



# EXAMINING THE BANKRUPTCY TRUSTEE'S CONTROVERSIAL CLAWBACK TOOL

MARCH 26, 2009



# Agenda

- Introduction
- Presentation
  - Rick Kirby, K&L Gates
  - Dr. Fred Dunbar, NERA Economic Consulting
  - Dr. Marcia Kramer Mayer, NERA Economic Consulting
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
  - [www.securitiesdocket.com](http://www.securitiesdocket.com)
- Wrap-up

# Webcast Series

- Series of webcasts — every other week
- [www.securitiesdocket.com/webcasts](http://www.securitiesdocket.com/webcasts)

# Panel



Rick Kirby



Dr. Fred Dunbar



Dr. Marcia Kramer Mayer



Bruce Carton

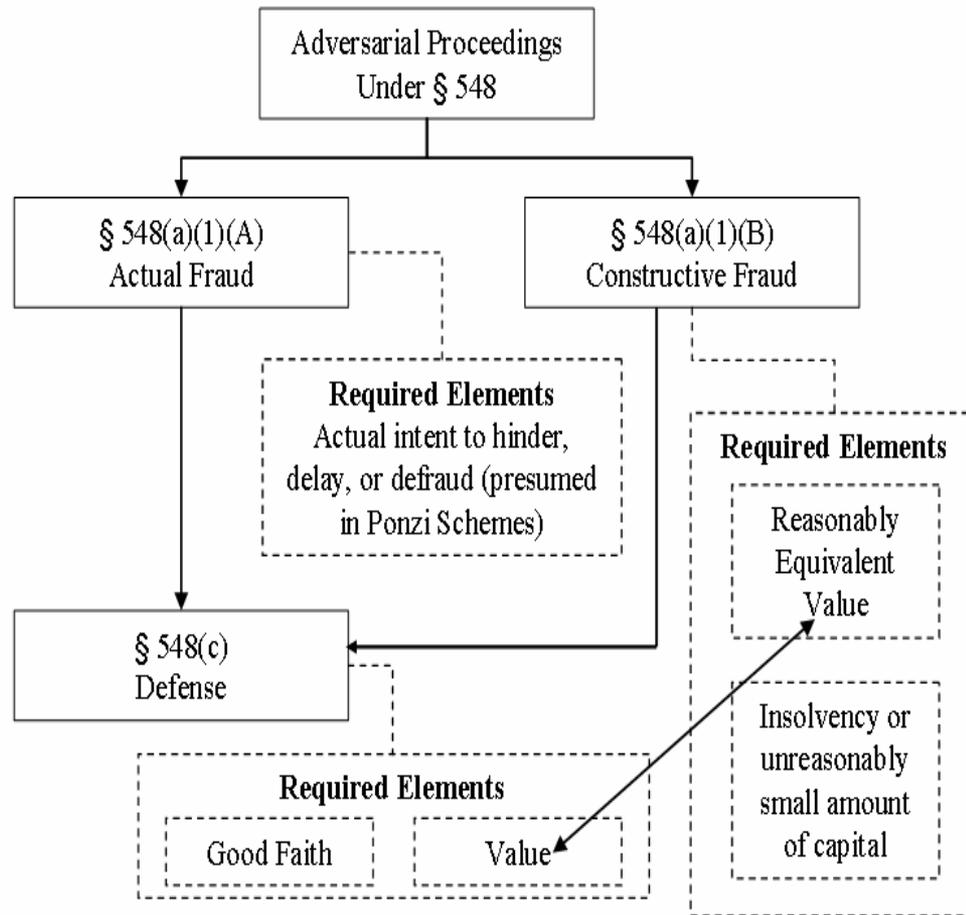
# Clawback Claims in Bankruptcy and Receivership

Richard A. Kirby  
Scott P. Lindsay

[www.klgates.com](http://www.klgates.com)

## Overview of Fraudulent Transfer Claims

- Actual Fraud – Section 548(a)(1)(A)
- Constructive Fraud – Section 548(a)(1)(B)
- Applicability of State Law – Section 544
- Affirmative Defenses – Section 548(c)
- Recovery from initial or subsequent transferees – Section 550(a)
- Statute of limitations –
  - Section 548 – 2 years from bankruptcy filing
  - Section 550 – recovery from subsequent transferee within 1 year
  - New York – 6 years from bankruptcy filing



*\*The analysis of value is the same under § 548(a)(1)(B) and under § 548(c)*

## Actual Fraud – Section 548(a)(1)(A)

- Trustee may avoid the entire amount of any transfer made with “actual intent to hinder, delay, or defraud creditors.”
- Only the intent of the transferor matters for the trustee to prove its *prima facie* case.
- In a Ponzi scheme, every transfer is presumed to have been made with the actual intent to hinder, delay, or defraud creditors.

## Constructive Fraud – Section 548(a)(1)(B)

- The trustee may avoid any transfer made for less than reasonably equivalent value while the debtor was insolvent or about to be insolvent.
- In a Ponzi scheme, courts presume insolvency from outset.
- “Value” is defined as “property, or satisfaction or securing of a present or antecedent debt.”
  - 11 U.S.C. 548(d)(2); see also discussion of value under Section 548(c) *infra*.

## Application of State Law – Section 544

- Under Section 544, trustee can bring any action that a creditor can bring under state law.
- Most states have adopted a form of the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act.
- The New York fraudulent transfer statute, NY DCL § 273 *et seq.*, is functionally equivalent in all respects to Section 548, except it has a 6 year statute of limitations.

## Affirmative Defenses – Section 548(c)

- A trustee may not recover against a transferee that took for “value” and “in good faith,” but the burden rests on the defendant to affirmatively prove both.
- Value –
  - “Value” is defined as “property, or satisfaction or securing of a present or antecedent debt.”
  - In a Ponzi scheme, an investor has a rescission claim for the amount of its principal investment and can claim value to the extent of redeemed principal, but not false profits.
- Good faith –
  - Determined according to an objective, “reasonable person” standard.
  - Three-part test:
    1. Was the transferee on inquiry notice of facts that should have led a reasonable person to inquire further into the status of the debtor?
    2. Did the transferee conduct a diligent inquiry?
    3. Did the diligent inquiry reasonably satisfy the transferee that there was no cause for concern?

## Recovery of Fraudulent Transfers – Sec. 550

- Section 550 provides for recovery of a fraudulent transfer that has been avoided under Section 548.
- A trustee may recover the property transferred or the “value of such property” from the initial transferee or any subsequent transferee.
- Trustee may not recover against a subsequent transferee that:
  1. “takes for value,”
  2. “in good faith,” and
  3. “without knowledge of the voidability of the transfer.”

## Case example: *In re Bayou Group*

- Bayou was a \$400m hedge fund Ponzi scheme whose principals pleaded guilty to multiple counts of fraud in 2005.
- Creditors sought appointment of a receiver who brought the funds into bankruptcy.
- Debtors-in-possession brought Section 548 actual fraud claims against 131 investors that had redeemed prior to collapse.
- Court found:
  - Actual intent to hinder, delay, or defraud presumed in Ponzi scheme;
  - All redemptions of false profits avoided – defendants cannot prove “value;”
  - Most defendants were on objective inquiry notice of the fraud;
  - Many defendants could not satisfy their affirmative duty to prove good faith by (1) having conducted a diligent investigation, and (2) showing that the investigation ameliorated any concerns about the funds prior to redemption.
  - *Bayou Group, LLC v. WAM Long/Short Fund II, L.P.*, 362 B.R. 624 (Bankr. S.D.N.Y. 2007); *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.*, 396 B.R. 810 (Bankr. S.D.N.Y. 2008).
- Result: many cases settled, some defendants appealing grant of summary judgment, a handful of cases sent to trial on issue of good faith.

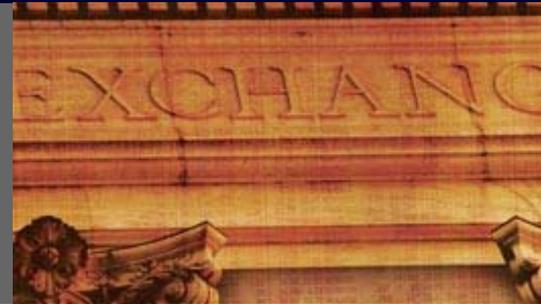
## Bernard L. Madoff Investment Securities LLC (BMIS)

- The scope and complexity of the BMIS liquidation raises novel and interesting fraudulent transfer issues.
- The SIPC Trustee has said he will pursue actions to avoid transfers of “false profits” in “significant economic amounts.”
  - “False profits” defined as any amount redeemed in excess of the net principal investment.
  - No comment regarding pursuit of redeemed principal.
- The SIPC Trustee has said he has not made the decision whether to pursue secondary clawback claims against feeder fund investors – “it is as much a policy decision as a legal decision.”
- There is significant potential exposure for thousands of investors that invested and redeemed through feeder funds.

## Recent Receivership Cases

- Receivers have been appointed to liquidate assets and pursue claims in two recent large-scale Ponzi schemes:
  - Westgate Capital Management LLC
  - Stanford Group
- In these cases, the receivers have been specifically empowered to bring those entities into bankruptcy to take advantage of the powers of the Bankruptcy Code.
- Receivers have may have limited standing to pursue fraudulent transfer claims.
  - *See Eberhard v. Marcu*, 530 F.3d 122 (2d Cir. 2008).

# Bankruptcy Clawbacks of Hedge-Fund Investors:



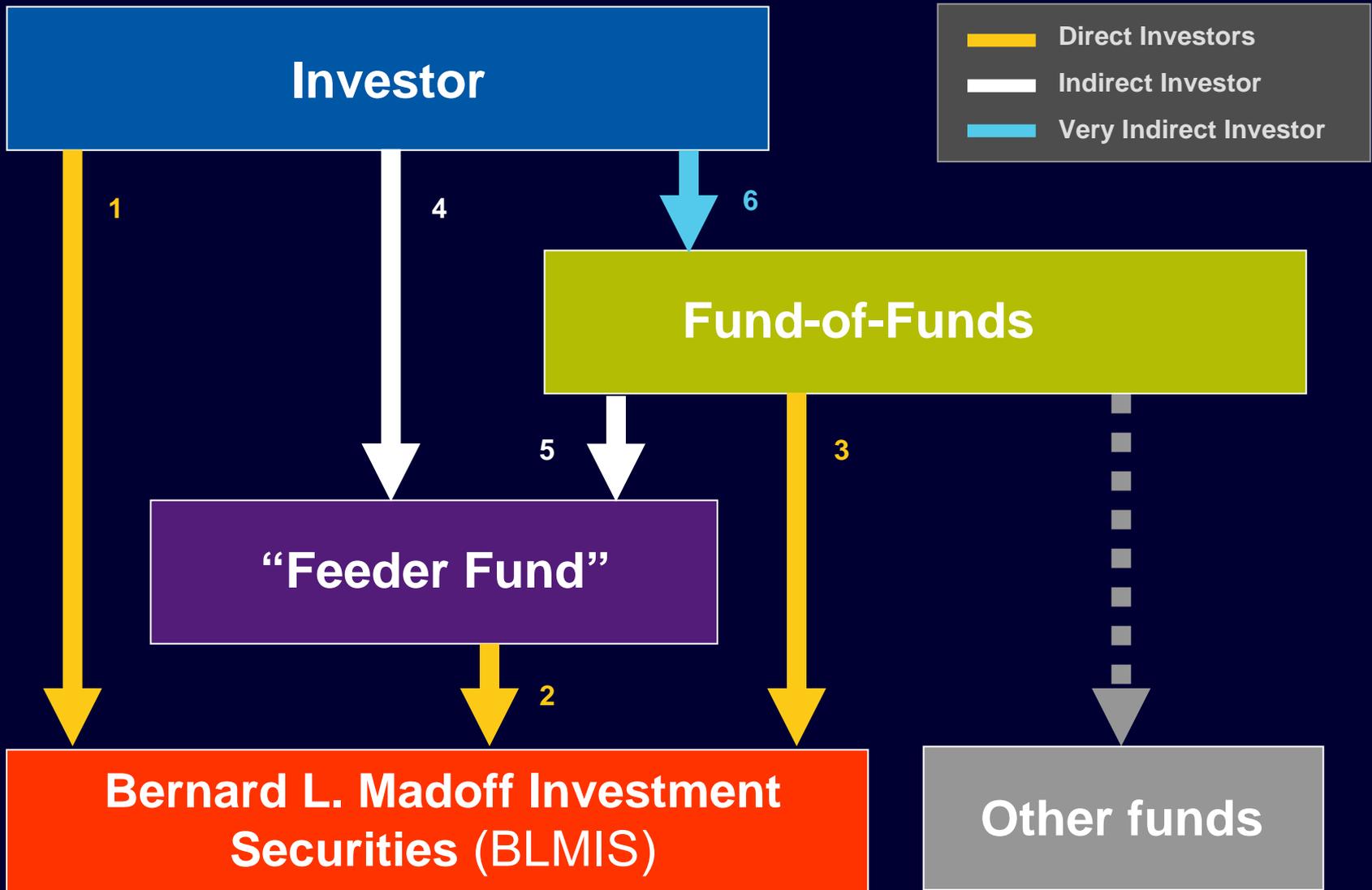
## Governing Principles and Controversial Issues

Frederick C. Dunbar,  
Senior Vice President

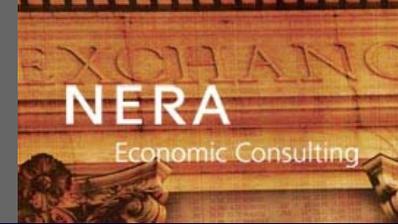
Marcia Kramer Mayer,  
Senior Vice President

New York, NY  
March 26, 2009

# Modes of Investment

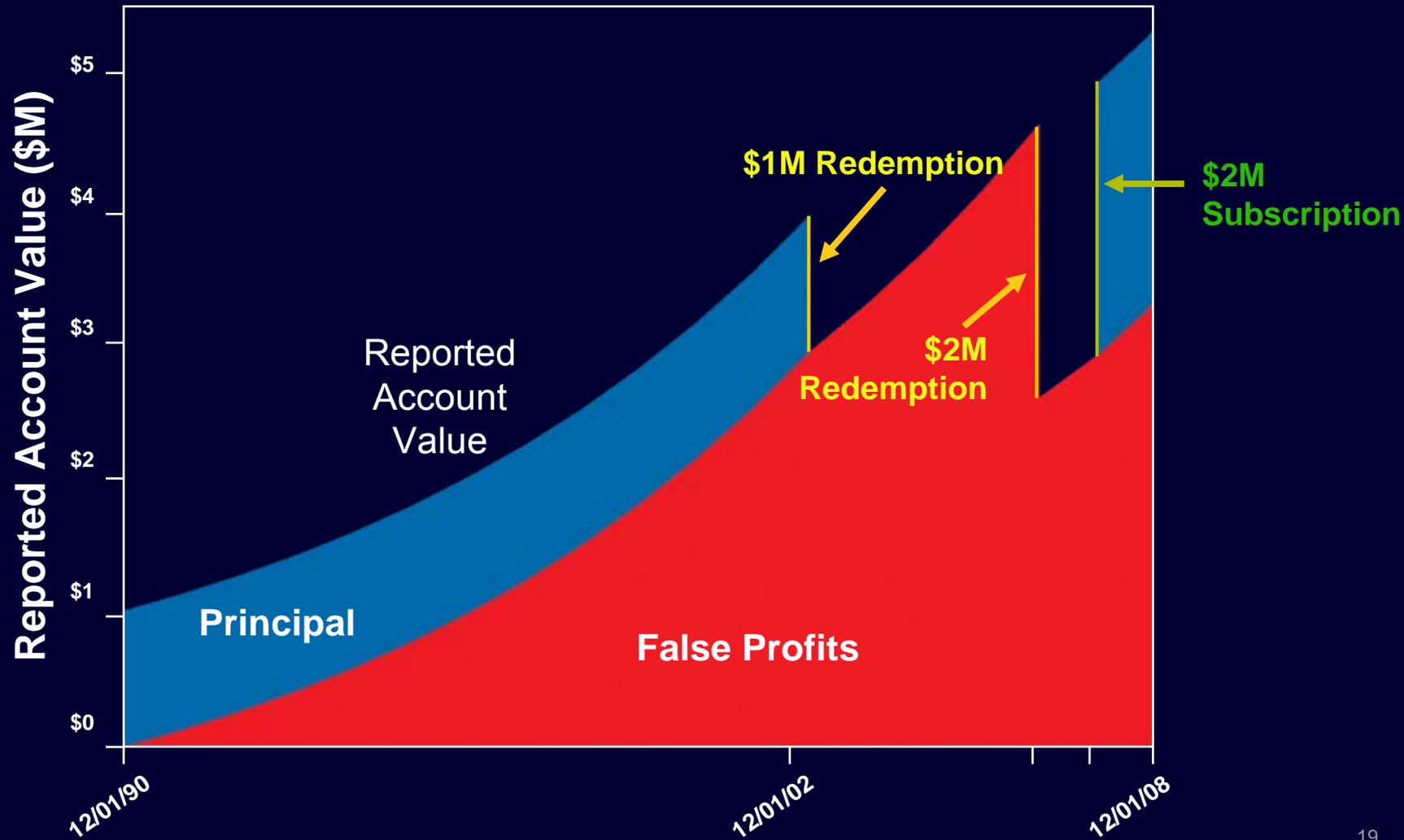
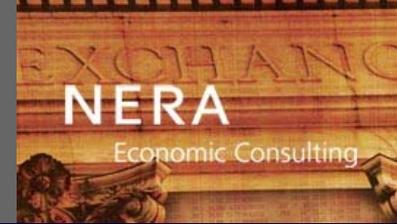


# What *Might* a Debtor-Hedge Fund Trustee Attempt to Clawback?



- Redemptions
  - Direct investors: individuals, organizations, hedge funds
  - Investors in hedge funds that invested directly
- Monies paid to third parties who--knowingly or otherwise--were critical to perpetuating the fraud
  - “Finder fees” to those who brought in investors
  - Fees to accounting firm
  - Compensation to employees in on the scheme
- Salaries, rent, other ordinary business expenses

# Are False Profit Redemptions in the Clawback Period Attachable if Matched by Later Subscriptions?



# Equity and Efficiency Considerations Relevant to Clawbacks Actions



- Composition of redemption
- Size of redemption
- Time since redemption
- Motive for redemption
- Situation of the transferee



- **The case for clawing back “false profits” only**
  - They were never earned, so there was no entitlement to them
  - Net equity redemptions differ because “reasonably equivalent value” was provided by the transferee on subscription
  - Perception of equity may be greater if net equity is let be
  
- **The case for clawing back principal as well**
  - Each dollar redeemed disadvantaged creditors equally
  - The time to assess exchange value is upon redemption, not subscription; on redemption, nothing was provided in exchange
  - Unredeemed net equity is as phantom as “profits,” most of it having been embezzled or fraudulently conveyed to others

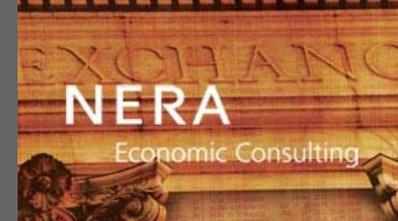
- **The case for not trying to claw back “small” redemptions**
  - Inefficient. Litigation cost may exceed recovery.
  - The efficiency-relevant consideration is an investor’s aggregate relevant redemptions, not her individual relevant redemptions
- **The case for disregarding size**
  - Equity. Unfair if some (relatively small) investors gained handsomely at the expense of others who invested comparable sums at same time
  - Defendants’ class action a possible economic vehicle

- The case for ignoring old redemptions
  - Inefficient to chase them. Monies are more likely to have been dissipated, making them harder to trace and reclaim. Higher cost per dollar recovered
  - Expectations of entitlement are more reasonable, having gone unchallenged longer.
- The case for pursuing all redemptions, and for potentially discounting *recent* ones relative to old
  - Long-ago redemptions had more time to benefit the transferee.

- The case for retaining the good faith defense
  - Those who knowingly disadvantage others (by redeeming on “red flags” rather than sounding an alarm) deserve to fare worse than those who redeem innocently.
- The case for disallowing a good faith defense
  - Clawbacks are not intended to be punitive but rather to improve equity (*Bayou*).
  - Those who remained invested were disadvantaged the same by all redemptions, regardless of motive

- Should charitable organizations be treated less harshly than private persons?
  - Yes, as clawback would harm meritorious causes
- Should invested funds (feeder funds, FOFs) be treated more harshly than private persons?
  - Yes, as better positioned and able to spot “red flags”
- Should wealthier investors be treated more harshly than less wealthy (or destitute) ones?
  - Yes, on efficiency ground; more chance of success.
  - Yes, for reasons of compassion

# Trustee's Distribution Formula for Individual Investors



- $p = \text{Recoveries} \div \Sigma (\text{Allowed Claims})$
- $\text{Allowed Claim} = \text{Cash In} - \text{Cash Out}$   
 $= \text{Net Equity if } > 0, \text{ and } 0 \text{ otherwise}$
- $\text{Distribution} =$ 
  - 0 if  $\text{Allowed Claim} < \$500\text{K}$  (the SIPC max)
  - $\text{Allowed Claim} - \$500\text{K}$  if  
 $\$500\text{K} < \text{Allowed Claim} < \$500\text{K} + p * \text{Allowed Claim}$
  - $p * \text{Allowed Claim}$  if  
 $\text{Allowed Claim} > \$500\text{K} + p * \text{Allowed Claim}$

# Trustee's Distribution Formula Example



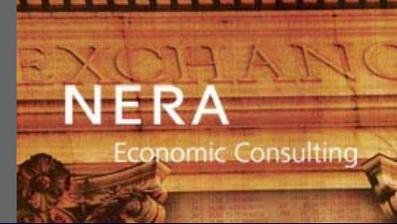
- $p = \$10 \text{ billion} \div \$20 \text{ billion} = 0.5$
- Allowed Claim = \$800,000
- $p * \text{Allowed Claim} = \$400,000$
- $\$500,000 < \text{Allowed Claim} < \$500,000 + \$400,000$
- Distribution =  $\$800,000 - \$500,000 = \$300,000$
- Total Recovery by Individual = \$800,000

# Alternative Distribution Formula



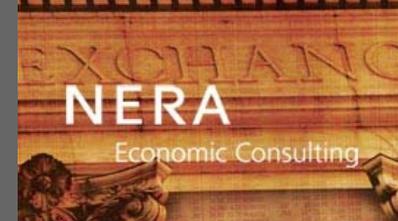
- Allowed Claim = the larger of (Net Equity - \$500,000) and 0
- $r = \text{Recoveries} \div \sum (\text{Net Equity} - \text{SIPC Payments})$
- Distribution =
  - $r * (\text{Net Equity} - \$500,000)$  if Net Equity > \$500,000
  - 0 if Net Equity < \$500,000

# Alternative Distribution Formula Example



- $r = \$10 \text{ billion} \div (\$20 \text{ billion} - \$3 \text{ billion}) = 0.6$
- $\text{Allowed Claim} = \$800,000 - \$500,000 = \$300,000$
- $\text{Distribution} = 0.6 \times \$300,000 = \$180,000$
- $\text{Total Recovery by Individual} = \$680,000$

# Alternative Formula Has More Desirable Characteristics



- Trustees formula has computational and process-related problems:
  - the excess over the Allowed Claim of ( $\$500,000 + p * \text{Allowed Claim}$ ) is an amount that has been recovered, but not distributed to any investor
  - Presumably, such residual amounts then have to be distributed according to some formula that would likely leave another residual amount undistributed
  - Etc.

- Feeder Funds have a higher likelihood of satisfying the criteria for clawback
  - Relationship to Madoff
  - Size
  - Account activity
  - Time period of involvement
- Account balance of an investor in a feeder Fund includes false profits (other investors' money according to the Trustee)
  - 80% of profits went to the Individual Investor
  - 20% of profits Went to the Feeder Fund G.P.s



- The SIPC Recovery and the Trustee's distribution formula both disadvantage feeder fund Investors
  - Feeder fund investors, apparently, will have to share a single SIPC claim (= \$500,000) with all other investors in the fund
  - This creates a disadvantage in the Trustee's distribution formula compared to the alternative distribution formula for Feeder Fund investors

# Issues for Feeder Fund Investors



## ■ Trustee's Formula

- Net Equity = \$800,000
- Share of SIPC recovery = \$50,000
- $p = 0.5$
- Distribution = \$400,000
- Total recovery = \$450,000

## ■ Alternative Formula

- Net Equity = \$800,000
- Share of SIPC recovery = \$50,000
- $r = 0.6$
- Distribution = \$450,000  
(=  $0.6 \times \$750,000$ )
- Total recovery = \$500,000

# Contact Us



Frederick C. Dunbar

Senior Vice President  
New York  
+1 212 345 5378  
[fred.dunbar@nera.com](mailto:fred.dunbar@nera.com)

Marcia Mayer

Senior Vice President  
New York  
+1 212 345 2196  
[marcia.mayer@nera.com](mailto:marcia.mayer@nera.com)

# Questions?

# Thank You

Thank you for attending this webcast.

