act, or the Code. Rather, the affected creditor was required to prove that the debtor acted with an actual intent to defraud other creditors at the time of the conveyance to have the conveyance avoided.[110] Thus, an aggrieved creditor was forced to prove the parties' subjective intent in making the fraudulent conveyance.[111] This proved to be extremely difficult.

In response to this problem, the English courts began to allow creditors to prove subjective intent by presenting objective evidence that demonstrated the debtor's actual intent to defraud.[112] While the standard remained subjective, the standard could be satisfied with objective evidence that conclusively proved the debtor must have acted with an actual, subjective intent to defraud his creditors. The evidence most pertinent proving this subjective intent became known as the 'badges of fraud.'[113] A few examples of the traditional badges of fraud include retention of the transferred property by the seller, transfers of all the assets of the transferor, concealed transfers, removal of all assets from the jurisdiction of the court, and conveyance made after the filing of a lawsuit against the transferor.[114] Although none of these badges is conclusive individually, the badges represent highly

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delay, or defraud . . . is fraudulent *as to both present and future creditors*" is proposition directly taken from The Statute of Elizabeth enacted in 1570); Moore v. Browning, 50 P.3d 852, 855 (Ariz. Ct. App. 2002) ("Parliament adopted legislation in 1570, known as [T]he Statute of Elizabeth, that limited an owner from conveying his property with 'the express or implied intent to hinder, delay, or defraud his creditors.'").

[110] *See* 13 Eliz. Ch. 5 (1570); *see also Eberhard*, 530 F.3d at 129–30 (noting The Statute of Elizabeth enacted by Parliament in 1570 required actual intent and constructive intent was insufficient); Johnson v. Barrett, 237 F. 112, 114 (N.D. Ga. 1916) (noting actual fraud necessary for invalidating conveyance "and it makes no difference that the conveyance was made upon a valuable consideration, if made for the purpose of hindering, delaying, or defrauding creditors").

[111] *See* 13 Eliz. Ch. 5 (1570); *see also* Bigelow Design Group, Inc. v. Harman (*In re* Jeffrey Bigelow Design Group, Inc.), 956 F.2d 479, 484 (4th Cir. 1992) (stressing actual fraudulent intent requires subjective evaluation); *In re* Ducate, 369 B.R. 251, 264 (Bankr. D.S.C. 2007) ("[A]ctual fraudulent intent requires subjective evaluation of the debtor's motive.").

[112] *See Eberhard*, 530 F.3d at 130 ("[T]he National Conference of Commissioners on Uniform State Laws sought to eliminate the confusion caused by attempts to stretch [T]he Statute of Elizabeth (and its state law progeny) to 'cover all conveyances which wrong creditors,' including those made without an actual intent to defraud."); *see also In re Goldberg*, 277 B.R. at 292–93 (noting courts had trouble defining "what kinds of transactions hinder, delayed, or defrauded creditors" leading common-law judges to develop new rules); 3 COLLIER ON BANKRUPTCY, ¶ 548.04[2][b], at 548-26 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (stating badges of fraud first saw use by Britain's Star Chamber in *Twynes*).

[113] *See* Sharp Int'l Corp. v. State St. Bank & Trust (*In re* Sharp Int'l Corp.), 403 F.3d 43, 56 (2d Cir. 2005) ("Due to the difficulty of proving actual intent to hinder, delay, or defraud creditors, the pleader is allowed to rely on 'badges of fraud' to support his case, i.e., circumstances so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent." (quoting Wall St. Assocs. v. Brodsky, 684 N.Y.S.2d 244, 247 (N.Y. App. Div. 1999))); *see also In re* Prichard, 361 B.R. 11, 16 (Bankr. D. Mass. 2007) ("As debtors will rarely admit an actual intent to defraud, courts have long considered certain recognized indicia [known as the badges of fraud doctrine] to determine the existence of fraudulent intent in the context of a fraudulent conveyance action."); COLLIER, *supra* note 112, at 548-26 (discussing how "badges of fraud" are used to "aid in the examination of the circumstances of the transaction").

[114] *See In re* Spatz, 222 B.R. 157, 167 (Bankr. N.D. Ill. 1998) (listing eleven factors for determining indicia of fraud); *see also In re* Miami Gen. Hosp., Inc., 124 B.R. 383, 392 (Bankr. S.D. Fla. 1991) (denoting eight common factors establishing indicia of fraud discussed by Florida's Fifth District Court of Appeals); COLLIER, *supra* note 112, at 548-26, 27.

suspicious circumstances that would suggest that the debtor and transferee were attempting to defraud creditors by making the conveyance.[115] Further, many of the badges indicate a close relationship between the debtor and grantee. In fact, under The Statute of Elizabeth, the grantee was generally on trial rather than the debtor. This clearly demonstrates that fraudulent conveyance law was developed to punish transferees who collude with a debtor in a way that hurts the debtor's other creditors rather than to promote equality among creditors.

For example, in *Twyne's Case*,[116] the first case that employed the badges of fraud, the debtor, Pierce, owed creditor Twyne 400 pounds and creditor C 200 pounds.[117] When creditor C brought an action against Pierce, and pending the writ in that action, Pierce secretly gifted all of his estate to Twyne. Suspiciously, Pierce stayed in control of all of his property.[118] When the Queens Attorney General, Sir Edward Coke, examined the circumstances he gave five reasons why the transfer should be avoided as fraudulent: (1) The gift was general and without exception; (2) Pierce continued to remain in possession of the property; (3) the gift was made in secret; (4) the gift was made pending litigation (writ); and, (5) the gift included a trust between the parties.[119] Thus, the court held that even though the transfer was supported by valuable consideration—the repayment of a debt—it was not *bona fide*—taken in good faith—because it was apparent that there was a trust between Pierce and Twyne.[120] This trust between the two parties to the conveyance allowed Pierce to defraud his other creditors while retaining possession of his lands.[121] Thus, the court convicted Twyne of receiving a fraudulent conveyance.[122]

In *Twyne's Case*, the court not only focused heavily on a trust between the debtor and the transferee, but also how the debtor and the transferee used this trust to allow the debtor to retain possession of his property in spite of claims from other creditors.[123] The court probably would not have found Twyne guilty if he had simply taken the Pierce's property, even all of Pierce's property.[124] If that had been

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[115] *See* Cunningham v. Merchant's Nat. Bank of Manchester (*In re* Ponzi), 4 F.2d 25, 30–31 (1st Cir. 1925) (stating fraud cannot be committed without "distinct intent to do so"); *see also* Richardson v. Germania Bank, 263 F. 320, 322 (2d Cir. 1919) ("[T]ransfers are avoided only when actually fraudulent, and if made in good faith, though for an antecedent consideration, are valid, even though their effect may be to hinder creditors by removing from their reach assets of the debtor.") (internal quotations omitted); COLLIER, *supra* note 112, at 548-30 ("The existence of a badge of fraud is merely one piece of circumstantial evidence, and not conclusive proof of the existence of actual fraudulent intent.").

[116] (1601) 76 Eng. Rep. 809 (Star Chamber).

[117] *Id.* at 810–11.

[118] *Id.* at 811.

[119] *Id.* at 812–13.

[120] *Id.* at 814.

[121] *Id.*

[122] *Id.* at 823.

[123] *See id.* at 815 ("[The trust] betwixt the donor and donee, . . . is in truth, as to all the creditors, a fraud, for they are thereby defeated and defrauded of their true and due debts.").

[124] *See Twyne's*, 76 Eng. Rep. at 813 ("Here was a trust between the parties, for the donor possessed all, and used them as his proper goods . . . and fraud is always apparelled and clad with a trust, and a trust is the cover of fraud."); *see also* Harris v. Shaw, 272 S.W.2d 53, 55–56 (Ark. 1954) (listing retention of property by debtor after legal conveyance among badges of fraud); Stephens v. Reginstein, 8 So. 68, 68 (Ala. 1890)

the case, Twyne merely would have taken a preference from Pierce, which was not avoidable under The Statute of Elizabeth.[125] What doomed Twyne was that he was holding title of the property for Pierce to allow Pierce to retain the use of his property regardless of attacks from Pierce's other creditors.[126] Twyne's involvement in Pierce's scheme to defraud C was the cornerstone of his fraud.[127]

Conversely, in the 1916 case of *English v. Brown*,[128] the Third Circuit held that three transfers from a husband to his wife were not avoidable even though several badges of fraud were present.[129] There, the court decided the case under the New Jersey common law, which at the time had not changed substantially from The Statute of Elizabeth.[130] The court held that the petitioning creditors must prove that the grantee was involved in the debtor's scheme to defraud his creditors in order to avoid a conveyance as fraudulent.[131] The court explained that the petitioning creditors could not prove that the wife was involved in the husband's scheme to hinder, delay, or defraud his creditors despite the existence of badges of fraud, including a relationship between the parties to the conveyance.[132] There, the debtor's wife had made several loans to the debtor, Brown.[133] Brown made three conveyances of stock and assets to his wife as repayment for these loans.[134] The first two transfers were made while Brown was solvent and therefore were upheld

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(holding debtor's maintaining control of company after transfer was key in finding transfer of company fraudulent).

[125] *See* Irving Trust Co. v. Chase Nat. Bank, 65 F.2d 409, 411 (2d Cir. 1933) (noting good faith payment without intent to injure creditors beyond usual injuries inflicted by preference payment was not avoidable under The Statute of Elizabeth); *see also* PETER A. ALCES, THE LAW OF FRAUDULENT TRANSACTIONS, 5-21 (Warren, Gorham & Lamont 1989) (suggesting Twyne merely received a preference from Pierce and not a fraudulent conveyance); Paul Sinclair, *The Sad Tale of Fraudulent Transfers (Part II): When Did Ponzi Preferences Morph into Fraudulent Transfers?*, AM. BANKR. INST. J., 44, 66 (May 2009) ("[P]aying an actual debt in good faith, without any plan to injure creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law, the [S]tatue of Elizabeth or the Bankruptcy Act.").

[126] *Twyne's*, 76 Eng. Rep. at 814; *see also In re* Baker, 93 B.R. 760, 763 (Bankr. M.D. Fla. 1988) (suggesting even giving recipient of trust specific direction as how to distribute assets is enough to suggest fraud); UNIF. FRAUDULENT TRANSFER ACT § 4(b)(2) (1984) ("In determining actual intent . . . consideration may be given, among other factors, to whether . . . the debtor retained possession or control of the property transferred after the transfer.").

[127] *Twyne's*, 76 Eng. Rep. at 812–14 ("Here was a trust between the parties, for the donor possessed all, and used them as his proper goods . . . and fraud is always apparelled and clad with a trust, and a trust is the cover of fraud.").

[128] 229 F. 34 (3d Cir. 1916).

[129] *Id.* at 41.

[130] *Id.* at 39 ("The principles of law controlling the transfer and conveyance of property in fraud of creditors are well established . . . There must be no combination between [the creditor] and his debtor to hinder, delay or defraud other creditors of the debtor.").

[131] *Id.* at 41 ("[T]here was noting in her conduct or in the circumstances of the transaction from which might be inferred a purpose on her part to help her husband to defraud English brothers or to participate in a scheme to withhold his property from them.").

[132] *Id.* at 40 ("Brown's act was a bald preference of his wife to English brothers, and although the consequence of the act was to make impossible the payment of his debt to English brothers, the legal effect of the act was not a fraud upon them.").

[133] *Id.* at 35–36 (describing debtor's repayment of loans from wife).

[134] *Id.* at 35.

by the New Jersey District Court.[135] However, Brown made his third conveyance of stock to his wife while he was insolvent and after a suit had been filed against him by two of his creditors, the English brothers.[136] Because of Brown's insolvency and the pending lawsuit, the District Court avoided the conveyance in favor of the English brothers.[137]

The Third Circuit Court of Appeals reversed the District Court's ruling on the third conveyance.[138] The court recognized that Brown's wife knew that her husband was insolvent and that the English brothers had brought a lawsuit against her husband.[139] However, the court held that the conveyance could not be avoided because the conveyance was made to satisfy a valid debt and the creditors could not prove that the wife helped Brown hide his assets.[140] Supporting its decision, the Third Circuit explained that, "Brown's wife knew that payment to her meant loss to English brothers, that knowledge does not constitute fraud."[141] Rather, the court explained that to prove actual fraud, a creditor must show facts and circumstances demonstrating that the transferee was taking payment on its debt with the intent to participate in a scheme to withhold payment from other creditors.[142] Evidence that the result of a conveyance is that one creditor will be paid at another creditor's expense is insufficient to prove fraud.[143] The rule is that fraud requires fault on the part of the party taking payment as well as the debtor.

Comparing the results of *Tywne's Case* with *English v. Brown* illuminates two key aspects of fraudulent conveyance law that permeates even the modern statutes and case law. First, fraudulent conveyance law seeks to ensure that at least one creditor is able to levy on the remaining assets of a debtor; however, it does not seek to ensure that all creditors are guaranteed payments from the debtor's assets or that all creditors are paid equally. In *Twyne's Case*, the court found that a fraudulent conveyance had occurred because the debtor stayed in possession of his assets, yet the debtor's other creditors could not realize his assets. On the other hand, the *English v. Brown* court found that despite the fact the English Brothers could not realize the stock that was transferred by the debtor to his wife, the

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[135] *Id.* at 36–37.

[136] *Id.* at 35–37. The English Brothers dropped their original suit. *Id.* at 37. And Brown conveyed the stock while no suit was actually pending. *Id.* However, Brown and his wife were aware that the English Brothers were planning on filing another lawsuit. *Id.*

[137] *Id.* at 37–38 (discussing district court's reasons for finding third conveyance preferential).

[138] *Id.* at 41 ("We are of opinion that the District Court committed no error in holding valid the first and second transfers of stock, and that it erred in holding invalid the third transfer.").

[139] *Id.* at 37–38 (explaining Brown's wife knew about her husband's poor financial circumstances).

[140] *Id.* at 40–41 (determining Brown had right to give preference to his wife because she was one of his creditors).

[141] *Id.* at 41 (finding lack of evidence to indicate Brown's wife helped him defraud English brothers).

[142] *Id.* at 38 (emphasizing bad faith and intent to defraud creditors is required to prove fraud).

[143] *Id.* at 40–41 ("[The] English Brothers can no more complain of the application of Brown's assets to the discharge of his indebtedness to his wife than could Mrs. Brown complain if Brown had transferred his stock to English Brothers in discharge of his indebtedness to them."). *See generally* Klaseus v. Meester, 217 N.W. 593 (1928) (demonstrating similar fact pattern to *English* where court did not allow avoidance based on fraud).

conveyance was not fraudulent because the stock was transferred to satisfy a legitimate debt and the debtor did not retain possession of the property at the expense of his creditors. In other words, the transferee did not hold the conveyance in trust for the benefit of the debtor.

Second, comparing the results in *Tywne's Case* and *Brown*, reveals that whether a conveyance is *bona fide* or taken in good faith by a grantee is a question of the grantee's involvement with the debtor. In both cases, the debtors made conveyance to grantees that were owed legitimate debts. However, in *Tywne's Case* the grantee took the conveyance not as satisfaction for his debt but rather as part of a scheme to allow the debtor to keep his property at the expense of the debtor's other creditor. Tywne was actually involved in the debtor's fraud. Conversely, in *Brown*, the English brothers were not able to recover the conveyances made to the wife because they were unable to demonstrate that Brown's wife was involved in a scheme with Brown to defraud the his other creditors. Thus, in both cases, there were several badges of fraud and suspicious circumstances, including knowledge of the debtor's insolvency; yet, the determining factor was whether the grantee was at least partially at fault in defrauding the other creditors beyond merely collecting its debt. The difference between these cases, and the reason why one grantee was found not to be bona fide and the other grantee was found to be bona fide, was the use of the knowledge of the debtor's insolvency and fraudulent intent.

B. Uniform Fraudulent Conveyance Act

The term of art 'good faith' first entered into the language of fraudulent conveyances when it was included in the definition of 'fair consideration'[144] in the Uniform Fraudulent Conveyances Act (hereinafter "UFCA").[145] Fair consideration has two definitions under the UFCA, both of which contain a good faith requirement. Under the UFCA, "fair consideration" is given when: (1) "When in

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[144] *See* UNIF. FRAUDULENT CONVEYANCE ACT § 3 (1918) (defining fair consideration with requirement of good faith); *see also Good Faith and Fraudulent Conveyances*, *supra* note 62, at 498 (explaining Act's inclusion of good faith requires court to conduct subjective evaluation); Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 248 (1976) (stating fair consideration requires transfer to be made in good faith).

[145] UNIF. FRAUDULENT CONVEYANCE ACT § 3. The UFCA was drafted in 1918 by the Commissioners on Uniform Laws and adopted much of common law under the Statute of Elizabeth. However, the Commissioners felt that the courts were inconsistently applying the common law's subjective actual-intent standard in order to come to desirable results. The Commissioners were mainly concerned with court created presumptions of law in cases where debtors made conveyances that were not supported by consideration, which depleted the debtor's assets. Although the Commissioners agreed with the courts that these conveyances should be considered fraudulent, the Commissioners felt that the courts' application of the law was both inconsistently applied and inconsistent with the statute. Therefore, the Commissions sought to solve this problem by creating the concept of constructive fraud. *See* Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1509 (1987) (determining courts can infer fraud from evidence of inadequate consideration and insolvency); *see also* Comment, *The Uniform Fraudulent Conveyance Act in Pennsylvania*, 5 U. PITT. L. REV. 161, 177 (1939) (explaining constructive fraud can be inferred from debtor's "badges of fraud"). *See generally Good Faith and Fraudulent Conveyances*, *supra* note 62 (providing history of purpose of Commissioner's creation of constructive fraud provisions of UFCA).

exchange for such property [of the debtor], or obligation [from the debtor], as a fair equivalent therefore, and in good faith, property is conveyed or an antecedent debt is satisfied;" or, (2) "When such property [of the debtor], or obligation [from the debtor] is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, obligation obtained."[146] Under both definitions, a transferee is required to provide the debtor with some form of value, either in the form of contemporaneous exchange or debt satisfaction, and provide that value in good faith to have given fair consideration for a conveyance.[147]

Fair consideration and its good faith component play an important role in the constructive fraud provisions of the UFCA, which were newly created in UFCA. The UFCA's constructive fraud provisions seek to ensure that financially troubled debtors are prevented from depleting their assets by making conveyances for less than fair consideration.[148] The provisions operate without regard to a debtor's intent, and focus on the debtor's financial condition at the time of the conveyance and the value exchanged for the conveyance. Under constructive fraud, a creditor is not forced to present subjective evidence of a debtor's fraudulent intent. Rather, a creditor is allowed present objective evidence of two requirements to invalid a conveyance.

First, the creditor must prove that the debtor was in financial distress at the time of the conveyance.[149] Under the UFCA, a creditor can prove this by demonstrating

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[146] UNIF. FRAUDULENT CONVEYANCE ACT §§ 3(a)–(b); *see also* N.Y. DEBTOR & CREDITOR LAW §§ 272(a)–(b) (2001) (adopting UFCA in New York).

[147] *See* HBE Leasing Corp. v. Frank, 61 F.3d 1054, 1058–59 (2d Cir. 1995) (requiring property to be conveyed in good faith to satisfy antecedent debt); *see also In re* Sharp Int'l Corp., 302 B.R. 760, 779 (E.D.N.Y. 2003) (indicating fair consideration requires exchange to be made in good faith to discharge antecedent debt for fair consideration); *In re* Skalski, 257 B.R. 707, 710 (Bankr. W.D.N.Y. 2001) (determining property must be conveyed for antecedent debt in good faith). The UFCA also contained an actual fraud provision that held that any transfer made by a debtor with an actual intent to "hinder, delay or defraud creditors" was fraudulent. The UFCA's actual fraud requirements were merely a codification The Statute of Elizabeth. In fact, a creditor must use the badges of fraud as objective evidence of the subjective intent of the debtor. If a creditor proves actual intent, the transferee is not protected even if he gave value for the transfer in good faith.

Thus, the UFCA allows a creditor to recover a fraudulent transfer under two theories. First, a creditor can prove a debtor's actual subjective intent to hinder, delay or defraud his creditors and recover the conveyance under actual fraud. Under the UFCA, the creditor must prove actual fraud in exactly the same manner as under the common law by using the badges of fraud to prove the subjective intent of the debtor. Second, the creditor can use the constructive fraud provisions.

[148] *See* Dionne v. Keating (*In re* XYZ Options, Inc.), 154 F.3d 1262, 1275 (11th Cir. 1998) (determining constructive fraud is evident if debtor transferred property soon after filing bankruptcy petition); *see also In re* World Vision Entm't, Inc., 275 B.R. 641, 657 (Bankr. M.D. Fla. 2002) (articulating constructive fraud provisions require trustee to prove debtor received low consideration and was insolvent); GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES 471 (Baker, Voorhis, rev. ed. 1940) (noting essential feature of a fraudulent conveyance is depletion of debtor's estate).

[149] *See In re XYZ Options, Inc*., 154 F.3d at 1275 (requiring proof debtor was insolvent at time of transfer); *see also* Convey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657, 659 (7th Cir. 1992) (indicating court considers whether or not debtor was insolvent at time of transfer to establish fraud); *In re World Vision Entm't, Inc.*, 275 B.R. at 657 (explaining constructive fraud requires evidence debtor was insolvent when transfer occurred). The UFCA does not contain this term. The term is used to generalize the ultimate

that: (1) the debtor was insolvent at the time of the conveyance;[150] (2) the debtor was left with unreasonably small capital after the conveyance;[151] or, (3) the debtor would be left with debts beyond its ability to pay as they mature because of the conveyance.[152] Second, a creditor must prove that the debtor did not receive fair consideration in exchange for the conveyance, which involves demonstrating that either the grantee did not give value or did not give the value in good faith.[153] Thus, good faith is the pivotal component in determining whether a conveyance from an insolvent debtor for value is voidable.

The UFCA does not expressly define the term good faith despite good faith's importance in determining fair consideration in constructive fraud. However, the UFCA's purpose and wording do reveal some possible intended meanings for the term. As mentioned above, the constructive fraud provisions of the UFCA sought to make it easier for creditors to ensure that a financially troubled debtor is using its limited assets to pay creditors rather than depleting its estate by making conveyances that are not supported by equivalent value.[154] However, the Commissioner's goal in seeking to ensure that the debtor's property is used to pay the debtor's creditors is not synonymous with the goal of promoting equality among the debtor's creditors.[155] Neither the operation of the actual fraud nor the

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requirements of several sections of the UCFA that require a creditor to prove that a conveyor is in one of several states of financial disrepair or insolvency.

[150] *See In re XYZ Options, Inc.*, 154 F.3d at 1275 (determining fraud can be inferred when debtor was insolvent at time of transfer); *see also In re World Vision Entm't, Inc.*, 275 B.R. at 657 (requiring debtor to be insolvent at time of transfer to establish fraud); UNIF. FRAUDULENT CONVEYANCE ACT § 4 (articulating voluntary transfer by insolvent creates presumption of fraudulent intent).

[151] UNIF. FRAUDULENT CONVEYANCE ACT § 5; *see also* Robert A. Fogelson, *Toward a Rational Treatment of Fraudulent Conveyance Cases Involving Leveraged Buyouts*, 68 N.Y.U. L. REV. 552, 557 (1993) (stating "debtor [being] left with unreasonably small capital for the continuation of its business" as one way to prove poor financial condition); Lee Hammer, *Turning a Blind Eye: The Ninth Circuit's Approach to Fraudulent Conveyances and Leveraged Buyouts*, 31 SW. U. L. REV. 237, 248–49 (2002) (noting "unreasonably small assets" as a way to invalidate a transaction as constructively fraudulent).

[152] UNIF. FRAUDULENT CONVEYANCE ACT § 6; *see also* Fogelson, *supra* note 151, at 557–58 (noting "debtor [being] left unable to pay its debts as they matured" as another way to prove poor financial condition of debtor); Hammer, *supra* note 151, at 248–49 (describing "debtor's accumulation of debts beyond its ability to pay" as a way to invalidate a transaction as constructively fraudulent).

[153] UNIF. FRAUDULENT CONVEYANCE ACT. § 3 (defining "fair consideration"); *see also* Fogelson, *supra* note 151, at 557 (explaining UFCA expressly requires good faith, but good faith alone will not salvage transaction when debtor retains no value); *Good Faith and Fraudulent Conveyances*, *supra* note 62, at 505 (describing "fair consideration" determination as two step process; either lack of fair equivalence in consideration or lack of good faith invalidates transfer).

[154] *See* GLENN, *supra* note 148, at 471–72 (explaining essential feature of fraudulent conveyance is depletion of debtor's estate); *see also* Kathryn V. Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781, 793 (1988) (explaining debtor's total estate value is diminished when debtor receives less than fair compensation in transaction, concern of creditors, especially if debtor becomes insolvent); Note, *A Palace for Peppercorn: A Post*-BFP *Proposal to Resurrect Section 548(A)(2)(A*), 73 WASH. U. L.Q. 1747, 1748 n.7 (1995) (describing purpose behind Bankruptcy Code fraudulent conveyances provisions, which were modeled after UFCA).

[155] *See* Boston Trading Group v. Burnazos, 835 F.2d 1504, 1508–09 (1st Cir. 1987) (noting some payment to some creditors is intent of fraudulent conveyance law); *see also* Goldstein v. Columbia Diamond Ring Co., 323 N.E.2d. 344, 347 (Mass. 1975) (opining as long as there is no collusion, preferences are better than

constructive fraud provisions accomplish the goal of equity among creditors. Under actual fraud, a debtor may pay any creditor he wishes at the expense of his other creditors as long as the debtor and the creditor are not colluding to allow the debtor to defraud his other creditors. A creditor who does not receive payment in this situation, like the English brothers in *Brown*, is without recourse against the grantee.

Similarly, the constructive fraud provisions do not seek to provide for equality amongst creditors.[156] The Commissioners' intent to ensure that at least one creditor is paid from the insolvent debtor's assets rather than all creditors are paid equally is evidenced by the inclusion of antecedent debts in the definition of fair consideration.[157] By allowing the payment of an antecedent debt to satisfy fair consideration, the UFCA allows an insolvent debtor to convey its assets to one creditor at the expense of all the debtor's other creditors. For example, if a debtor transferred all of its assets to a creditor, which the debtor owed an antecedent debt equal to or greater than the value of the debtor's assets, the debtor's estate would be entirely depleted. In that case, the debtor would not have assets to distribute to its other creditors. However, under the UFCA, the debtor's other creditors would not be able to attack the conveyance because the conveyance was supported by fair consideration. Thus, the constructive fraud provisions do not serve to promote equality among creditors because the provisions are satisfied once one legitimate creditor receives the debtor's assets, despite the effect the conveyance might have on the debtor's other creditors. Of course, the creditor must take the transfer in good faith.

As mentioned above, the Commissioners did not define good faith in the UFCA. The Commissioners' goal of elevating objective evidence over subjective inquiry into the minds of the parties to a conveyance suggests that good faith should take a secondary importance to the objective factors of value exchanged in constructive fraud.[158] Further, the UFCA considered as a whole suggests that the

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no payment at all); *In re* Johnson, (1881) 20 Ch.D. 389, 392 ("The intent of the statute is not to provide equal distribution of the estates of debtors among their creditors.").

[156] *See Boston Trading*, 835 F.2d at 1512 (noting concerns over finding actual fraud are at least equal to those over finding constructive fraud); *see also* Smith v. Whitman, 189 A.2d 15, 18 (N.J. 1963) (explaining legitimacy of preference made by insolvent debtor, where voiding transfer would just substitute different creditor, was not affected by UFCA). *See generally* Merchs. Bank v. Page, 128 A. 272, 273 (Md. 1925) (stating debtor may transfer entire worth of estate to pay off one antecedent debt as it just creates preference of one creditor).

[157] *See* UNIF. FRAUDULENT CONVEYANCE ACT. § 3 (including payment of antecedent debt in definition of fair consideration); *see also* Sharon Malchar Easley, *Bankruptcy: Eliminating the 45-Day Rule from the "Ordinary Course of Business" Exception to § 547(b) May Have Resulted in a Significant Abrogation of the Trustee's Avoidance Powers*, 41 OKLA. L. REV. 703, 705–06 (Winter 1988) (including antecedent debts in UFCA evidences drafter's intent to have preferential repayments rather than none at all); *Good Faith and Fraudulent Conveyances*, *supra* note 62, at 505–06 (explaining satisfaction of antecedent debt can be a conveyance fulfilling "fair equivalence" requirement of UFCA).

[158] *See* UNIF. FRAUDULENT CONVEYANCE ACT § 3; *see also* Scott B. Erlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 VA. L. REV. 933, 949–50 (1985) (suggesting drafters of UFCA intended to create objective inquiry into fair consideration, but statutory mention of good faith means courts must also consider intent of transferor); *Good Faith and*

role of good faith in the determination of fair consideration should be minimal. Because the UFCA contains actual fraud provisions, the term good faith cannot take a lesser standard than an honest belief in the propriety of the transaction or an intent to "hinder delay or defraud" a debtor's other creditor because then the actual fraud provisions would be rendered meaningless, at least in cases of insolvent debtors.[159] In order to avoid a transfer under the UFCA as actual fraud, a creditor must prove both that the debtor intended to "hinder, delay or defraud" creditors in making the transfer and that the transferee does not fall under the section 9 defense. However, if the standard for good faith is a standard lower than an honest belief or intent to defraud, a creditor will never need to resort to the actual fraud provisions and still be able to invalidate transfers by proving that the transferee lacked good faith under that lower standard. Thus, creditors could easily avoid transfers that are supported by consideration and would never need to use the actual fraud provisions, which would make those provisions useless in cases of insolvent creditors.

Further, the UFCA contains a savings clause in section 9 that protects grantees that gave value to a debtor that conveyed with an actual fraudulent intent.[160] Normally, a conveyance that is made with an actual fraudulent intent is voidable despite the value exchanged for the conveyance or the good faith of the grantee. However, section 9 allows a grantee that gave fair consideration for an actual fraudulent conveyance to keep the value that it gave for the conveyance as long as the grantee did not have knowledge of the debtor's actual fraudulent intent. In this section, fair consideration, which contains the good faith requirement, is paired with a knowledge requirement. Thus, the plain text of the UFCA suggests that good faith and knowledge have separate meanings, otherwise fair consideration would not have to be paired with an additional requirement. Despite these clues, the term good faith in the context of the UFCA has been wrestled over by the courts throughout the statute's history.[161]

Ultimately, two lines of cases have developed interpreting the good faith requirement of fair consideration. The first defines the role of good faith in the definition of fair consideration narrowly. Under this line of cases, the grantee's knowledge of the debtor's insolvency or fraudulent purpose is irrelevant. Further, the role of good faith took either a secondary role or a modifying role to that of

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Fraudulent Conveyances, *supra* note 62, at 499 ("[T]he drafters must have presumed that the objective fair-equivalence test would overshadow the good-faith determination.").

[159] UNIF. FRAUDULENT CONVEYANCE ACT § 7 (providing remedy for creditors against conveyances made with actual intent to defraud); *see also Good Faith and Fraudulent Conveyances*, *supra* note 62, at 502; Rosenberg, *supra* note 144, at 248 ("What, then, does 'good faith' mean?").

[160] *See* UNIF. FRAUDULENT CONVEYANCE ACT § 9; *see also* Scott F. Norberg, *Avoidability of Intercorporate Guarantees under Sections 548(a)(2) and 544(b) of the Bankruptcy Code*, 64 N.C. L. REV. 1099, 1124 (1986) (noting UFCA section 9 also protects innocent transferees who have given less than fair consideration); Rosenberg, *supra* note 144, at 261 (stating savings clause also found in Bankruptcy Act).

[161] *See, e.g.*, HBE Leasing Corp. v. Frank, 48 F.3d 623, 636 (2d Cir. 1995) (discussing different ways to define good faith); *In re* Sharp Int'l Corp., 302 B.R. 760, 779 (E.D.N.Y. 2003) ("The precise meaning of good faith . . . has been the bone of jurisprudential contention among the states that have adopted the UFCA."); *In re* Otis & Edwards, P.C., 115 B.R. 900, 907 (Bankr. E.D. Mich. 1990) ("Section 3 of the UFCA is the source of a fair amount of confusion . . . what role, if any, does 'good faith' play?").

"equivalent value."[162] Conversely, the second line of cases focuses on the grantee's knowledge of the debtor's circumstances to determine good faith, despite the clear language of section 9. Both lines of cases are distinguishable from the *Bayou* standard, despite the *Bayou* court's reliance on the language of the second line of cases. Further, the development of the UFCA case law on good faith provides some indication as to the intended meaning of good faith in section 548(c).

1. Cases Defining the Role of Good Faith Narrowly

The early case law applying the UFCA's constructive fraud provisions constructed a very narrow role for good faith within the standard for determining fair consideration.[163] In *Boston Trading Group, Inc. v. Burnazos*,[164] Judge Stephen Beyer, then on the First Circuit Court of Appeals, provides an extensive history of the role of good faith within fraudulent conveyances. There, the court explained that traditionally courts have defined the role of good faith in the fair consideration determination narrowly.[165] However, the court continued that despite defining a consistently narrow role for good faith courts have often assigned different meanings to the term.[166] Some courts have determined that good faith invalidates conveyances only when the grantee had some form of participation in the debtor's original fraud.[167] Other courts have defined good faith to mean honesty during the bargaining process.[168] Still others have defined good faith as an honest belief in the

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[162] *See Good Faith and Fraudulent Conveyances*, *supra* note 62, at 499 ("[T]he drafters must have presumed that the objective fair-equivalence test would overshadow the good-faith determination."); *see also* Jeffrey L. LaBine, *Michigan's Adoption of the Uniform Fraudulent Transfer Act: An Examination of the Changes Effected to the State of Fraudulent Conveyance Law*, 45 WAYNE L. REV. 1479, 1500 (1999) (noting earlier UFCA cases devoted most of "fair consideration" inquiry to reasonableness of value given). *But see* Fogelson, *supra* note 151, at 578 ("That good faith alone, in the form of this judicially created . . . commercial reasonableness test, has preserved LBO transfers . . . may represent a judicial decision to place greater emphasis on the good faith element and forgive the equivalent value element.").

[163] *See, e.g.*, Schlecht v. Schlecht, 209 N.W. 883, 885 (Minn. 1926) (focusing only on value to determine fair consideration); Osawa v. Onishi, 206 P.2d 498, 504 (Wash. 1949) (ignoring good faith requirement). The early cases under the Bankruptcy Act, which incorporated the UFCA, also defined a narrow role for good faith. *See, e.g.*, Gilmer v. Woodson, 332 F.2d 541, 547 (4th Cir. 1964) (finding good faith under Bankruptcy Act not lacking unless transferee "knowingly participated in the debtor-transferor's purpose to defeat other creditors").

[164] 835 F.2d 1504 (1st Cir. 1987).

[165] *Id.* at 1512.

[166] *Id.*

[167] *See* Sharp Int'l Corp v. State St. Bank and Trust Co. (*In re* Sharp Int'l Corp.), 403 F.3d 43, 54 (2d Cir. 2005) (declaring preference between creditors does not amount to bad faith); *see also Boston Trading*, 835 F.2d at 1512 (suggesting preferences do not rise to level of fraudulent conveyances); English v. Brown, 229 F. 34, 40 (3d Cir. 1916) (finding transfer in satisfaction of debt from insolvent husband to wife not fraudulent when wife knew of husband's insolvency because husband simply chose wife over other creditors).

[168] *Boston Trading*, 835 F.2d at 1512 (determining bad faith is found if transferee participated in fraud); *see also* Jaeger v. Kelley, 52 N.Y. 274, 275 (N.Y. 1873) (finding inadequacy of price insufficient to prove fraud); GLENN, *supra* note 101, at 397 ("One must be able to conclude that there was bad faith as distinct from a tight trade.").

propriety of the transaction.[169] Like these courts, in *Boston Trading*, the court assigned a narrow role to good faith in the tradition of the case law that it described.

In *Boston Trading*, the receiver[170] for two money management companies, Boston Trading Group ("BTG") and Northeast Investment Services ("NIS"), sought to recover several conveyances that the receiver considered to be fraudulent.[171] Specifically, the receiver sought to avoid transfers made to Robert Burnazos, the former owner of the Boston Trading Group, by BTG's and NIS's principals, Richard Shaw and Theodore Kepreos.[172] In 1981, Shaw and Kepreos, who already owned NIS, agreed to purchase BTG from Burnazos for roughly $1.6 million. Under the purchase agreement, Shaw and Kepreos were to pay Burnazos $400,000 up front and would make sixteen $73,000 payments to cover a balance of roughly $1.2 million. Shaw and Kepreos paid the down payment and one of the sixteen payments before going into receivership.[173]

After selling BTG to Shaw and Keproes, Burnazos discovered that Shaw and Keproes were cheating their customers by churning[174] their customer's accounts to generate unnecessary fees. The two were also misappropriating BTG money for themselves.[175] Burnazos, upon discovering the fraud, sued them for depleting the assets of the company, which were the only funds that could be used to pay off Burnazos note.[176] The suit settled for $400,000.[177] Once BTG and NIS went into receivership, the receiver tried to recover the settlement payment and the first sale payment as fraudulent conveyances. The receiver argued that Burnazos knew that Shaw and Keproes were committing fraud against their clients.[178] Therefore, the receiver contended that Burnazos could not have taken the payments in good faith.

The First Circuit disagreed. The court held that knowledge of the debtor's fraudulent purpose alone does not negate a transferee's good faith in taking the conveyances for value.[179] So long as a creditor is receiving payment on a debt from the debtor, the goals and purposes of fraudulent conveyance law are satisfied. The court stated that "[t]he basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy some of his creditors; it normally does not

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[169] *Boston Trading*, 835 F.2d at 1512 (observing "subjective appreciation" may determine good faith); *see also* Mayors v. Comm'r of Internal Revenue, 785 F.2d 757, 761 (9th Cir. 1986) (finding good faith where transferee believed she gave fair consideration even though contract may not have been enforceable); Tacoma Ass'n of Credit Men v. Lester, 433 P.2d 901, 904 (Wash. 1967) (listing one factor of good faith to be "[a]n honest belief in the propriety of the activities in question").

[170] *Boston Trading*, 835 F.2d at 1506 (explaining *Boston Trading* was state law receiver case heard in federal courts).

[171] *Id.* at 1506.

[172] *Id.*

[173] *Id.*

[174] *Id.* Churning is the act of making excessive amounts of trades in order to collect commissions. *See* BLACK'S LAW DICTIONARY 275 (9th ed. 2009).

[175] *See Boston Trading*, 835 F.2d at 1506.

[176] *See id.*

[177] *See id.*

[178] *See id*. at 1506–07.

[179] *See id.* at 1512 (finding knowledge of debtor's fraud when taking preference does not in and of itself negate good faith).

try to choose among them."[180] The court buttressed this reasoning by noting that there are other remedies that seek to promote equity amongst creditors, mainly preference law.[181] The court explained that a conveyance made to a grantee who merely knows about the fraud is only a preference and a preference cannot be invalidated under the fraudulent conveyance law.[182] Thus, the court reasoned that fraudulent conveyance law is based on fault not equity among creditors and that the good faith standard should be subjective.[183]

Similarly, In *In re Sharp International Corp.*,[184] the District Court for the Eastern District of New York held that good faith is not negated by the transferee's knowledge of the debtor's fraud or insolvency, even when the transferee conceals this knowledge from other creditors.[185] There, the debtor, Sharp, an importer of wristwatches, clocks, pens, and mechanical pencils, was the subject of a massive fraud committed by its officers, the Spitz's.[186] Before discovering the fraud, State Street, a large commercial bank, extended Sharp a $20 million credit line and ultimately loaned Sharp $26 million.[187] Sharp was able to make nearly $24 million in payments to State Street by issuing subordinate notes to a group of investors. Sharp raised $12 million of this money while State Street was aware of the Spitz fraud. In bankruptcy, Sharp tried to recover the $11 million paid to State Street under New York's version of the UFCA.[188]

There, Sharp was able to show convincing evidence that State Street knew of and concealed the Spitz's fraud from the investors who bought the subordinated notes.[189] For example, Sharp breached several provisions of its loan agreement, including failing to provide information that was required under the agreement and refusing to use State Street's lockbox account.[190] Further, State Street became nervous about Sharp when it noticed that Sharp was growing "at an alarming pace" and consuming a large amount of cash.[191] Because of these suspicions, State Street contacted several Sharp consumers and conducted extra diligence including obtaining a Dun and Bradstreet report that confirmed that Sharp had fraudulently created fictitious customers and accounts.[192] Notwithstanding this knowledge of

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[180] *Id.* at 1509 (emphasis omitted).
[181] *See id.* at 1508.
[182] *See id.* ("This conveyance may be unfair . . . , but it is not a 'fraudulent conveyance' because it satisfies a debt owed to a person who is, at least, a legitimate creditor.").
[183] *See id.* at 1512 (explaining "subjective appreciation of the situation . . . might help a court determine whether the exchange was a fair one").
[184] 302 B.R. 760 (E.D.N.Y. 2003).
[185] *See id.* at 781, 784.
[186] *See id.* at 764.
[187] *Id. at* 765.
[188] *Id.* at 768–69. The bankruptcy was an involuntary proceeding brought by the defrauded note holders. *Id.* at 768. Despite being a bankruptcy case, the *Sharp* case was decided under New York's version of the UFCA because it was outside of the two years reach back period of section 548. *Id.* at 777–78.
[189] *Id.* at 771–74 (explaining Sharp's allegations were sufficient to permit inference State Street knew of Sharp's false sales and embezzlement).
[190] *Id.* at 765–66.
[191] *Id.* at 766.
[192] *Id.* at 767.

Sharp's fraud, State Street halted its investigation when Sharp agreed to raise the capital to pay State Street by obtaining additional loans by selling new notes to unsuspecting investors.[193] Sharp took these actions and paid State Street over $12 million reducing its debt to $2.7 million.[194]

Despite this egregious fact pattern, the district court held that State Street gave value in good faith.[195] Taking the *Boston Trading* logic to its extreme, the court held that the payments to State Street from Sharp were merely preferences rather than fraudulent conveyances.[196] The court noted, "[A] finding that good faith is lacking based solely on the transferee's awareness that the transferor . . . lacks the resources to satisfy all his debts would run afoul of the fundamental principle that a preference—a payment by an insolvent debtor satisfying debts to one creditor at the expense of others—is not a fraudulent conveyance."[197] The court explained that even though State Street knew of Sharp's fraud and knew that the funds were coming from defrauded note holders, absent State Street's participation in Sharpe's fraud State Street acted in good faith.[198] The Second Circuit affirmed the district court's decision.[199]

The *Boston Trading* and *Sharp* cases are consistent with the traditional interpretations of the role of good faith that stands in stark contrast to how the *Bayou* court interpreted good faith. The *Boston Trading* and *Sharp* courts, like the Third Circuit in *English v. Brown*, correlated a lack of good faith with some impropriety beyond mere knowledge of the debtor's insolvency and fraudulent purpose. Both cases involved a creditor who recovered more of the debtor's assets than other creditors because of its knowledge. However, neither case involved a creditor who used this knowledge to improperly position itself to receive more than its antecedent debts, nor a creditor who sought to use his knowledge to continue to profit from the debtor's fraud. The *Bayou* case has close parallels to each of these situations and, in fact, probably involves less egregious circumstances than *Sharp*. In *Bayou*, the redeeming investors, specifically the Altegris investors and the CSG investors, were certainly at least aware of problems with the Bayou Funds. However, the Bayou investors never used this knowledge to take advantage of the debtor's other creditors, take advantage of the debtor, or collude with the debtor in any way. The investors merely used their knowledge to collect on what the investors considered their legitimate antecedent debts.[200] Under the logic of *Boston Trading*, *Sharp* and *English v. Brown*, the investors merely received a preference that is not avoidable under the fraudulent conveyance laws.

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[193] *Id.*
[194] *Id.* at 768.
[195] *Id.* at 780.
[196] *Id.*
[197] *Id.*
[198] *Id.*
[199] Sharp Int'l Corp. v. State Street Bank & Trust (*In re* Sharp Int'l Corp.), 403 F.3d 43, 57 (2d Cir. 2005).
[200] *See In re* Bayou Group, LLC, 396 B.R. 810, 869–71 (Bankr. S.D.N.Y. 2008) (noting CSG's recommendation to investors to redeem their investments). The investors also may have just perceived these to be legitimate debts. *See id.*

2. The Expansive View of Good Faith

Other courts have sought to expand the role of good faith within the fair consideration requirement in order to exclude grantees who have knowledge or who should have knowledge of the debtor's fraudulent purposes from satisfying the fair consideration requirement.[201] In *Tacoma Assoc. of Credit Men v. Lester*, [202] the Supreme Court of Washington started a trend that elevated good faith for the first time as an equal requirement of fair consideration.[203] Under this interpretation of good faith, a transferee takes a conveyance in good faith when the transferee has: (1) an honest belief in the proprietary of the activities in question; (2) no intent to take unconscionable advantage of others; and, (3) no intent to, or knowledge of the fact that the activities in question will, hinder, delay or defraud creditors.[204] In *Tacoma*, the debtor company's owner transferred $23,000 dollars to another company the debtor solely owned on account of an alleged debt.[205] The second company then loaned the money back to the first company in exchange for a lien on all the first company's assets.[206] The lien was perfected four months before the company went into receivership, which was outside of Washington State's preference period.[207] The court avoided and nullified the lien using the partly objective test outlined above.[208]

Tacoma is widely considered the start of the trend towards defining good faith in an objective manner and assigning the requirement an expanded role.[209] In fact, the majority of the Circuit Courts that have interpreted good faith in section 548(c) have relied on *Tacoma* as a lead case.[210] However, *Tacoma* is a case of extremely

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[201] *See* Julien J. Studley, Inc. v. Lefrak, 66 A.D.2d 208 (N.Y. App. Div. 1979) (noting good faith as "indispensible condition in the definition of fair consideration"); *see also* Southern Indus., Inc. v. Jeremias, 66 A.D.2d 178 (N.Y. App. Div. 1978) (holding transfer to be void despite being made for fair consideration because it was "not made in good faith"). *See generally Good Faith and Fraudulent Conveyances*, *supra* note 62, at 495 (discussing expanding role of good faith in fair consideration).

[202] 433 P.2d 901 (Wash. 1967).

[203] *See id.* at 904 (noting good faith to be integral part of fraudulent conveyance analysis).

[204] *See Jeremias*, 66 A.D.2d at 183; *see also Tacoma*, 433 P.2d at 904; *Good Faith and Fraudulent Conveyances*, *supra* note 62, at 500.

[205] *Tacoma*, 433 P.2d at 904.

[206] *Id.* at 902–03.

[207] *Id.* at 903.

[208] *Id.* at 905.

[209] *See id.* at 904 (explaining the presence of good faith is determined by "looking to the intent behind or the effect of a transaction"); *see also Good Faith and Fraudulent Conveyances*, *supra* note 62, at 499 (positing expansion of good faith started with *Tacoma* case); John C. McCoid, II, *Corporate Preferences To Insiders*, 43 S.C. L. REV. 805, 816 n.46 (1992) (noting *Tacoma* as "earliest known case" to expand good faith requirement and treat objectively).

[210] *See* Sinclair, *supra* note 16, at 79–80 (tracing evolution of modern bankruptcy case law on good faith back to *Tacoma* decision); *cf.* Jobin v. McKay (*In re* M & L Bus. Mach. Co., Inc.) 84 F.3d 1330, 1338 (10th Cir. 1996) (concluding objective standard for good faith is appropriate); Brown v. Third Nat'l Bank (*In re* Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995) ("[A] transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency."); *In re* Agretech, 916 F.2d 528, 535–36 (9th Cir. 1990) (using objectivity in its good faith analysis).

egregious circumstances that could have been decided under a fraud.[211] There, the companies involved all had a substantial identity and a single controlling owner.[212] Moreover, the companies used their shared identity to ensure that the struggling company's assets would be out of the reach of creditors by giving a lien on its assets to the company not in financial trouble.[213] The *Boston Trading* court distinguished cases taking an expansive partly objective view of good faith, such as *Tacoma*, from cases where the grantee only had knowledge or inquiry notice of the debtor's fraud.[214]

The *Boston Trading* court specifically targeted *Tacoma* and demonstrated that, notwithstanding its broad statements, the *Tacoma* court based its decision on the grantee's fault and subjective bad faith rather than simple knowledge.[215] The First Circuit argued that it was the unique facts and circumstances of that case that negated good faith rather than the knowledge of the debtor's fraudulent purposes.[216] The court pointed specifically to the relationship between the debtor and the transferee in *Tacoma*. Thus, the transferee's involvement in the debtor's scheme to pay an insider in order to hide its assets from legitimate creditors, and not the transferee's knowledge of the debtor's financial situation, was the reason the transfer was fraudulent.[217] The court suggested that *Tacoma* should have been decided under actual fraud rather than constructive fraud.[218]

Interestingly, most of the Code cases adopt the *Tacoma* logic. The Code cases also generally involve egregious facts and circumstances beyond a transferee's mere knowledge or notice of the debtor's ill intent or financial instability.[219] Generally, the trustee in those cases has been able to prove the transferee had knowledge of the debtor's fraudulent purpose and that the transferee used this knowledge to harm other creditors. In each of those cases, the transferee did more than simply redeem its principal or perceived debts from the debtor, which demonstrates that the transferees not only lacked objective good faith but also that each of the transferees' lacked subjective good faith. Thus, the Code cases, like *Tacoma*, involved facts and circumstances that are generally reconcilable with the traditional interpretations of

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[211] *See* Boston Trading Group v. Burnazos, 835 F.2d 1504, 1513 (1st Cir. 1987) (explaining *Tacoma* contains facts which come closer to actual fraud than case where grantee merely has knowledge of source of preference payments); *see also Good Faith and Fraudulent Conveyances, supra* note 62, at 500 (explaining *Tacoma* contained egregious facts).

[212] *Tacoma*, 433 P.2d at 905 ("The very fact that appellant seems to have controlled both Ace and Northwest, and to have engaged them in a series of circuitous transactions which resulted in giving appellant a singular advantage over Northwest's other creditors raises a suspicion of bad faith.").

[213] *Id.* at 905 ("It would seem that the mortgage was conveyed for the sole purpose of allowing appellant to minimize any losses he might incur because of Northwest's insolvency.").

[214] *Boston Trading*, 835 F.2d at 1513 (comparing several cases based on objective view of good faith and knowledge of fraud).

[215] *Id.* ("[W]hether the transferee honestly believes in the fairness of the deal.").

[216] *Id.* (explaining facts and circumstances in *Tacoma* line of cases come considerably closer to actual fraud than cases where grantee merely has knowledge of debtor's insolvency or fraud).

[217] *Id.* at 1516 ("[P]references given by insolvent corporations to insiders are fraudulent.").

[218] *Id.* at 1513 (stating "facts of the cited cases," including *Tacoma*, "fall considerably closer" to actual fraud).

[219] *See infra* Part III.4.

good faith and the purposes of fraudulent conveyance law even if they applied an erroneous standard. In contrast, the *Bayou* case significantly expands the role of knowledge in the good faith determination from the *Tacoma* standard in two significant ways. First, *Bayou* substitutes an inquiry notice standard for *Tacoma's* knowledge standard. Second, *Bayou* ignores *Tacoma*'s inquiry into the transferee's attempts to take advantage of the debtor's other creditors.

C. Fraudulent Transfers under the Bankruptcy Code

The Code's provisions on fraudulent transfers were greatly influenced by the UFCA. Like the UFCA, the Code contains both actual and constructive fraud provisions.[220] Under the Code, actual fraud still requires a showing of an actual intent to "hinder, delay or defraud creditors" in order to avoid a transfer.[221] Similarly, the Code's version of constructive fraud is still based on the value exchanged between the debtor and the transferee.[222] However, the Code's provisions on fraudulent transfers contain some significant functional differences from the UFCA. These changes are especially significant when dealing with Ponzi scheme bankruptcies and the section 548(c) good faith defense.

First, the Code clarifies that when determining actual fraud, it is the debtor's intent or actions that are determinative.[223] A trustee can avoid a transfer with only evidence of the debtor's intentions for actual fraud, rather than having to prove the subjective intent of both the debtor and the transferee, or a showing a trust between the debtor and the creditor.[224] In a Ponzi scheme bankruptcy, a trustee will be able be able to prove that nearly every transfer is made with an intent to defraud creditors because, by definition, Ponzi schemes use the investments from later investors to pay earlier investors for the purpose of attracting more investors.[225] Therefore, the trustee's avoidance actions in Ponzi scheme bankruptcies under the

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[220] *See* 11 U.S.C. §§ 548 (a)(1)(A)–(B) (2006) (allowing trustee to pursue both actual fraud and constructive fraud actions against transferee within two years of transfer).

[221] *See* 11 U.S.C. § 548(a)(1)(A) (requiring showing of actual intent to defraud creditors).

[222] *See* 11 U.S.C. § 548(a)(1)(B) (allowing fraud to be presumed if trustee demonstrates transfer was made while debtor was insolvent and transfer was not made in exchange for reasonably equivalent value).

[223] *See* 11 U.S.C. § 548(a)(1)(A) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud.").

[224] *See In re* Cahillane, 408 B.R. 175, 191 (Bankr. N.D. Ind. 2009) (noting focus is on state of mind of debtor, and culpability of transferee is not essential); *see also In re* National Audit Defense Network, 367 B.R. 207, 221 (Bankr. D. Nev. 2007) ("It is key in this analysis that the required intent to hinder, delay or defraud is the debtor's; no collusion with the transferee is necessary."); ALCES, *supra* note 125, at 5–13[c] ("[C]omparisons of the value received by the debtor are not complicated with subjective determination regarding the good faith of the transferee.").

[225] *See* Conroy v. Shott, 363 F.2d 90, 91–92 (6th Cir. 1966) (noting "the question of intent to defraud is not debatable" because debtor was conducting Ponzi scheme); *see also In re* Indep. Clearing House Co., 77 B.R. 843, 860 (D. Utah 1987) ("Knowledge to a substantial certainty constitutes intent in the eyes of the law . . . and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.") (citation omitted); McDermott, *supra* note 16, at 174–75 (describing Ponzi scheme presumption of actual fraud).

Code are usually brought as actual fraud rather than constructive fraud like the cases described above under the UFCA.[226] However, the Code's saving clause more closely mirrors the UFCA fair consideration definition than the UFCA's section 9 savings clause.[227]

Second, the Code drops the fair consideration terminology.[228] Instead, the Code includes a savings clause in section 548(c), which allows a transferee to retain any transferred interest to the extent the transferee gave value in "good faith."[229] And, although the definition of fair consideration under the UFCA only provides protection to a transferee who gave value in good faith in cases of constructive fraud,[230] section 548(c) operates as a defense and saving clause for both actual fraud

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[226] *See* James Butler Cash, Jr., Note, *When is an Equity Participant Actually a Creditor? The Effect of* In re AFI Holding *on Ponzi Scheme Victims and the Good Faith Defense*, 98 KY. L.J. 329, 336, 339–340 (2009) (noting actual fraud and constructive fraud both require proof Ponzi scheme operator maintained interest in investors' funds, but constructive fraud has two more elements to satisfy whereas actual fraud has only one more, and it is satisfied by Ponzi scheme presumption of actual fraud); *see also* McDermott, *supra* note 16, at 173 (noting actual fraud gives substantial advantage to trustee in being able to recover all amounts transferred to investor, not just fictitious profits trustee can obtain under constructive fraud); Arthur J. Steinberg & John F. Isbell, *The Need to Revisit the 'Value in Good Faith" Defense to Fraudulent Transfer Claims*, 18 NORTON J. BANKR. L. & PRAC., 393, 394 (2009) (arguing in actual intent cases, trustee's burden of proof for prima facie case if there is a Ponzi scheme is easier to satisfy than constructive intent cases). Note, however, that an investor's profits will be avoided under constructive fraud theories. *See In re* Bayou Group, LLC, 396 B.R. 810, 827–28 (Bankr. S.D.N.Y. 2008) (holding plaintiff's constructive fraud claims are limited to ficticious profits); *see also* Cash, *supra*, at 336, 340 (stating constructive fraud allows for avoidance of ficticious profits); McDermott, *supra* note 16, at 168 (stating, in regards to constructive fraud, courts have refused to allow investors to retain any profit). An investor will not be able to assert the section 548(c) defense for his profits because the investor will not have given value for the profits. *See In re* Randy, 189 B.R. 425, 442 (Bankr. N.D. Ill. 1995) (stating courts have denied transferees trying to protect profits from Ponzi scheme shelter of section 548(c) because they did not give any value for transfer); *see also In re Indep. Clearing House*, 77 B.R. at 859 ("[T]he use of investors' money to perpetuate a Ponzi scheme is not the type of 'property' and hence 'value' Congress had in mind when it passed section 548(a)(2)."); McDermott, *supra* note 16, at 168 (1998) ("To analyze the entire set of transfers to an investor, rather than focusing on the profit component, incorrectly assumes that there is something of value in a Ponzi scheme when in fact the whole series of transaction has been a sham.").

[227] *Compare* 11 U.S.C. § 548(c) ("[A] transferee . . . that takes for value and in good faith . . . may retain any interest transferred . . . to the extent that such transferee . . . gave value.") *and* UNIF. FRAUDULENT CONVEYANCE ACT § 3 (1918) (defining fair consideration as requiring "fair equivalent therefore" and exchange is done in "good faith") *with* UNIF. FRAUDULENT CONVEYANCE ACT § 9 (allowing transferee to keep any value given if transfer gave fair consideration—requiring value and good faith—*and* is without knowledge of the debtor's fraudulent purpose).

[228] *See In re* Richardson, 23 B.R. 434, 444 (Bankr. D. Utah 1982) (stating Bankruptcy Code substituted "reasonably equivalent value" for "fair consideration"); *see also* Scott B. Ehrlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 VA. L. REV. 933, 945 (1985) (noting phrase "reasonably equivalent value" replaced "fair consideration" language); Sinclair, *supra* note 125, at 66 (noting Bankruptcy Code of 1978 took "fair consideration" out of constructive-fraud section).

[229] *See* 11 U.S.C. § 548(c); *see also* Peter A. Alces, *Fraud Bases of Bulk Transferee Liability*, 63 TEMP. L. REV. 679, 690 (1990) (noting Bankruptcy Code drafters saw issues with having good faith element in fair consideration calculus, so they dropped fair consideration and moved good faith to savings clause); Sinclair, *supra* note 125, at 66 ("Good faith was moved to [section] 548(c) so that when coupled with 'value,' it became a defense.").

[230] *See* UNIF. FRAUDULENT CONVEYANCE ACT § 3. As mentioned, under the UFCA, a transferee would have to prove lack of knowledge as well as fair consideration to keep the value it exchange for an actual fraudulent transfer. *See id*. at § 9.

and constructive fraud.[231] Therefore, under the Code's fraudulent transfer provisions, a transferee is protected up to the amount of value it gave in good faith in both cases of constructive and actual fraud.[232] This section 548(c) defense should be an important protection to redeeming creditors in a Ponzi scheme bankruptcy.

In a Ponzi scheme bankruptcy, a trustee has a lower burden to prove actual fraud under the Code than under the UFCA.[233] The trustee will only have to prove that it was the subjective intent of the debtor to "hinder, delay or defraud" its creditors according to section 548(a)(1). However, the trustee will have to prevent the transferee from demonstrating that the transferee gave value to the debtor in good faith in order to avoid the transfer because section 548(c) protects a transferee up to the value the transferee gave to the debtor in good faith.[234] Thus, the analysis for determining if a trustee can avoid a transfer under the Code's actual fraud provision, such as a Ponzi scheme, becomes nearly identical to the analysis for recovering under constructive fraud under the UFCA. The transferee's good faith, or lack thereof, will be determinative of whether or not the transferee will be able to keep the value it gave in exchange for the transfer.[235]

Despite the pivotal nature of the term "good faith" in the functioning of section 548(c), Congress did not define that term in the Code.[236] Because of the similarities

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[231] *See* Paul L. Hammann & John C. Murray, *Creditors' Rights Risk: A Title Insurer's Perspective*, 38 J. MARSHALL L. REV. 223, 245 (2004) (stating section 548(c) good faith defense applies to both actual and constructive fraud claims); *see also* Patrick E. Ogle, In re Armstrong: *Gambling with Other People's Money*, 56 ARK. L. REV. 455, 473 (2003) (noting after either actual fraud or constructive fraud is established, good faith defense under section 548(c) is available); Sinclair, *supra* note 125, at 66 (explaining good faith coupled with value is now saving clause for both actual and constructive fraud). Under section 9 of the UFCA a creditor had to show both fair consideration and a lack of knowledge of the debtor's fraud to be protected against an avoidance action under actual fraud. *See* UNIF. FRAUDULENT CONVEYANCE ACT § 9.

[232] *See* McDermott, *supra* note 16, at 176 ("[A]n investor can retain amounts representing a return of his principal investments—but only if the investor can establish that he acted in good faith.").

[233] *See* Terry v. June, 432 F. Supp. 2d 635, 639 (W.D. Va. 2006) ("One can infer intent to defraud future undertakers from the mere fact that the debtor was running a Ponzi scheme."); *see also* Peter S. Kim, *Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying The Stockbroker Defense and The Good Faith Defense*, 2008 COLUM. BUS. L. REV. 657, 674–75 ("Most courts have held that the finding of a Ponzi scheme creates a presumption of actual fraud as a matter of law on all parties and transactions involved . . . this translates to an automatic determination that 'enterprises operating Ponzi schemes are, by definition, insolvent from the start.'"); McDermott, *supra* note 16, at 174–75 (discussing presumption of actual fraud for Ponzi scheme scenarios).

[234] *See* 11 U.S.C. § 548(c); *see also In re* Hill, 342 B.R. 183, 203 (Bankr. D.N.J. 2006) (stating use of section 548(c) defense "requires proof of two elements: 'first, innocence on the part of the transferee, and second, an exchange of value'"); *In re* Lakes States Commodities, 253 B.R. 866, 877–78 (Bankr. N.D. Ill. 2000) ("[A] trustee may recover the full amount paid a Ponzi scheme investor unless the investor can establish . . . that it received payments from the scheme "for value and in good faith.").

[235] *See* Brown v. Third Nat'l Bank (*In re* Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995) ("When a transfer is avoided under [section] 548(a), a transferee who takes for value and in good faith is given a lien to the extent of the value given to the debtor in exchange for the transfer under [section] 548(c)."); *see also In re* Practical Inv. Corp., 95 B.R. 935, 941 (Bankr. E.D. Va. 1989) (retaining deed of trust permitted if deed of trust taken for value and in good faith); McDermott, *supra* note 16, at 176 ("[A]n investor can retain amounts representing a return of his principal investments—but only if the investor can establish that he acted in good faith.").

[236] *See* Jobin v. McKay (*In re* M & L Bus. Mach. Co.) 84 F.3d 1330, 1335 (10th Cir. 1996) (indicating good faith is not defined in Bankruptcy Code); *see also In re Sherman*, 67 F.3d at 1355 (stating good faith is

between the mechanics of the Code and the UFCA, Congress probably intended to adopt the UFCA's existing subjective meaning.[237] Notwithstanding that section 548(c) is a defense to both actual and constructive fraud, the terminology of section 548(c) and fair consideration under the UFCA contain nearly identical requirements, as both require value and good faith.[238]

However, unlike the cases decided under the UFCA, the Code cases construing the term good faith under section 548(c) of the Code have very consistently applied at least a partially objective good faith standard.[239] The majority of Circuit Courts construing good faith under section 548(c) profess that an objective standard determines good faith and examines what the transferee knew or should have known about the debtor's fraudulent purpose at the time of the transfer. The *Bayou* case claimed to follow in the footsteps of these cases and adopted much of the language of the objective standard case law.[240] However, a discussion of the major cases applying the partially objective standard reveals that the cases decided under this standard closely resembles the *Tacoma* line of cases. A factual analysis of the major bankruptcy good faith cases demonstrates that the transferees in each of the major cases decided under the prevailing objective standard used their knowledge of the debtor's fraudulent purpose or insolvency to gain an advantage over other creditors.

D. The Good Faith Standard Under the Bankruptcy Code

The majority of Circuit Courts interpreting good faith have followed a standard closer to the standard that was defined in the *Tacoma* case than the standard applied by *Bayou*. In each of the cases that follow, the courts have professed to use a

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determined case-by-case); *In re Practical Inv. Corp.*, 95 B.R. at 942 (finding good faith at time PIC recorded deed of trust).

[237] *See* Sinclair, *supra* note 125, at 66 (arguing since Congress did not expressly define good faith, courts should apply meaning of term from previous case law). *But see In re* Agretech, 916 F.2d 528, 535–36 (9th Cir. 1990) (stating objective standard is used to determine good faith); *In re* Enron Corp., 340 B.R. 180, 207 n.25 (Bankr. S.D.N.Y. 2006) (determine good faith based on objective standard "rather than examining what the transferee actually knew from a subjective standpoint" (citing *In re M & L Bus. Mach. Co.*, 84 F.3d at 1336)).

[238] *Compare* 11 U.S.C. § 548(c) ("[A] transferee . . . that takes for value and in good faith . . . may retain any interest transferred . . . to the extent that such transferee . . . gave value.") *with* UNIF. FRAUDULENT CONVEYANCE ACT § 3 (1985) (defining fair consideration as requiring "fair equivalent therefore" as well as "good faith"), *and* McDermott, *supra* note 16, at 175–76 (indicating similar language in UFTA, UFCA, and section 548(c)).

[239] *See In re M & L Bus. Mach. Co.*, 84 F.3d at 1338 (stating good faith under section 548(c) should be measured objectively); *see also In re Practical Inv. Corp.*, 95 B.R. at 942–43 (explaining courts definitions of good faith); McDermott, *supra* note 16, at 174–75 (explaining majority of courts have held good faith is established by an objective knowledge standard).

[240] *See generally In re* Bayou Group, LLC, 396 B.R. 810, 843–49 (Bankr. S.D.N.Y. 2008) (providing standard by which *Bayou* court determined good faith).

strictly objective test. However, in each case the courts point to a factor beyond knowledge in order to negate the transferee's good faith. For example, in *In re Agricultural Research and Technology Group, Inc.* (*In re* Agretech),[241] the Ninth Circuit held that a transferee who knew or should have known that the debtor was operating as a Ponzi scheme and coerced a transfer from the debtor by promising to recruit new investors did not take the transfer in good faith.[242] There, the debtor, Agricultural Research and Technology Group, Inc. (hereinafter "Agretech"), was a Ponzi scheme masked as a seed cultivation and germination business. The company's Ponzi scheme was supported by investors who would send Agretech germinated seedlings and an initial cultivation cash advance.[243] In exchange for the seeds and the cash advance, Agretech promised to cultivate the plants and buy the cultivated plants from the investors at a profit on a predetermined date in the future.[244] However, Agretech's predetermined prices far exceeded the actual value of any of the cultivated plants.[245] Agretech set the prices exorbitantly high in order to induce more investors to send the initial cultivation advances, so that it could use those payments to pay off earlier investors.[246]

During the course of the Ponzi scheme, Agretech made two transfers to a limited partnership, Palm Seedlings-A.[247] Originally, Palm Seedlings-A entered into an agreement for the cultivation of $56,000 worth of chamaedora seifrizzi (palm) seedlings.[248] Under the agreement, Palm Seedlings purchased the $56,000 worth of seedlings from a third-party seed broker for Agretech to cultivate and paid Agretech a $40,000 cultivation advance.[249] In return, Agretech agreed to purchase the cultivated palm plants for $225,000.[250] However, due to a series of mishaps, fewer than five percent of the palm seedlings were cultivated. Remarkably, Agretech agreed to pay Palm Seedlings-A, $114,750 more than half of the original predetermined purchase price and well above the $5,200 that the plants were actually worth.[251]

It was later discovered that Palm Seedlings-A's general partner agreed to form a second limited partnership to invest in Agretech in exchange for the transfer.[252] The general partner convinced Agretech that if it made the payment he would be able to convince new investors to invest in a second partnership, which would also invest in Agretech.[253] A second transfer was made under similar conditions after similar

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[241] 916 F.2d 528, 540 (9th Cir. 1990).
[242] *Id.* at 536.
[243] *Id.* at 532.
[244] *Id.*
[245] *Id.*
[246] *Id.*
[247] *Id.* at 532–33.
[248] *Id.* at 532.
[249] *Id.*
[250] *Id.*
[251] *Id.*
[252] *Id.* at 533.
[253] *Id.*

promises of new investment. Soon after, Agretech was revealed to be a Ponzi scheme. In Agretech's subsequent bankruptcy, Agretech's trustee in bankruptcy moved to avoid and collect the Palm Seedling-A transfers.[254]

The Ninth Circuit held that the transfers were made with actual fraudulent intent and that Palm Seedling-A could not successfully assert the section 548(c) defense because the partnership lacked good faith when it took the transfers from Agretech.[255] Although the court admitted that no party had fully briefed the meaning of "good faith," the court posited that good faith must be determined by an objective standard. Therefore, good faith is lacking if a transferee "knew or should have known" that the debtor was operating a Ponzi scheme.[256] The question of a transferee's good faith was not decided by the transferee's claims of subjective good faith.[257] However, the court did not clearly define what objective facts would be sufficient to impute knowledge that the transferor was operating a Ponzi scheme on a transferee.[258] Further, the court only briefly mentioned that one other court believed that inquiry notice should be the standard for determining good faith.[259] However, the court did not apply an inquiry notice standard or require an investigation based on suspicious facts.[260]

Rather, the Ninth Circuit relied on the egregious facts of the *Agretech* case instead of defining a clear standard for determining good faith under section 548(c).[261] The interplay of two factors provided the basis for the finding that Palm Seedlings-A lacked good faith. The first factor was that Palm Seedlings-A received a "grossly" and disproportionately high payout as compared to the actual value of the plants successfully cultivated.[262] This overpayment was "highly probative" of good faith because it should have alerted Palm Seedlings-A that Agretech was running a Ponzi scheme.[263] The second factor was that Palm Seedlings-A's general partner enticed the transfers by promising Agretech that the payments would entice new investors.[264] In fact, the court suggested promises made by Palm Seedlings-A's general partner were indicative that the general partner was participating in the fraud, not just that he had knowledge of it.[265]

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[254] *Id.* at 531.
[255] *Id.* at 535, 539.
[256] *Id.* at 535–36.
[257] *Id.* at 536.
[258] *Id.* at 534–35 (discussing how different courts have approached issue of fraudulent intent).
[259] *Id.* at 536.
[260] *Id.* (noting at least one court has required notice and investigation).
[261] *Id.* ("Courts have been candid in acknowledging that good faith 'is not susceptible of precise definition.'" (quoting *In re* Roco Corp., 701 F.2d 978, 984 (1st Cir. 1983))). The court continued by explaining that in this case it did not need to formulate a precise definition because the facts of the case show that Palm Seedlings-A did not perform in good faith. *In re Agretech*, 916 F.2d at 536.
[262] *Id.* at 539.
[263] *Id.*
[264] *Id.* This would also suggest that the general partner and Agretech were not making an arm's length bargain. Rather, the general partner was seeking to use his knowledge of Agretech's fraud for a profit.
[265] *Id.* ("Indeed, Grant's statement regarding new investment, coupled with the disproportionate exchange of value, is a strong indication that Grant not only knew of the fraud, but was an active participant in it as well.").

Thus, the Ninth Circuit standard in *Agretech* does not define good faith as narrowly as suggested by *Bayou*. On its face, the *Agretech* standard appears extremely objective. Yet, like the court in *Tacoma*, the *Agretech* court did not base its decision solely on the objective facts that the transferee knew about the debtor's intent. Rather, the *Agretech* court applied traditional notions of fraud, such as actions by the transferee that suggest a trust between the transferee and the debtor, as objective evidence of the transferee's lack of subjective good faith.[266] The *Agretech* court considered the transferee's knowledge of the debtor's fraudulent intent as a factor in determining that the transferee lacked good faith but did not place determinative weight on knowledge. Rather, the court combined the evidence of knowledge with the transferee's continued reinvestment in the company and the transferee's active attempts to induce new investors into the fraud in exchange for payments from the Ponzi scheme to determine that the transferee lacked good faith. This analysis suggests that the court applied a subjective analysis of the transferee's good faith despite espousing an erroneous objective standard. Essentially, the transferee used his knowledge to gain an advantage over Agretech's other investors by coercing grossly high returns in exchange for recruiting new investors, which is why the transferee could not establish good faith.

Similarly, in *In re M & L Business Machine Co.*,[267] the Tenth Circuit adopted a standard for good faith with highly objective language but also used traditional indicators of fraud to determine that a transferee lacked good faith.[268] There, the debtor, M & L Business Machine Co. ("M & L"), was a Ponzi scheme, masked as a computer leasing business.[269] The transferee, McKay, invested with M & L on four separate occasions between June 19, 1990 and September 10, 2009.[270] For these investments, M & L promised McKay that he would receive at least a nine percent weekly return, which was far above the market rate.[271] In total, McKay received a total of $43,500 dollars from the Ponzi scheme before M & L's October 1, 1990, bankruptcy filing. The trustee sought to recover these transfers as fraudulent transfers claiming that the debtor made the payments with an actual intent to defraud its creditors and that McKay did not take these payments in good faith.[272]

The Tenth Circuit first held that good faith must be measured, at least in part, objectively.[273] In making this determination, the court aptly observed that even cases cited for determining good faith under a subjective standard used some objective factors to determine a transferee's subjective good faith.[274] Under this

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[266] *Id.* Here, Coke's language of a trust being the marker of fraud is particularly apt. *See supra* note 127.
[267] 84 F.3d 1330 (10th Cir. 1996).
[268] *Id.* at 1338–39 (listing as factors demonstrating transferee's lack of good faith: returns greatly exceeding market rate, both questionable explanation by company officials regarding how company could pay these exorbitant rates and transferee's investment sophistication).
[269] *Id.* at 1332.
[270] *Id.*
[271] *Id.*
[272] *Id.* at 1331–32.
[273] *Id.* at 1338.
[274] *Id.* at 1337.

reasoning, there is always an objective component for finding a transferee's subjective mindset.[275] Surprisingly, the court adopted a wholly objective inquiry notice standard for good faith.[276] The court misquoted the *Agretech* holding by stating "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."[277] Ultimately, the court stated that the standard for good faith is whether a reasonably prudent investor in the transferee's position should have known about the debtor's insolvency or fraudulent intent.[278]

However, despite purporting to apply this strict objective standard, the court's decision was based on extremely traditional indicators of bad faith. The decision primarily focused on the unreasonably high return that the transferee was receiving on his investment.[279] The court explained that, as an experienced investor, McKay should have realized that returns of 120% per year on one of his investments and 468% on two other investments were too high.[280] Since these returns were so shockingly above the market rate, McKay should have realized that something was wrong.[281] Additionally, there were other objective factors that should have given McKay knowledge that M & L was a fraud.[282] The court explained that as soon as McKay made his investment he received postdated checks, which is a classic sign of fraud.[283] The first check McKay received from M&L bounced, which should have put McKay on notice of the company's financial troubles.[284] McKay also discovered that the business professor, who induced him to invest, received commissions for recruiting investors.[285] Even after becoming aware of these indications that M & L was a fraud, McKay continued to leave his money invested, collect interest payments, and reinvest in the company.[286] The only explanation for McKay, a sophisticated investor, to continue to invest was that he was attempting to

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[275] *See id.* at 1338; *see also* Eisenberg v. Flaten (*In re* Allied Dev. Corp.), 435 F.2d 372, 375 (7th Cir. 1970) (noting objective component, coupled with subjective evidence, established lack of good faith intent); Gilmer v. Woodson (*In re* Decker), 332 F.2d 541, 547 (4th Cir. 1964) (considering several objective factors to determine transferee's subjective intent).

[276] *In re M & L Bus. Mach. Co.*, 84 F.3d at 1338.

[277] *Id.* (quoting *In re* M & L Bus. Mach. Co., 164 B.R. 657, 661 (D. Colo. 1994)) (emphasis omitted). *Compare In re* Agretech, 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.") (first emphasis added) *with In re M & L Bus. Mach. Co.*, 84 F.3d at 1338 (stating affirmatively *Agretech* adopted inquiry notice standard).

[278] *In re M & L Bus. Mach. Co.*, 84 F.3d. at 1339.

[279] *Id.* at 1338–39.

[280] *Id.* at 1339.

[281] *Id.*

[282] *Id.*

[283] *Id.*

[284] *Id.* at 1338–39 (concluding McKay failed to meet his burden showing good faith).

[285] *Id.* (listing commission as factor in objective good faith test).

[286] *Id.* at 1339 (holding reasonable prudent investor should have understood fraudulent intent due to circumstances).

profit from the company's fraud at the expense of other creditors. Thus, the court could have established that McKay lacked not only objective, but also subjective good faith because McKay could not have honestly believed in the propriety of the transactions given his knowledge and the excessive returns he was seeking.

Considering the facts and circumstances of *Agretech* and *M & L Business Machine*, it becomes apparent that the courts in those cases considered more than the transferee's knowledge or constructive knowledge of the debtors fraud when deciding that they lacked good faith. In *Agretech* and *M & L Business Machine*, both the Ninth and Tenth Circuits defined a strict objective test for determining good faith. Both courts held that a transferee who knew or should have known of the debtor's insolvency or fraudulent intent could not establish good faith.[287] However, both *Agretech* and *M & L Business Machine* involved transferees who used their knowledge to take advantage of the debtor's other creditors by seeking to increase their gains from the debtor. In *Agretech*, the transferee used his knowledge to induce a large payment from the Ponzi scheme in exchange for the promise of recruiting new investors.[288] In *M & L Business Machine*, the transferee, who was an experienced investor, blindly ignored obvious warning signs that the company was a fraud and continued to reinvest, helping the company to continue to defraud its investors.[289] Thus, the *Agretech* and *M & L Business Machine* cases closely resemble the *Tacoma* case, where the court defined an objective standard, but based its decision not on the transferee's knowledge, but the acts of the transferee after it acquired its knowledge.

Another illustrative example of how courts combine the transferee's notice with the transferee's actions after receiving notice to determine the transferee's good faith is *Brown v. Third National Bank* (In re *Sherman*).[290] Although *Sherman* did not involve a Ponzi scheme, *Sherman* is a seminal case on the meaning of good faith and is a clear example of how courts profess to use a completely objective notice standard, but actually combine this notice with a transferee's actions to establish the subjective fault of the transferee. There, the debtors, Larry and Karen Sherman, transferred twelve properties to J.D. Sherman, Larry Sherman's father.[291] Before transferring the properties, the Sherman's had experienced a variety of financial difficulties.[292] The Sherman's had fallen behind on their payments to Benson, their main supplier of material.[293] Benson had commenced a lawsuit against the Sherman's for $37,000 in Missouri state court.[294] Also, the Sherman's had fallen

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[287] *See id.* at 1336 (citing Richards v. Platte Valley Bank, 866 F.2d 1576, 1583 (10th Cir. 1989)) (noting existence of objective component to good faith); *see also In re* Agretech, 916 F.2d 528, 539 (9th Cir. 1990) ("[A]ppellants carry the burden of demonstrating their objective good faith at trial.") (emphasis omitted).

[288] *See In re Agretech*, 916 F.2d at 539 (noting transferee an "active participant" in Ponzi scheme).

[289] *See In re M & L Bus. Mach. Co.*, 84 F.3d at 1338–39 (listing instances where transferee turned a blind eye).

[290] 67 F.3d 1348 (8th Cir. 1995).

[291] *Id.* at 1352 (noting bank provided financing for these properties).

[292] *Id.* at 1351 (discussing debtors' multiple financial problems).

[293] *Id.* at 1352.

[294] *Id.*

behind on their mortgage payments and were facing foreclosure on all 12 properties. The Eighth Circuit held that because J.D. Sherman knew of these facts, he did not give value in good faith for the properties.[295]

However, the Eighth Circuit did not end its good faith analysis when it determined that J.D. Sherman had notice or knowledge of his son and daughter-in-law's financial troubles.[296] Rather, the court buttressed its reasoning by demonstrating that J.D. Sherman used his knowledge to gain a bargaining advantage over the debtors.[297] The court explained that J.D. Sherman bought the properties at a deep discount.[298] Although the debtors held significant equity in the properties, J.D. Sherman only paid the amount of the mortgages securing the properties.[299] This allowed J.D. Sherman to receive the properties while Benson would receive nothing from the insolvent debtors because the properties were the Shermans' only assets.[300] Thus, J.D. Sherman's good faith was not negated by knowledge alone. Rather, J.D. Sherman's use of his knowledge to prevent the debtors from bargaining at arm's length was an essential factor in the court's decision to hold that J.D. Sherman lacked good faith.

Like *Agretech* and *M & L Business Machines*, *Sherman* demonstrates that even in the objective standard cases, knowledge is not the pivotal factor in the good faith analysis. In each of these cases, objective evidence of the transferees' notice or knowledge of the debtors' fraud or insolvency merely should have been evidence used by the courts to determine that the transferees' subjective intent was to harm other creditors or take advantage of the debtor. Thus, in each of these cases, the good faith standard is not wholly objective or based solely on notice, rather the standard is subjective and good faith is ultimately negated only by the transferee's fault. Further, in those cases good faith is negated because with the knowledge the transferees had it would be impossible to believe that the profits or bargains the transferees were receiving were not the result of fraud.

In contrast, *Bayou* completely abandons any subjective analysis of the transferee's intent or fault. The facts of *Bayou* are much more analogous to *Boston Trading*, *Sharp* and *English v. Brown* than *Agretech*, *M & L Business Machines* and *Sherman* or *Tacoma*. Like the transferees in *Boston Trading*, *Sharp* and *English v. Brown*, the *Bayou* investors never used their knowledge to seek profit, induce others to invest, or take unfair advantage of the debtor's other creditors.[301] Rather, the *Bayou* investors merely sought payment of a debt that they honestly believed was owed to them by the Bayou Fund. The *Bayou* court fully recognized that the

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[295] *Id.* at 1355–56 (holding Sherman on "inquiry notice" of debtors' insolvency).
[296] *Id.* at 1355.
[297] *Id.* at 1355–56.
[298] *Id.* at 1356 (noting Shermans' purchased property for $64,000 less than appraisal value).
[299] *Id.*
[300] *Id.* at 1355–56.
[301] *See In re* Bayou Group, LLC, 396 B.R. 810, 848 (Bankr. S.D.N.Y. 2008) (holding good faith does not depend on mala fides); *see also supra* Part II.

investors' actions were not improper.[302] Yet, the *Bayou* court placed determinative weight on the transferees' knowledge of "red flags" and notice of potential infirmities in the investments. Because the *Bayou* court ignored the facts and circumstances that led the *Agretech*, *M & L Business Machine*, *Sherman* and *Tacoma* courts to hold that the transferees in those cases lacked good faith, mainly the transferees bad faith acts, the *Bayou* case stands alone in its reasoning to avoid its investor's redemption payments.

IV. DOES STATUTORY INTERPRETATION SUPPORT THE BAYOU DECISION?

Neither the Bankruptcy Code nor the legislative history of the Code defines the term "good faith." Therefore, the meaning of "good faith" is a matter of statutory interpretation. As discussed in Part III of this Note, there was a preexisting judicial interpretation of the meaning of "good faith" under the fraudulent conveyance laws. The lack of a clear definition under the Code indicates that Congress did not intend to replace the pre-existing meaning and role of "good faith."[303] This Note contends that *Bayou* took a substantially different interpretation than any pre-Code cases. *Bayou* is also not reconcilable with the Circuit Court decisions interpreting the meaning of good faith in the Code. Further, the *Bayou* court's interpretation of good faith cannot be squared with meanings that would be rendered by other major tools of statutory interpretation.

First, the *Bayou* court's interpretation of good faith is in conflict with the well-established understanding of good faith in commercial law at the time of the drafting of the Code. The major piece of commercial legislation in affect at the time of the drafting of the Code was the Uniform Commercial Code (hereinafter "UCC"). "Good faith" is a term used in many provisions of the UCC.[304] The UCC standard for "good faith" in nearly every one of its articles was subjective in 1978 when the Bankruptcy Code was enacted and in section 1-201 the 1978 UCC defined good faith as honesty in fact.[305]

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[302] *See In re Bayou Group, LLC*, 396 B.R. at 849–50 (explaining investors were unknowing and could prove good faith); *see also supra* Part II.

[303] *See* Field v. Mans, 516 U.S. 59, 69 (1995) (stating where Congress includes term with settled common law meaning, that meaning is intended unless further statutory definition is provided) (citations omitted); *see also In re* Consol. Capital Equities Corp., 175 B.R. 629, 637 (Bankr. N.D. Tex. 1994) (noting "good faith" not defined in Bankruptcy Code implying Congress intended interpretation on case-by-case basis); David A. Roby Jr., *Municipal Bankruptcy: Will Labor be Forced to take the Proverbial Haircut?*, 26 GA. L. REV. 959, 978–79 (1992) (stating "good faith" is never clearly defined in Bankruptcy Code).

[304] *See* E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 667 (1963) (noting about fifty of UCC's 400 sections contain good faith requirement); *see, e.g.*, U.C.C. § 2-306(1) (2003) (necessitating good faith in output requirements); *see also* U.C.C. § 2-311(1) (requiring sale conducted in good faith).

[305] *See* Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 812–14 (1958) (explaining good faith in UCC was defined subjectively). However, good faith did contain an objective component in article 2 of the UCC. And, in the early 1990s, the UCC was updated with a definition of good faith that contained an objective component. *See* Bryan D. Hull & Aalok Sharma, *Satisfaction Not Guaranteed: California's Conflicting Law on the Use of Accord and Satisfaction Checks*, 33 LOY. LA L. REV. 1, 25 n.172 (1999) (stating article 3 of UCC has both subjective and objective components

Second, the term "good faith" is used in many other sections of the Code. Most prominently, section 550(b)(1) of the Code grants a subsequent transferee protection from a trustee's avoidance powers.[306] Comparison of the language of section 550(b)(1) of the Code and the language of section 3-304 of the UCC makes clear that "good faith" under the Code should take a definition that does not include knowledge.

Third, section 547 of the Code allows a trustee to avoid transfers made within ninety days of the petition as preferences, without consideration to the debtor's intent or the transferee's good faith.[307] By comparing section 547 with section 548 it becomes clear that the purpose of fraudulent transfer law is based on fault, despite the *Bayou* courts contention to the opposite, and preference law is based equity among creditors.

Applying well-established tools of statutory interpretation reveals two things about the Code case law interpreting good faith. First, if *Agretech*, *M & L Business Machine*, and *Tacoma* line of cases are actually applying a strict objective standard, those cases are wrong. However, if those courts are instead applying a subjective standard and using each defendant's knowledge or notice as evidence that combined with the transferees' actions to take advantage over other creditors, those case can be reconciled with the meanings of good faith suggested by statutory interpretation. Second, the *Bayou* decision's reliance on inquiry notice to determine good faith cannot be reconciled with any meaning of good faith suggested by statutory interpretation of good faith.

A. The Definition of Good Faith in the Uniform Commercial Code

Unlike the legislative history of the Code, the legislative history of the UCC contains an ample discussion of the meaning of the term "good faith."[308] The original drafts of the UCC that circulated in the late 1940's and early 1950's defined good faith as "honesty in fact and the observance of reasonable commercial standards."[309] Under this definition, good faith would be determined by a mixed

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of good faith definition); *see also* Kathleen Patchel & Boris Auerbach, *The Article I Revision Process*, 54 SMU L. REV. 603, 607–08 (2001) (noting addition of objective element to good faith definition as significant change to UCC).

[306] *See* 11 U.S.C. 550(b)(1) (2006) (allowing subsequent transferee "that takes for value . . . in good faith, and without knowledge of the voidability of the transfer avoided" to keep the value of such transfer).

[307] *See* 11 U.S.C. § 547(b)(4)(A) (directing preferential transfer must have been made "on or within 90 days before the date of the filing").

[308] *See generally* Braucher, *supra* note 305, at 812–14 (describing legislative history of good faith requirement in UCC).

[309] *See* Braucher, *supra* note 305, at 812; *see also* Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 3 (1973); U.C.C. § 1-201(20) ("[M]eans honesty in fact and the observance of reasonable commercial standards of fair dealing.").

objective and subjective test.[310] In fact, Pennsylvania, the first state to enact a version of the UCC, actually enacted a version of the statute with this more objective definition of good faith.[311] However, the banking lobby was concerned that an obligation of good faith that contained an objective component would discourage the exchange of negotiable instruments.[312] In the final version of the UCC, section 1-201 defined good faith only as "honesty in fact."[313] Good faith under the UCC had a wholly subjective meaning.[314]

The debates over the meaning of good faith centered on the UCC's regulation of negotiable instruments in article three.[315] Specifically, article three's holder in due course provisions were hotly debated.[316] Under the UCC, a buyer of negotiable instruments that is a holder in due course is protected against any defenses the original obligor on a note might be able to assert.[317] Under UCC § 3-302(1), a purchaser is a holder in due course if it can show three elements: (1) it gave value; (2) in good faith; and (3) without notice of a claim or defense.[318] The banking lobby was worried that if good faith retained an objective component that buyer of notes, specifically banks, might be forced make greater inquiries into the underlying bona fides of the notes being purchased and the businesses being funded.[319] As Professor

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[310] *See* Braucher, *supra* note 305, at 812 (viewing current UCC as subjective test); *see also* Countryman, *supra* note 309, at 3 (discussing movement of good faith from objective to subjective); Neil O. Littlefield, *Good Faith Purchase of Consumer Paper: the Failure of the Subjective Test*, 39 S. CAL. L. REV. 48, 56–59 (1966) (stating 1949 version of the UCC included reasonable commercial standards, an objective test).

[311] *See* First Nat'l Bank of Philadelphia v. Anderson, 7 Pa. D. & C.2d 661, 663 (Pa. Com. Pl. 1956) (having good faith include "observance of the reasonable commercial standards"); *see also* Braucher, *supra* note 305, at 798 (mentioning Pennsylvania adopted UCC in April 1953); Richard E. Speidel, *Introduction to Symposium on Proposed Revised Article 2*, 54 S.M.U. L. REV. 787, 788 (2001) (stating 1949 was first draft of UCC, and it was first enacted by Pennsylvania).

[312] *See* Braucher, *supra* note 305, at 812 (mentioning ABA's objection to original definition of good faith as ambiguous and overly broad); Countryman, *supra* note 309, at 3 (showing financing institutions did not want good faith to require reasonable commercial standards of any business or trade); Littlefield, *supra* note 310, at 56 (stating the banking industry strongly opposed the original good faith requirment).

[313] U.C.C. § 1-201 (1957). As mentioned above, the definition of good faith was changed in the early nineties to incorporate an objective component.

[314] *See* Braucher, *supra* note 305, at 812 (defining good faith as honesty in fact); *see also* Countryman, *supra* note 309, at 3 (showing at one point good faith was wholly subjective test of honesty in fact); Littlefield, *supra* note 310, at 57 (discussing good faith was subjective only in 1962).

[315] *See* Braucher, *supra* note 305, at 812–14 (showing good faith was inserted in several places of article 3, as well as other articles of the UCC); *cf.* U.C.C. § 3-302(a)(2) (2002) (requiring good faith for holder of an instrument); U.C.C. § 3-406 (2002) ("A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, ***in good faith***, pays the instrument or takes it for value or for collection.") (emphasis added).

[316] *See* Braucher, *supra* note 305, at 812–13. *Compare* U.C.C. § 3-302 (1957) ("[I]n good faith including the observance of the reasonable commercial standards of any business in which the holder may be engaged."), *with* U.C.C. § 3-302(a)(2) (2002) ("[T]he holder took the instrument . . . (ii) in good faith . . . .").

[317] *See* U.C.C. § 3-302 (2002); *see also* Countryman, *supra* note 309, at 3 (claiming consumer must either disqualify financer or impeach any testimony financer took instrument without notice of defense).

[318] U.C.C. § 3-302 (2002).

[319] *See* Frederick K. Beutel, *The Proposed Uniform Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 341 (1952) (claiming in 1950's, good faith requirement in UCC was different for bankers than for individuals); *see also* Countryman, *supra* note 309, at 3 (believing courts might construe good faith to

Vern Countryman sarcastically described the events leading to the rejection of the objective standard, "[F]inancing institutions quickly realized, courts might have construed that phrase to require the exercise of some reasonable discretion about the responsibility of the merchants financed." [320] Afraid that the extra diligence would produce unwarranted costs, the banking lobby fought to ensure there would be a purely subjective standard.[321]

The operation of good faith in the holder in due course case law reflects the subjective standard demanded by the banking lobby. Courts and law reviews alike have recognized that the standard for determining whether a buyer of notes is a holder in due course has been "a pure heart and an empty head."[322] Under the UCC, notice and good faith were separately defined.[323] Notice was defined as actual knowledge, notification, or reason to know that some fact exists.[324] Under that requirement, if a purchaser of notes has not acquired actual notice of a defense, the obligor of a note has no recourse.[325] Further, an obligor has not satisfied its burden to demonstrate that a buyer has notice of a defense simply by presenting evidence of the problems with the original grantor of the notes.[326] Rather, an obligor must be

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require exercise of reasonable discretion for financed merchants); Edward Rubin¸ *Efficiency, Equity, and the Proposed Revision of Articles 3 and 4*, 42 ALA. L. REV. 551, 554 (1991) ("[U]nder some pressure from the banking interests, to which [the American Law Institute] responded by shifting liability to customers in certain cases, and expanding the role of negotiability.").

[320] *See* Countryman, *supra* note 309, at 3.

[321] *See* Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L. REV. 299, 310 n.70 (2006) (citing William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 537 (1992)); *see also* Countryman, *supra* note 309, at 3; S. Scott Luton, *The Ebb and Flow of Section 10(B) Jurisprudence: An Analysis of Central Bank*, 17 U. ARK. LITTLE ROCK L. REV. 45, 89 (1994) ("Instead of abrogating excessive and vexatious litigation, the reasonable diligence standard is sure to initiate even more litigation.").

[322] *See* Gill v. Cubitt, (1824) 107 Eng. Rep. 808 (defining standard for good faith in purchase of as "pure heart and empty head"); *see also* Braucher, *supra* note 305, at 812; Countryman, *supra* note 309, at 3.

[323] *See* U.C.C. §§ 1-201(19), (25) (1978).

[324] *See* U.C.C. § 1-201(25) (2005):

> "A person has "notice of a fact when
> (a) he has actual knowledge of it; or
> (b) he has received a notice or notification of it; or
> (c) from al the facts and circumstances known to him at the time question he has reason to know that it exists."

[325] *See* Frequency Elec., Inc. v. Nat'l Radio Co., 422 F. Supp. 609, 612 (S.D.N.Y. 1975) (stating party had not "sustained his burden of showing that he had no notice of the defense of failure of consideration at the time the note was negotiated to him in April, 1970"); *see also* Countryman, *supra* note 309, at 3; Sarah Howard Jenkins, *A Payee Who is a Holder in Due Course May Be Subject to Personal Defense Arising From Unauthorized Acts or Promises by an Agent*, 9 ST. LOUIS U. PUB. L. REV. 191, 221 (1990) ("As a general rule, a principal's knowledge may be affected by the agent's knowledge at the time the agent engages in a transaction.").

[326] *See* Countryman, *supra* note 309, at 3; *see also* Stewart P. Greene, *Affirmative Recovery Against Assignees Under Section 9-318(1)(a) of the Uniform Commercial Code*, 51 GEO. WASH. L. REV. 465, 471 (1983) ("[I]n most instances an assignee's notice of fraud must be proved for an obligor to recover."); *cf.*

able to show the buyer had notice of facts and circumstances from which the buyer should know that there was a defense to defeat the holder in due course defense.[327] Thus, the notice requirement of UCC § 3-302 requires an "empty head."

Because the plain reading of UCC § 3-302(1) suggests that "good faith" and "with notice of a claim or defense" are two separate requirements of being a holder in due course, good faith must only require a buyer to have a "pure heart." As discussed above, good faith was defined in UCC § 1-201 as "honesty in fact." Thus, courts have found that a buyer could have acted in good faith under a subjective standard but not have acted without notice of a defense.[328] A buyer of notes must only act with honestly in fact - "with a pure heart" - in order to satisfy the good faith requirement of section 3-302. This demonstrates that throughout the UCC in its form in 1978, with the exception of article two where good faith is defined with an objective component, good faith triggered a subjective analysis. The good faith analysis was not based on notice or knowledge because notice was a separate consideration in UCC § 3-302. This definition should be applied to good faith throughout the Code.

The UCC was the prominent piece of commercial legislation in effect during the drafting of the Code and is strong evidence that Congress intended good faith to have a subjective definition in the Code. Although *Bayou* argues that good faith should not take the layman's definition of good faith or the version of good faith accepted in other forms of law, there is a long history of bankruptcy courts looking to state law to fill gaps left by Congress. For example, in *Butner v. United States* the Supreme Court held that because Congress did not exercise its power to define secured creditor's rights in rents from properties used to secure debts that state laws should apply.[329] Although *Butner* is a pre-Code case, it demonstrates that courts of the highest level have looked to state law to fill gaps in Congress's bankruptcy laws and that the *Bayou* court erred by not looking to state law to attempt to define good faith.

Further, there is a long history of bankruptcy courts looking to UCC to define terms left undefined in the Code. After the enactment of the Code, courts used the

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James A. Stuckey, *Louisiana's Non-Uniform Variations in U.C.C. Chapter 9*, 62 LA. L. REV. 793, 870 (2002) (discussing burden of proof on obligors under U.C.C. Article 9).

[327] *See* Edward Petry Co. v. Greater Huntington Radio Corp., 245 F. Supp. 963, 968 (S.D. W. Va. 1965) (stating acceptance of novation can be determined based on "facts and circumstances" deduced from transaction and parties' later conduct); *see also* Countryman, *supra* note 309, at 3; Jenkins, *supra* note 325, at 220–21 ("A holder in due course is one who takes an instrument without notice that any person may have a defense against the instrument or a claim of ownership to it.").

[328] *See* Martin Marietta Corp v. New Jersey Nat'l Bank, 612 F.2d 745, 751 (3d Cir. 1979) (discussing good faith of buyer under subjective standard); *see also* Bowling Green, Inc. v. State St. Bank and Trust Co., 425 F.2d 81, 85 (1st Cir. 1970) (applying U.C.C. provisions related to holder in due course who takes instrument in good faith under subjective standard but without notice); Andrea G. Nadel, Annotation, *What Constitutes Taking Instrument in Good Faith, and Without Notice of Infirmities or Defenses to Support Holder-in-Due-Course Status, Under UCC § 3-302*, 36 A.L.R. 4th 212 (1985) ("[T]here are occasions in which the courts have found a purchaser to have acted in good faith in the taking of the instrument but not without notice of defense.").

[329] 440 U.S. 48, 54 (1979).

UCC to define security interests and define the trustee's strong-arm powers.[330] Throughout the history of the Code, the UCC has been consulted to define the term Purchase Money Security Interest ("PMSI"). The term PMSI was used in sections 522(f) and 1110 but was not expressly defined in the Code.[331] Judges turned to the UCC to define the term.[332] More recently, courts have turned to the UCC to determine whether negative equity can be included in a PMSI under the hanging paragraph enacted in 2005.[333] The *Bayou* court ignores this long-standing tradition of courts looking to state law when Congress leaves a term of art undefined.[334]

B. The Separation of Good Faith and Knowledge in Section 550(b) and its relation to the use of Good Faith Throughout the Code

Section 550(b)(1) protects a subsequent transferee who receives transferred property for value from the original transferee of a transfer that is avoidable under any of the avoidance provisions of the Code.[335] This section bars a trustee from recovering the proceeds of a transfer avoided under several sections of the Code, including section 548, from a subsequent transferee if the subsequent transferee can meet three requirements.[336] To qualify for this defense, a subsequent transferee must prove that it: (1) gave value in exchange for the transfer; (2) in good faith; and, (3)

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[330] *See* Triad Int'l Maint. Corp. v. S. Air Transp., Inc. (*In re* S. Air Transp., Inc.), 511 F.3d 526, 531–32 (6th Cir. 2007); *see also In re* Waner Corp., 146 B.R. 973, 979 (Bankr. N.D. Ill. 1992) (using UCC § 9-312 to explain both terms); Dienna Ching, *Does Negative Equity Negate the Hanging Paragraph?*, 16 AM. BANKR. INST. L. REV. 463, 471 (2008) (discussing use of UCC to define terms in Bankruptcy Code).

[331] *See* Reiber v. GMAC, LLC (*In re* Peaslee), 585 F.3d 53, 56 (2d Cir. 2009) ("A PMSI is not defined in the hanging paragraph or elsewhere in the federal Bankruptcy Code."); *see also* Ford Motor Credit Co. v. Mierkowski (*In re* Mierkowski), 580 F.3d 740, 742 (8th Cir. 2009) ("PMSI is not defined in the Bankruptcy Code."); Ching, *supra* note 330, at 471.

[332] *See In re* Gayhart, 33 B.R. 699, 700 n.1 (Bankr. N.D. Ill. 1983) (using UCC to define PMSI); *see also, e.g.*, *In re* Vega, 344 B.R. 616, 622 (Bankr. D. Kan. 2006) (employing UCC's definition of PMSI after finding PMSI definition is controlled by state law); Ching, *supra* note 330, at 470–472 (illustrating how UCC is appropriate to define PMSI).

[333] *See* Graupner v. Nuvell Credit Corp. (*In re* Graupner), 537 F.3d 1295, 1301–02 (11th Cir. 2008) (determining whether Georgia state law included negative equity under PMSI using the hanging paragraph); *see also In re* Ford, 387 B.R. 827, 831 (Bankr. D. Kan. 2008) (employing Kansas state law to determine whether negative equity falls within PMSI definition); Ching, *supra* note 330, at 471 (noting courts looking to determine whether negative equity is part of purchase price "look to other state statutes to supplement the U.C.C. definition").

[334] *See Butner*, 440 U.S. at 54–55 (advocating use of state law when issue is unaddressed by Code); *see also In re* Muldrew, 396 B.R. 915, 923–24 (E.D. Mich. 2008) (using definition of PMSI found in state law in bankruptcy case because Bankruptcy Code contains no official definition); Jean Braucher, *A Guide to Interpretation of the 2005 Bankruptcy Law*, 16 AM. BANKR. INST. L. REV. 349, 409 (2008) (arguing best practice to define undefined terms in Bankruptcy Code is to use UCC).

[335] 11 U.S.C. § 550(b)(1) (2006).

[336] *See, e.g.*, Woods & Erickson, LLP v. Leonard (*In re* AVI, Inc.), 389 B.R. 721, 736 (B.A.P. 9th Cir. 2008) (stating section 550(b)(1) provides "safe harbor" to transferees acting in good faith); *In re* Cahillane , 408 B.R. 175, 208 (Bankr. N.D. Ind. 2009) (discussing good faith transferee defense under section 550(b)); *In re* Sawran, 359 B.R. 348, 354 (Bankr. S.D. Fla. 2007) (stating trustee's right to recover limited where transferee takes for value without knowledge).

without knowledge of the voidability of the initial transfer.[337] The inclusion of this provision in the Code shows that Congress did not intend for good faith to be a determined by a notice standard.

First, the legislative history of section 550(b) provides one of the only clues as to the intended meaning of good faith in the Code. The committee reports for both the House and Senate state that the inclusion of good faith in section 550(b) is intended to prevent an immediate transfer from "'washing' the transaction through an innocent third party."[338] Congress worried that immediate transferees would attempt to gain the protections of 550(b)(1) by first transferring the property to another transferee and then having that transferee retransfer the property back to them.[339] This purpose suggests that the good faith requirement was included in this section to prevent a subsequent transferee from participating in a scheme with an immediate transferee so that the immediate transferee may shelter ill-gotten gains from recovery. Thus, the good faith requirement seeks to prevent a transferee from using its knowledge to defraud other creditors not merely from refraining acting on knowledge in all circumstances. And, this legislative history unequivocally evidences that Congress intend good faith requirements to avoid transfers between debtors and transferees working together to prejudice other creditors.

Second, a plain reading of section 550(b) suggests that "good faith" is distinct from knowledge. Congress would not have included a knowledge requirement in section 550(b)(1) if it understood good faith to incorporate a knowledge component.[340] Further, good faith cannot be a lower standard than knowledge, such as constructive knowledge or inquiry notice, because then the good faith requirement would make the knowledge requirement redundant. For example, *Bayou* adopts a standard of inquiry notice that bases the determination of good faith on whether the transferee was aware of facts that merely raise suspicions of the debtor's insolvency or fraudulent purpose.[341] However, application of this good faith standard to 550(b)(1) would completely eliminate the knowledge requirement.[342]

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[337] *See, e.g.*, *In re AVI, Inc*., 389 B.R. at 736 (listing three requirements to qualify for good faith defense); *In re Cahillane* , 408 B.R. at 208 (stating three criteria for good faith defense); *In re Sawran*, 359 B.R. at 354 (announcing three requirements for good faith defense).

[338] H.R. REP. NO. 95-595, at 376 (1977); S. REP. NO. 95-989, at 90 (1978).

[339] *Id.* at 90 ("The phrase 'good faith' in this paragraph is intended to prevent a transferee from whom the trustee could recover from transferring the recoverable property to an innocent transferee and receiving a retransfer from him; that is, 'washing' the transaction through an innocent third party. In order for the transferee to be excepted from liability under this paragraph, he, himself, must be a good-faith transferee.").

[340] *See, e.g.*, Hartford Underwriters Ins. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000) ("Congress 'says in a statute and means in a statute what it says there.'" (quoting from Connecticut Nat. Bank v. Germain, 503 U. S. 249, 254 (1992))); United States v. Ron Pair Enter., Inc., 489 U. S. 235, 241 (1989) (stating Congress's use of language to convey availability of post petition interest is sufficiently precise not to require inquiry into history and pre-Code practices); *see also* Sinclair, *supra* note 16, at 80 (arguing "good faith" is distinct from knowledge).

[341] *See In re* Bayou Group, LLC, 396 B.R. 810, 823 (Bankr. S.D.N.Y. 2008) (adopting inquiry notice standard for determining good faith).

[342] *See, e.g.*, Boston Trading Group Inc. v. Burnazos, 835 F.2d 1504, 1509, 1512 (1st Cir. 1988) ("The basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them . . . . Whatever 'good faith' may mean, however,

Clearly, under the plain language of section 550(b)(1), only actual knowledge is sufficient to deprive a subsequent transferee of protection. Yet, under the *Bayou* definition a subsequent transferee who acted with subjective good faith would lose that protection if the investor was merely on notice of suspicious circumstances. If a creditor lacks good faith because of notice of circumstances that would lead to knowledge of the voidability of a transfer, surely a creditor who has knowledge of the voidability of the transfer also lacks good faith. Under this logic, any creditor who fails the knowledge requirement would have already failed the good faith requirement. Thus, the combination of knowledge and good faith would be redundant.

Further, in the very next section, 550(b)(2), there is no knowledge requirement.[343] Section 550(b)(2) protects a transferee who takes a transfer from the first subsequent transferee.[344] Although the first subsequent transferee must pass a three part test that requires the transferee to "give value . . . in good faith, and without knowledge" in order to be entitled to the protections of section 550(b)(1), a transferee taking from the first subsequent transferee must only prove that it took in good faith in order to gain similar protections under section 550(b)(2).[345] Thus, Congress took the care to include both good faith and knowledge in one section in the Code and in the very next section included only good faith. This unambiguously shows that Congress understood that good faith was not based on a knowledge or notice standard. To hinge the good faith analysis on notice, or even actual knowledge, would require that one definition be given to good faith when evaluating the first transfer and a second definition given to good faith for the second transfer.

Buttressing the idea that knowledge and good faith are different concepts, the Code uses good faith in situations where knowledge of all circumstances can be assumed. For example, section 1129(a)(3) requires a debtor in a chapter 11 case to file a plan of reorganization in good faith.[346] Section 1325(a)(3) makes good faith

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we believe it does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies which the debtor obtained at the expense of other creditors.") (emphasis in original); *see also* Territorial Savings & Loan Assoc. v. Baird, 781 P.2d 452, 461 (Utah App. 1989) ("[W]hat constitutes good faith . . . involves a subjective interpretation of all of the surrounding circumstances."); Sinclair, *supra* note 125, at 66 (discussing separation of knowledge and good faith in section 550(b)).

[343] 11 U.S.C. § 550(b)(2) (2006) (requiring transferee of subsequent transferee to take in good faith).

[344] *See* 11 U.S.C. § 550(b)(2) ("The trustee may not recover . . . from . . . any immediate or mediate good faith transferees of such transferee."); *In re* Coleman, 21 B.R. 832, 836 (Bankr. S.D. Tex. 1982) ("Any subsequent transferee of a transferee meeting this standard is protected if he took the property in good faith."); 5 COLLIER ON BANKRUPTCY, ¶ § 550, at 550-21 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (stating once transferee of debtor's initial transferee meets requirements of (b)(1) then any subsequent transferee need only show good faith).

[345] *See* 11 U.S.C. § 550(b)(2); *see also In re Coleman*, 21 B.R. at 836 ("Any subsequent transferee of a transferee meeting this standard is protected if he took the property in good faith."); *see, e.g.*, Nordberg v. Arab Banking Corp. (*In re* Chase & Sanborn Corp.) 904 F.2d 588, 597 (11th Cir. 1990) (illustrating narrow line often separates entity from being characterized as initial transferee or subsequent transferee).

[346] *See* 11 U.S.C. § 1129(a)(3) (requiring chapter 11 plan to be filed in good faith); *see, e.g.*, B.M. Brite v. Sun Country Dev. Inc. (*In re* Sun Country Dev., Inc.), 764 F.2d 406, 408 (5th Cir. 1985) ("[W]here the plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the

essential to the filing of a plan of reorganization under chapter 13.[347] Neither of these sections contains a knowledge requirement. In these situations, however, it would be safe to assume that a debtor has full knowledge of its circumstances and is either acting in good or bad faith by filing a plan that does or does not conform to the purposes of the Code. The question under these sections of the Code is whether the debtor subjectively intended to abuse "the provisions, purpose, or spirit of [the Code] in the proposal."[348] Thus, the inquiry is subjective apart from knowledge.[349]

Despite the clear separation of good faith and knowledge in the Code, the circuit court cases interpreting both knowledge and good faith requirements of section 550(b) curiously blend the two terms together. As discussed above, the *In re Sherman* court determined an immediate transferee's lack of good faith by demonstrating that the transferee had knowledge of the debtor's poor financial health and buttressed this finding by showing that the transferee used this knowledge to gain an unfairly low purchase price on the properties.[350] Arguably, the good faith determination was not made on knowledge alone, but rather a combination of knowledge or notice plus the use of this knowledge to gain an advantage over the debtor.[351] In determining that a subsequent transferee could not gain the protections of section 550(b)(1), the court focused solely on whether the subsequent transferee had inquiry notice that the previous transfer was avoidable.[352]

In that case, the bank that financed J.D. Sherman's discounted purchase of his son's twelve properties received a lien for the purchase price secured by the properties.[353] The trustee in the Sherman chapter 7 bankruptcy argued that the bank's liens should not be protected by section 550(b)(1) because the bank had

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good faith requirement of section 1129(a)(3) is satisfied."); *In re* Unichem Corp., 72 B.R. 95, 98 (Bankr. N.D. Ill. 1987) (stating independent duty of bankruptcy court to ascertain plan was proposed in good faith).

[347] *See, e.g.*, *In re* Hurdle, 11 B.R. 304, 306 (Bankr. E.D. Va. 1981) (remarking on courts requiring good faith); *In re* Melroy, 7 B.R. 513, 514 (Bankr. E.D. Cal. 1980) (explaining plan must be filed in good faith as required by statute); *see* 11 U.S.C. § 1325(a)(3) (requiring a chapter 13 plan to be filed in good faith).

[348] Virginia M. Hunt, *The Bankruptcy Good Faith Issue*, 47 CONSUMER FIN. L.Q. REP. 402, 405 (1993); *see, e.g.*, Baker v. Latham Sparrowbush Assoc. (*In re* Cohoes Indus. Terminal), 931 F.2d 222, 227 (2d. Cir. 1991) ("Generally, courts should conclude that a debtor has no demonstrable intent to reorganize only if, upon considering the totality of the circumstances, there is substantial evidence to indicate that the debtor made a bad faith filing."); Carolin Corp. v. Miller (*In re* Carolin Corp.), 886 F.2d 693, 700–02 (4th Cir. 1989) (stating if movant fails to demonstrate both facets of objective-subjective test, then motion to dismiss will be denied).

[349] *See* Hunt, *supra* note 348, at 405 ("Good Faith is said to merge with the power of the court to protect its jurisdictional integrity . . . the power to avoid the use of its statutory machinery as part of a fraudulent scheme."). Another example of this is bad faith filing. *See, e.g.*, Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393, 1395 (11th Cir. 1988) (positing subjective bad faith alone is sufficient to dismiss chapter 11 petition); *In re* North Redington Beach Assocs., 91 B.R. 166, 169 (Bankr. M.D. Fla. 1988) ("[T]his Court is satisfied that when one considers the good faith or lack of same of a debtor who seeks relief under the current Chapter 11, the real test that still remains is the presence of honest intention of the Debtor and some real need and real ability to effectuate the aim of the reorganization even if this involves the total liquidation of the assets.").

[350] Brown v. Third National Bank (*In re* Sherman), 67 F.3d 1348, 1356 (8th Cir. 1995).

[351] *Id.* at 1356–57.

[352] *Id.*

[353] *Id.*

knowledge of the voidability of the transfer to Sherman.[354] The court reasoned that knowledge is not defined in the Code, but that the term is stronger than notice.[355] If a transferee has knowledge of facts that would lead a reasonable person to believe that the previous transfer may be fraudulent then the subsequent transferee should be charged with knowledge.[356] Thus, a subsequent transferee who has knowledge of facts that would lead a reasonable person to believe that the previous transfer was avoidable cannot gain the protections of the section 550(b)(1) defense.[357] Tellingly, this subsequent transferee would not lose the protections of section 550(b)(1) for lack of good faith, but rather because the transferee would fail the separate requirement of not possessing knowledge of the voidability of the previous transfer.[358] Because the court found that the bank knew of Sherman's knowledge of his son's poor financial health and that Sherman was buying the properties at a discount, the court denied the bank the protection of the section 550(b) defense for having knowledge of the voidability of the transfer to Sherman.[359]

If the *Sherman* court's good faith standard rested solely on inquiry notice, as the language of the decision suggests, the *Sherman* good faith standard would be identical to the knowledge standard defined above. However, the *Sherman* court's inclusion of a discussion about how J.D. Sherman (the initial transferee) used his knowledge of the debtor's poor financial condition to gain a low price for the properties is what separates the subjective good faith standard from the objective knowledge standard. If this boundary is removed, the standards become hopelessly intertwined.

Third, the wording of section 550(b)(1) is almost identical to the UCC's holder in due course rule, which suggests that Congress intended the good faith standard under the Code to mirror the UCC's subjective good faith standard. Section 550(b)(1) states that a trustee cannot recover from "a [immediate or subsequent] transferee that takes for value . . . in good faith, and without knowledge of the

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[354] *Id.*

[355] *Id.* at 1357 ("[W]e do not require a transferee to be a vigilant monitor for the creditor's benefit when he possesses no information suggesting that there is a fraudulent conveyance in the chain.").

[356] *See* Wasserman v. Bressman (*In re* Bressman), 327 F.3d 229, 236 (3d Cir. 2003) (holding reasonable person standard applicable for subsequent transferee knowledge); *see also In re Sherman*, 67 F.3d at 1356–57 (upholding Bankruptcy Court's finding that bank, as subsequent transferee, had knowledge of voidability of transfers when reasonable person would); *In re* Erie Marine Enters., Inc., 216 B.R. 529, 536–37 (Bankr. W.D. Pa. 1998) (noting subsequent transferee knowledge based on reasonable person standard).

[357] *See In re Bressman*, 327 F.3d at 235 (stating section 550(b)(1) defense requires subsequent transferee to have no knowledge of voidability); *see also In re Sherman*, 67 F.3d at 1357 (denying bank's request for section 550(b) protection when bank found to have knowledge of voidability); *In re Erie Marine Enters., Inc.*, 216 B.R. at 537 (denying section 550(b) defense when subsequent transferee had no knowledge).

[358] *See In re Bressman*, 327 F.3d at 235–36 (noting section 550(b)(1) defense includes good faith, but neglecting to consider this aspect when denying defense); *see also In re Sherman*, 67 F.3d at 1357 (holding section 550(b) defense unavailable for bank because of knowledge, with no discussion on good faith). *But cf.* Smith v. Mixon, 788 F.2d 229, 232 n.2 (4th Cir. 1986) (quoting 4 COLLIER ON BANKRUPTCY, ¶ 550.03, at 550-10 (Alan N. Resnick et al. eds., 15th ed. rev. 2006)) (noting knowledge requirement of section 550(b)(1) defense intended to be example of good faith).

[359] *In re Sherman*, 67 F.3d at 1356.

voidability of the transfer avoided."[360] Similarly, the version of UCC § 3-302(b)(1) applicable in 1978 stated that a purchaser of a negotiable instrument is a holder in due course if "a holder [] takes the instrument (a) for value; and (b) in good faith; and (c) without notice . . . of any defense."[361] Although the UCC section adopted the lesser "notice" standard for its third requirement, the requirements and drafting remain very similar. Both sections require that a holder or transferee give value in good faith and then add an additional requirement based on knowledge or notice. Further, both statutes deal with substantially similar situations—when is an entity that gave value for an interest or property protected from the interests of others. Thus, good faith should be defined similarly in both statutes. As mentioned above, good faith under the UCC took a subjective standard in nearly all fifty states during the time the Code was drafted.[362]

A similar comparison can be made to section 9(1) of the UFCA. As described above, section 9 of the UFCA serves as a savings clause for a transferee who gave value where the debtor made a conveyance with an actual intent to defraud creditors.[363] Under section 9(1), a transferee is entitled to keep the value it gave to the debtor if it gave "fair consideration" without knowledge of the debtor's fraud.[364] Again, UFCA section 9(1), like UCC § 3-302(1) and Code section 550(b), contains what amounts to three requirements—value, good faith, and a lack of knowledge. Although courts have generally interpreted that the without knowledge language to mean that a transferee who is on inquiry notice cannot invoke the protections of this section, that requirement is distinct from the good faith requirement.[365] Therefore,

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[360] 11 U.S.C. § 550(b)(1) (2006).

[361] U.C.C. § 3-302(1) (1978).

[362] *See supra* Part IV.1. *See generally* Countryman, *supra* note 309;

[363] *See In re* Structurlite Plastics Corp., 193 B.R. 451, 461 (Bankr. S.D. Ohio 1995) (describing UFCA section 9 savings clause), *rev'd on other grounds*, 224 B.R. 27 (B.A.P. 6th Cir. 1998); *see also* UNIF. FRAUDULENT CONVEYANCE ACT § 9(2) ("A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment."); *supra* note 160 and accompanying text.

[364] *See In re* Morse Tool, Inc., 148 B.R. 97, 140 (Bankr. D. Mass. 1992) (granting transferee value under UFCA § 9(1) when transferee provided fair consideration without knowledge of fraud); *see also* Robert J. White, *Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code—Like Oil and Water, They Just Don't Mix*, 1991 ANN. SURV. AM. L. 357, 375 n.82 (1991) ("[U.F.C.A.] § 9(1) protects good faith transferees who gave fair consideration even if there was fraudulent intent on part of the debtor."); UNIF. FRAUDULENT CONVEYANCE ACT § 9(1) (stating creditor who receives fraudulent conveyance has claim against anyone except, *inter alia*, "purchaser for fair consideration without knowledge of the fraud").

[365] *See, e.g.*, HBE Leasing Corp. v. Frank, 48 F.3d 623, 636 (2d Cir. 1995) ("[T]he transferee need not have actual knowledge of the scheme that renders the conveyance fraudulent."); *see also* Columbia Int'l Corp. v. Perry, 344 P.2d 509, 511 (Wash. 1959) ("[A]ctual knowledge is not always needed. A transferee may be charged with knowledge where he is aware of facts and circumstances which are calculated to put him on inquiry, and such inquiry would have led him to discover the intent of the transferor."); ALCES, *supra* note 125, at 5-123 ("Generally, so long as a grantee is aware of facts and circumstances that put the grantee on at least inquiry notice of the potential avoidability of the conveyance, the grantee will be denied the protection of the subsection."). This standard for knowledge seems to be strikingly similar to the objective inquiry notice standard for defining good faith. *See, e.g., In re* Royal Dutch/Shell Transp. Sec. Litig., 380 F. Supp. 2d 509, 565 (D.N.J. 2005) (citation omitted) (describing objective inquiry notice as "when a plaintiff discovered or in the exercise of reasonable diligence should have discovered" issue at hand), *overruled on other grounds*, 404 F. Supp. 2d 605 (D.N.J. 2005); Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.,

an interpretation of good faith that incorporates an inquiry notice standard would be redundant and read the knowledge/notice standard out of the law. Against this background, Congress's deletion of the UFCA's knowledge prong in 548(c) was intentional and it is inappropriate for courts to read it back into the statute though distorted interpretations of good faith.

Further, UFCA § 9(1) creates a higher standard for recovering and keeping value when the debtor acted with an actual fraudulent intent than when intent is presumed under constructive fraud.[366] Conversely, under Bankruptcy Code section 548(c) the standard for a transferee who wishes to retain payments from the debtor is the same, merely value and good faith.[367] This suggests that the drafters of the Code sought to move away from the inquiry notice standard or at the very least remove inquiry notice's determinative status. Remarkably, the courts applying the 548(c) savings clause in Ponzi scheme bankruptcies have preached the exact opposite.[368]

C. The Differences Between Fraudulent Transfers and Preferences

Further, good faith must be defined by a subjective standard in order to ensure section 548 does not conflict with the goals and purposes of the preference section of the Code, as codified in section 547.[369] Moreover, a subjective standard is necessary to preserve the Code's revisions to preference law in section 547. Preference law, like fraudulent transfer law, developed in English insolvency law.[370]

No. 02 C 5893, 2004 WL 574665, at * 11 (N.D. Ill. Mar. 22, 2004) (quoting Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997)) (defining objective inquiry notice as upon discovery or when discovery should have been made); Freundt-Alberti v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F. Supp. 2d 1298, 1302 (S.D. Fla. 2001) (citing Dodds v. Cigna Sec., Inc., 12 F.3d 346, 351–52 (2d Cir. 1993)) (equating objective inquiry notice with whether person had enough notice of facts to create duty to inquire further).

[366] *See, e.g.*, *In re* Simpson, No. 02-11044-RS, 2007 WL 4459081, at *8–9 (Bankr. D. Mass. Dec. 17, 2007) (noting U.F.C.A. § 9(1) requires actual intent where U.F.C.A. § 4 does not). *Compare* UNIF. FRAUDULENT CONVEYANCE ACT § 4 (requiring creditor to give fair consideration, which has two requirements value and good faith) *with* UNIF. FRAUDULENT CONVEYANCE ACT § 9(1) (requiring creditor to give fair consideration and be without knowledge of the debtor's actual fraudulent intent—three requirements).

[367] *See* 11 U.S.C. § 548(c) (2006) (defense available to "transferee . . . that takes for value and in good faith"); *see also* Jimmy Swaggart Ministries v. Hayes (*In re* Hannover Corp.), 310 F.3d 796, 799 (5th Cir. 2002) (stating section 548(c) requires "[taking] value in good faith" (quoting 11 U.S.C. § 548(c))); *In re* Jacobs, 394 B.R. 646, 662 (Bankr. E.D.N.Y. 2008) (noting section 548(c) requirements include good faith and value).

[368] *See* Plotkin v. Pomona Valley Imps., Inc. (*In re* Cohen), 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996) (requiring lack of inquiry notice for good faith); *see also* Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 861–62 (D. Utah 1987) (determining whether defendant had good faith); McDermott, *supra* note 16, at 176–77 (quoting 4 COLLIER ON BANKRUPTCY, ¶ 548.07[2], at 548-68 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (stating courts require investors to establish lack of inquiry notice to prove good faith)).

[369] *See* 11 U.S.C. § 547 (2006); *see also* Begier v. I.R.S., 496 U.S. 53, 58 (1990) (discussing section 547).

[370] *See* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 714–18 (1985) (discussing development of preference law in England); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 995–1000 (1992) (explaining the development of preference law).

Although originally labeled as "fraud," preference law, unlike fraudulent transfer law, is not based on traditional notions of fraud—such as a debtor trying to hide his assets or gift his assets to a friend or family.[371] Rather preference law seeks to remedy fraud on bankruptcy's purpose of an equal distribution among creditors. Specifically, preference law targets transfers from debtors to legitimate creditors that would allow the preferred creditor to receive a larger share of the debtor's estate than the other creditors. Thus, preference law's goal is to promote equality among creditors in bankruptcy.[372]

As first developed in English law by Lord Mansfield, preference law specifically targeted debtors who attempted to manipulate the bankruptcy distribution by voluntarily repaying some creditors but not others. Mansfield considered this a fraud "on the public law of the land."[373] Under Mansfield's interpretation, a court could avoid a transfer as a preference if the debtor made a voluntary transfer to a creditor on the eve of bankruptcy.[374] This first conception of preferences focused completely on the debtor intent to change the distribution in bankruptcy.[375] In fact, a creditor who demanded and received payments on debts owed to him by a debtor did not receive a voidable preference.[376] The parliament first codified preference law in 1869. This law also focused debtor's intent to give one creditor more than others on the eve of bankruptcy.[377] There, the English Parliament defined a preference as any payment or transfer to a creditor within the three months of bankruptcy made by the debtor "with the view of giving such a creditor a preference over the other creditors."[378] Thus, the English view focused completely on the intent of the debtor rather than the behavior of creditors. However, American preference law has largely rejected this debtor intent requirement, while retaining the purposes of preserving the equality of distribution in bankruptcy.

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[371] *See* Countryman, *Preferences*, *supra* note 370, at 718 ("Although the preference in the English statute still is deemed 'fraudulent and void' against the bankruptcy trustee, fraud is no part of the definition."); *see also* Kevin Baum, Note, *"No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subrogation, and Inquiry Notice are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Credit Market*, 83 ST. JOHN'S L. REV. 1357, 1361—62 (2009) ("Although preferential transfers are voidable by the trustee, this power of avoidance is not based on fault—generally, the debtor's or creditor's motives for making the preferential transfer are of no importance in bankruptcy.").

[372] *See Begier*, 496 U.S. at 58 (recognizing the goal of preference law is to preserve equality of distribution among creditors); *see also* 5 COLLIER ON BANKRUPTCY, ¶ 547.01, at 547-9 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (explaining purposes of section 547); 4 NORTON BANKRUPTCY LAW AND PRACTICE § 66:1, at 66-6 (William L. Norton, Jr. ed., 3d ed. 2009) (discussing themes underlying section 547); Vern Countryman, *Preferences*, *supra* note 370, at 748 (noting section 547 legislative history mentions preserving policy of equitable distribution).

[373] *See* Countryman, *Preferences*, *supra* note 370, at 716 (*quoting* Alderson v. Temple, 96 Eng. Rep. 384, 385 (K.B. 1768)).

[374] *See id.*

[375] *See id.*

[376] *See id.*

[377] *See id.*

[378] *See id.*

Although the first American preference statutes merely adopted the English law, American preference law has subsequently departed from English law significantly. First, the 1910 amendments to the Bankruptcy Act eliminated the requirement that the debtor intended to give a preference.[379] Second, American preference law has traditionally included a requirement that the creditor receiving the transfer know, or have reason to know, that either the debtor was insolvent or the debtor was intending to make a preferential payment.[380] Third, the American preference period was traditionally four months instead of three months like under English law.[381] Despite taking a different approach, American preference law like English preference law still focuses on maintaining equality among creditors in bankruptcy.

Evidence that the goal of preference law is to promote equality among creditors, and fraudulent transfer law is not, is found in the different treatment given to payments of antecedent debts under each type of law. Any payment or transfer to satisfy an antecedent debt made by a debtor before bankruptcy will change the distribution in bankruptcy; ultimately, the transfer will favor the creditor receiving the transfer over the debtor's other creditors. Because of the inequalities caused by these payments, preference law ensures that payments made on account of antecedent debts within the preference period are avoidable.[382] Thus, preference law ensures that at least within the preference period the debtor's limited estate can be divided equally among the debtor's creditors.

By contrast, fraudulent transfer law *promotes* the payment of antecedent debts, which is strong evidence that fraudulent transfer does not seek to promote equality among creditors.[383] Traditionally, fraudulent transfer law does not affect creditors owed legitimate debts because in the definition of value contained in every fraudulent transfer or conveyance law includes as value the payment or satisfaction of an antecedent debt.[384] Rather, fraudulent transfer law is a recovery tool for creditors against non-creditors.[385] A debtor may pay his entire estate to a single

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[379] *See id.* at 723 ("With this amendment [in 1910], the search for debtor culpability or other inquiry into the debtor's state of mind disappeared from the American concept of a voidable preference.").

[380] *See id.* at 725 ("[F]or the entire history of the old Act, a trustee seeking under section 60 to avoid a preference acquired within the four month period prior to bankruptcy had to prove something about the state of mind of the transferee-creditor.").

[381] *See id.* at 724 (noting preference period under old Act was four months).

[382] *See* 11 U.S.C. § 547(b)(2) (requiring payments made on account of antecedent debts in the ninety-days before a debtor's bankruptcy be avoided).

[383] *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L REV. 829, 833–34 (1985) (explaining goal of fraudulent conveyance laws is to allow creditors more protects in collecting on antecedent debts); *see also* Boston Trading Group v. Burnazos, 835 F.3d 1504, 1509 (1st Cir. 1987) ("The basic objective of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy some of his creditors; it normally does not try to choose among them.").

[384] *See, e.g.*, 11 U.S.C. § 548(d)(2)(a) (2006) (defining value as including payment or satisfaction of antecedent debts); UNIF. FRAUDULENT TRANSFER ACT § 3(a) (1984) (noting payment or satisfaction of antecedent debt is value); UNIF. FRAUD CONVEYANCE ACT § 3 (a) & (b) (1918) (including payment or satisfaction of antecedent debt in fair consideration).

[385] *See* Baird & Jackson, *supra* note 383, at 836 (explaining fraudulent conveyance law is tool for creditors to recover assets after debtor misbehavior).

creditor so long as creditor is owed a debt that is not disproportionately small compared to the debtor's estate. In this scenario there would nothing to distribute in bankruptcy and, thus, there would be no equality among creditors. However, the *Bayou* court confuses the distinct goals of preference law and fraudulent transfer law by applying fraudulent transfer law with the goal of promoting equality among creditors.

By erroneously incorporating the goal of equality among creditors into fraudulent transfer law, the *Bayou* court violates congressional intent because it revives old concepts of preference law. Section 547 of the Code contains significant changes to the preference sections contained in the previous Bankruptcy Act. First, the preference standard became a completely objective, no-fault stand.[386] Congress eliminated the requirement that a creditor know or have reason to know that the debtor was insolvent at the time of the transfer.[387] Thus, creditors with knowledge should be treated equally as compared to ignorant creditors. Second, Congress shortened the preference period from the traditional four-month period to ninety days for all creditors except insiders.[388] The shortening of the preference period is a clear directive from Congress that repose important in commercial transactions.[389]

Despite Congress's changes to the Code's preference section, the *Bayou* court erroneous applied the rejected preference law instead of the correct fraudulent conveyance law by attempting to read a creditor equality goal into section 548.[390]

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[386] *See* Barash v. Pub. Fin. Corp., 658 F.2d 504, 510 (7th Cir. 1981) (determining creditor's knowledge of debtor's insolvency is irrelevant under section 547); *see also* H.C. Schmieding Produce Co., Inc. v. Alfa Quality Produce, Inc., 597 F. Supp. 2d 313, 319 (E.D.N.Y. 2009) (describing section 547 as "no-fault" statute); Rafael I. Pardo, *On Proof of Preferential Effect*, 55 ALA. L. REV. 281, 301 (2004) (stating current form of section 547 "signifies the complete transformation of preference law to a no-fault regime"). Further evidence that preference law is no fault is the fact that under section 727, discharge is not withheld from a debtor who gives a preference, while a debtor who grants a fraudulent transfer is barred from discharge. *See* 11 U.S.C. § 727(a) (determining a debtor's eligibility for discharge).

[387] *See Barash*, 658 F.2d at 510 (describing creditor's knowledge as irrelevant); *see also* Pardo, *supra* note 386, at 301 (noting section 547 does not require creditor knowledge of debtor's insolvency to disallow transfer).

[388] *See* 11 U.S.C. § 547(b)(4)(A) (stating trustee is able to avoid such transfer occurring within ninety days before filing); *see also* Superior Bank, FSB v. Boyd (*In re* Lewis), 398 F.3d 735, 746 (6th Cir. 2005) (observing section 547 allows avoidance of transfer on or within ninety days of date of filing); Morehead v. State Farm Mutual Auto. Ins. Co. (*In re* Morehead), 249 F.3d 445, 447 (6th Cir. 2001) (indicating Bankruptcy Code allows avoidance of "transfer made 'on or within 90 days' before the date of the filing of the petition"); Countryman, *Preferences*, *supra* note 370, at 724 (noting preference period under old Act was four months long).

[389] *See* Tabb, *supra* note 370, at 993 (discussing need to balance repose with equality among creditors in determining appropriate scope of trustee's avoidance powers). The Commission on bankruptcy laws also determined that a shortened preference period was necessary to balance the effects on commercial transactions of a no-fault preference statute. *See* REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93rd Cong., 1st Sess., pt. II (Bankruptcy Act of 1973), at 170 n.10 (1973).

[390] *See In re* Bayou Group, LLC, 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008) ("Section 548 is not a punitive provision designed to punish the transferee, but is instead an equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive fraudulent conveyances.")

Bayou's narrow interpretation of the good faith defense does violence to Congress's intent for sections 547 and 548. First, the *Bayou* interpretation turns the focus of fraudulent transfer law to creditor-versus-creditor transactions. Preference law and not fraudulent transfer law normally deals with creditor-versus-creditor transactions.

Second, the *Bayou* decision revives the old preference law that was discarded by Congress over a succession of bankruptcy laws. The *Bayou* decision essentially allows the avoidance of any knowing preference if the creditor has a reason to know that the debtor was insolvent or acting fraudulently. In a Ponzi scheme, every investor is a creditor of the scheme, which is by definition insolvent. When the Ponzi scheme debtor makes a payment to a creditor on account of the creditors initial investment, the debtor is essentially just repaying an antecedent debt despite the debtor's fraudulent intent. The redeeming creditor is preferred over the schemes other creditors because it will receive more on account of its debts than those who do not redeem. The *Bayou* court's good faith standard takes away the normal protections given to a creditor seeks the repayment of his antecedent debts and replaces those protections with an old preference standard—whether the creditor has notice of the debtor's insolvency or intent to give a preference. As mentioned above, Congress discarded the debtor's intent requirement in 1910 and eliminated the creditor knowledge prong in the Code. Yet, the *Bayou* good faith standard attempts to revive this preference theory in fraudulent transfer law. *Bayou's* good faith standard reads fault back into the no-fault preference section under the guise of fraudulent transfer law. And, thus, the decision places creditors with knowledge or even mere inquiry notice of the debtor's insolvency at a disadvantage to ignorant creditors despite congress's rejection of the reason to know requirement in the Code.

Further, *Bayou's* narrow good faith standard ignores the carefully crafted time limits for preferences set forth in the 1978 Code. By imposing an objective inquiry notice standard rather than a subjective honest-in-fact standard, the *Bayou* court allows for the extension of the preference period for knowing preferences from ninety days to two years under the Code and up to six years under some state's laws, including New York. This violates Congress's goal of promoting certainty in the commercial transactions, which is indicated by the shortening of the preference period in the Code. Although a creditor who takes a transfer in bad faith neither needs nor deserves repose, a creditor who merely knows that a debtor insolvent or worse merely fails to investigate a debtor before redeeming an investment that the creditor deems risky is entitled to repose. Congress intended section 547 to be a no-fault provision under which nearly all transfer made within the ninety days before a debtor's bankruptcy are avoidable regardless of a creditor's knowledge of the debtor's circumstances, and all transfers, except those to insiders, made before the ninety day period are entitled to repose. The *Bayou* decision strips legitimate creditors of this right to repose in direct contradiction of Congress's intent merely because a creditor who perceives an infirmity in his investment fails to investigate.

CONCLUSION

In conclusion, *Bayou's* wholly objective notice-based good faith standard is unsupportable. The *Bayou* standard ignores the long history of the operation of good faith in fraudulent conveyance law that dates back to the Statute of Elizabeth in the 1500's. Throughout that history, transferee's have been protected by good faith defenses unless they actively participated in a trust with the debtor to take advantage of the debtor's other creditors. More recently, courts have attempted to narrow the good faith defense by instituting a good faith standard that is objective and based on whether the transferee had knowledge of the debtor's fraud or insolvency. Although cases like *Tacoma*, *Agretech*, *M & L Business Machine*, and *Sherman* have claimed to apply this objective standard, in each of those cases, the courts have buttressed their findings that the transferee's lack good faith with additional evidence that actually establishes a lack of subjective good faith on the part of the transferees. Thus, those courts applied an incorrect standard but were actually faced with defendants who lacked subjective good faith.

Further, only a purely subjective good faith standard conforms to the meanings of good faith established by tools of statutory interpretation. First, the UCC contained a purely subjective definition of good faith in 1978 when the Code was draft. The UCC was the uniform commercial law in all fifty states at this time and Congress often intends that state law definitions be applied to undefined terms in federal law. Second, the Code incorporates several sections in which knowledge and good faith appear as separate requirements, including section 550(b)(1). This demonstrates that Congress understood that good faith was not a knowledge or notice based standard. Otherwise, Congress would have no reason to include a knowledge requirement in combination with a good faith requirement. Third, a good faith standard that is not purely subjective merges fraudulent transfer and preference law into one when each is a distinct set of laws with distinct goals and purposes. And, an objective good faith standard subverts congress's intent for section 547, as reflected by the changes to the preference laws in the Code. Thus, the good faith standard must be subjective.

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