APPENDIX

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 20-1333, 20-1334

IN RE: BERNARD L. MADOFF
INVESTMENT SECURITIES LLC

IRVING H. PICARD, TRUSTEE FOR THE LIQUIDATION
OF BERNARD L. MADOFF INVESTMENT
SECURITIES LLC, PLAINTIFF-APPELLANT

AND

SECURITIES INVESTOR PROTECTION
CORPORATION, APPELLANT

V.

CITIBANK, N.A.; CITICORP NORTH AMERICA, INC.,
DEFENDANTS-APPELLANTS[*]

IRVING H. PICARD, TRUSTEE FOR THE LIQUIDATION
OF BERNARD L. MADOFF INVESTMENT
SECURITIES LLC, PLAINTIFF-APPELLANT

AND

SECURITIES INVESTOR PROTECTION
CORPORATION, APPELLANT

V.

LEGACY CAPITAL LTD.; KHRONOS LLC,
DEFENDANTS-APPELLEES

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[*] The Clerk of Court is respectfully directed to amend the caption as set forth above.

Filed: August 30, 2021

Before: WESLEY, SULLIVAN, and MENASHI, Circuit Judges.

OPINION

WESLEY, Circuit Judge.

These appeals are the latest installments in the long-running litigation arising from Bernard Madoff's Ponzi scheme. Madoff falsely claimed to invest money he received from customers of Bernard L. Madoff Investment Securities LLC ("BLMIS"). When customers wanted to withdraw money, BLMIS transferred funds directly to them, the *initial transferees*, some of whom then transferred the funds to their own investors, the *subsequent transferees*. Irving H. Picard, trustee for the liquidation of BLMIS, brought actions against initial transferee Legacy Capital Ltd. and subsequent transferees Citibank, N.A., Citicorp North America, Inc., and Khronos LLC, seeking to avoid and recover the transfers pursuant to his authority under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa *et seq.* A SIPA liquidation is "conducted in accordance with" the Bankruptcy Code "[t]o the extent consistent with" SIPA. *Id.* § 78fff(b). Under the Bankruptcy Code, a transferee may retain transfers it took "for value" and "in good faith." 11 U.S.C. §§ 548(c), 550(b).

The United States District Court for the Southern District of New York (Rakoff, *J.*) held that in a SIPA liquidation, a lack of good faith requires a showing of at least willful blindness to the fraud on the part of the transferee and the trustee bears the burden of pleading the transferee's lack of good faith. Applying that decision, the United States Bankruptcy Court for the Southern District of New York (Bernstein, *J.*) dismissed Picard's actions against Appellees for failure to plead their willful blindness. We vacate both judgments of the bankruptcy court and hold that lack of good faith in a SIPA liquidation applies an inquiry notice, not willful blindness, standard, and that a SIPA trustee does not bear the burden of pleading the transferee's lack of good faith.

BACKGROUND

The details of the Madoff Ponzi scheme[1] are described at length in previous opinions of this Court and others. *See, e.g.*, *In re BLMIS*, 654 F.3d 229, 231 (2d Cir. 2011) (collecting cases). Madoff operated his Ponzi scheme through his investment firm BLMIS, a securities broker-dealer. A Ponzi scheme is "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors." *Picard v. Gettinger (In re BLMIS)*, 976 F.3d 184, 188 n.1 (2d Cir. 2020) (citation omitted), *cert. denied*, No. 20-1382, 2021 WL 1725218 (U.S. May 3, 2021).

Customers ranging from banks and hedge funds to individuals and charities entrusted BLMIS with their money, expecting it to make investments on their behalf. A number of the customers were "feeder funds," firms that pooled money from investors and invested directly (or indirectly) with BLMIS. When a feeder fund wanted

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[1] The term "Ponzi scheme" is named after Charles Ponzi, who developed a "remarkable criminal financial career" by convincing people to invest in his fake international postal coupons business. *Cunningham v. Brown*, 265 U.S. 1, 7 (1924); *see also Gettinger*, 976 F.3d at 188 n.1.

to withdraw money, it received a transfer directly from BLMIS, making it an "initial transferee." When an investor of a feeder fund wanted to withdraw money, the feeder fund transferred money it received from BLMIS, making that investor a "subsequent transferee." *See In re Picard*, 917 F.3d 85, 93 (2d Cir. 2019), *cert. denied sub. nom. HSBC Holdings PLC v. Picard*, 140 S. Ct. 2824 (2020).

BLMIS was a sham. It sent its customers account statements with fabricated returns; in actuality, it was making few, if any, trades. "At bottom, the BLMIS customer statements were bogus and reflected Madoff's fantasy world of trading activity, replete with fraud and devoid of any connection to market prices, volumes, or other realities." *Sec. Inv. Prot. Corp. v. BLMIS (In re BLMIS)*, 424 B.R. 122, 130 (Bankr. S.D.N.Y. 2010) (hereinafter "*SIPC*"), *aff'd*, 654 F.3d 229 (2d Cir. 2011). The customers' funds were commingled in BLMIS's bank account. When customers withdrew their "profits" or principal, BLMIS paid them from this commingled account. As a result, each time BLMIS transferred payments to a customer, it was money stolen from other customers. *See In re BLMIS*, 654 F.3d at 232.

Amid the global financial crisis of 2007-08, concerned customers began to withdraw their investments, leading to BLMIS's collapse as "customer requests for payments exceeded the inflow of new investments." *See SIPC*, 424 B.R. at 128. Following Madoff's arrest for securities fraud on December 11, 2008,[2] the Securities Investor Protection Corporation ("SIPC") requested that the United States

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[2] Madoff pleaded guilty to eleven felony counts and was sentenced to 150 years in prison: a "symbolic" sentence for his "extraordinarily evil" crimes. *See United States v. Madoff*, 465 F. Supp. 3d 343, 347-48 (S.D.N.Y. 2020) (citation omitted). He died in prison on April 14, 2021.

District Court for the Southern District of New York (Stanton, *J.*) place BLMIS into a SIPA liquidation to recover and distribute funds to BLMIS's customers who lost their investments.[3] The district court granted SIPC's petition, appointed Picard as the trustee, and referred the SIPA liquidation of BLMIS to the bankruptcy court. In this ongoing liquidation, Picard brought actions to recover approximately $343 million from subsequent transferees Citibank, N.A. and Citicorp North America, Inc. (together, "Citi"), $6.6 million from subsequent transferee Khronos LLC ("Khronos"), and $213 million from initial transferee Legacy Capital Ltd. ("Legacy").

I. The SIPA Liquidation of BLMIS

Congress enacted SIPA in 1970 to protect customers of bankrupt broker-dealers. As we have previously explained, "[a] trustee's primary duty under SIPA is to liquidate the [failed] broker-dealer and, in so doing, satisfy claims made by or on behalf of the broker-dealer's customers for cash balances." *Marshall v. Picard (In re BLMIS)*, 740 F.3d 81, 85 (2d Cir. 2014). "In a SIPA liquidation, a fund of 'customer property,' separate from the general estate of the failed broker-dealer, is established for priority distribution exclusively among customers." *In re BLMIS*, 654 F.3d at 233. The "customer property" fund consists of "cash and securities . . . at any time received, acquired, or held by" the debtor on behalf of the customers, including "the proceeds of any such property transferred by the debtor" and "property unlawfully converted." 15 U.S.C. § 78*lll*(4).

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[3] SIPC filed its request in a parallel civil action, which the Securities and Exchange Commission ("SEC") commenced against Madoff and BLMIS for securities fraud on the same day as Madoff's arrest in the criminal action. *See SIPC*, 424 B.R. at 126.

Although investors of BLMIS are considered "customers" under SIPA, *see In re BLMIS*, 654 F.3d at 236, under certain circumstances, those who indirectly invested in BLMIS do not qualify as customers, *see Kruse v. Picard (In re BLMIS)*, 708 F.3d 422, 426-27 (2d Cir. 2013).[4] Only BLMIS's customers with "allowed claims" are entitled to a distribution from the customer property fund. SIPA requires customers to "share ratably in such customer property on the basis and to the extent of their respective net equities." 15 U.S.C. § 78fff-2(c)(1)(B). We previously approved Picard's "Net Investment Method" to calculate each customer's "net equity," "crediting the amount of cash deposited by the customer into his or her BLMIS account, less any amounts withdrawn from it." *See In re BLMIS*, 654 F.3d at 233-34, 242. Accordingly, customers who withdrew less than they deposited have allowed claims.[5] *See id.* at 233.

Picard's goal in this liquidation is to satisfy the allowed customer claims. A SIPA liquidation is "conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of [the Bankruptcy Code]." 15 U.S.C. § 78fff(b). As is invariably true of Ponzi schemes, due to BLMIS's transfers of commingled customer funds before the Ponzi scheme unraveled, there was insufficient money in the

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[4] Specifically, if the investors "(1) had no direct financial relationship with BLMIS, (2) had no property interest in the assets that the [f]eeder [f]unds invested with BLMIS, (3) had no securities accounts with BLMIS, (4) lacked control over the [f]eeder [f]unds' investments with BLMIS, and (5) were not identified or otherwise reflected in BLMIS's books and records," they are not "customers" under SIPA. *Kruse*, 708 F.3d at 427-28.

[5] For the nuances of which customers are entitled to distributions from the BLMIS customer property fund, see *SIPC*, 424 B.R. at 125.

BLMIS customer property fund for Picard to satisfy all allowed claims. *See In re Picard*, 917 F.3d at 92. "Whenever customer property is not sufficient to pay in full the [customers'] claims . . . the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of Title 11." 15 U.S.C. § 78fff-2(c)(3). As a result, Picard initiated actions against Appellees under Sections 548 and 550 of the Bankruptcy Code, 11 U.S.C. §§ 548, 550, to avoid and recover BLMIS's transfers to them.

II. The Instant Actions Under Bankruptcy Code Sections 548 and 550

Avoidance and recovery are related but distinct concepts. Section 548 governs the avoidance of actually and constructively fraudulent transfers by the debtor. It permits a trustee to "avoid"—*i.e.*, cancel—"any transfer . . . made or incurred on or within 2 years before the date of the filing of the [bankruptcy] petition, if the debtor . . . made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted." 11 U.S.C. § 548(a)(1)-(a)(1)(A). Section 550 authorizes a trustee to recover the property transferred by the debtor to any transferee (initial or subsequent) "to the extent that a transfer is avoided under [(*inter alia*)] section . . . 548 . . . of this title." 11 U.S.C. § 550(a). As a result, before Picard can recover the funds from Appellees, he must first avoid BLMIS's transfers to Appellees.

Voidability under § 548(a)(1)(A) focuses on the fraudulent intent of the debtor-transferor.[6] Under the so-called

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[6] Voidability under § 548(a)(1)(B) covers constructively fraudulent transfers: if the transfer was made for "less than a reasonably equivalent value in exchange for such transfer or obligation" and the debtor

"Ponzi scheme presumption," "the existence of a Ponzi scheme demonstrates actual intent as [a] matter of law because transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors." *Picard v. Estate (Succession) of Igoin (In re BLMIS)*, 525 B.R. 871, 892 n.21 (Bankr. S.D.N.Y. 2015) (internal quotation marks and citations omitted). Madoff admitted in his plea allocution that "for many years up until my arrest . . . I operated a Ponzi scheme through . . . [BLMIS]," and the parties do not dispute the applicability of the Ponzi scheme presumption here.[7] *See* Madoff Allocution at 1, *United States v. Madoff*, No. 09-cr-00213 (S.D.N.Y. Mar. 12, 2009), ECF No. 50.

Recovery, by contrast, focuses on the transferee. As discussed above, Section 550 authorizes a trustee to recover transfers voided under Section 548 from initial and subsequent transferees. *See* 11 U.S.C. § 550(a). But those transferees may defend against such recovery under various provisions of Sections 548 and 550, depending on

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was insolvent, fraud is presumed without requiring an actual intent to defraud by the debtor. 11 U.S.C. § 548(a)(1)(B).

[7] Indeed, Citi's counsel explicitly stated at oral argument they "are not challenging the application of the Ponzi scheme presumption." Oral Argument at 27:29-34, *In re BLMIS*, (Nos. 20-1333, 20-1334), https://www.ca2.uscourts.gov/oral_arguments.html. Our concurring colleague criticizes the Ponzi scheme presumption as leading to counterintuitive results by treating what would otherwise be preferential transfers under 11 U.S.C. § 547 as fraudulent transfers under 11 U.S.C. § 548. As he acknowledges, we have no occasion to assess—and therefore we do not address—whether the Ponzi scheme presumption is well-founded. *See* Concurring Op. at 4, 5 n.7. We are not in the practice of opining on issues not raised and undisputed by the parties. *See, e.g., Cook v. Arrowsmith Shelburne, Inc.*, 69 F.3d 1235, 1241 n.2 (2d Cir. 1995) ("We [] do not address the issue because it has not been argued in the instant matter.").

whether they are initial or subsequent transferees. Section 550(b)(1), applicable only to *subsequent* transferees, enables "a transferee that takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided" to retain the property transferred. 11 U.S.C. § 550(a)(2)-(b)(1). Initial transferees find recourse in § 548(c), under which a transferee "that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer." *Id.* § 548(c). The "main difference" between § 550(b)(1) and § 548(c) is that § 550(b)(1) provides "a complete defense to recovery of the property transferred," whereas under § 548(c), "the transaction is still avoided, but the transferee is given a lien to the extent value was given in good faith." 5 Collier on Bankruptcy ¶ 548.09 (16th ed. 2021).

Picard sued Appellees because, as alleged, BLMIS made fraudulent transfers to them, which are voidable under § 548, and Picard can recover those transfers under § 550 from subsequent transferees Citi and Khronos and initial transferee Legacy, unless they took the transfers for value and in good faith.

A) Picard's Action Against Citi[8]

Citi did not receive transfers directly from BLMIS. Instead, it received at least $343 million in subsequent transfers between June 2005 and March 2008 from feeder fund Rye Select Broad Market Prime Fund, L.P. ("Prime Fund") "as repayment of funds [Citi] loaned to Prime Fund to invest with BLMIS[]." No. 20-1333 J.A. 333-34. Beginning in the spring of 2005, Citigroup Global Markets, Inc. ("CGMI"), the main Citi affiliate that conducted

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[8] These allegations are drawn from Picard's proposed amended complaint against Citi.

BLMIS-related business, uncovered facts suggesting that BLMIS was engaged in fraudulent activity. Specifically, in its diligence for deals with feeder funds, Citi was "unable to independently verify that BLMIS maintained segregated customer accounts, or even that the assets existed in any account," and it was "unable to find any evidence that BLMIS was in fact making the options trades" it was reporting to its customers. *Id.* at 335.

In March 2005, CGMI performed a quantitative analysis in its diligence on the deal with feeder fund Fairfield Sentry Limited ("Fairfield Sentry"). The results revealed BLMIS was not using Madoff's purported "split strike conversion" ("SSC") investment strategy[9] because BLMIS's returns outperformed the market in a manner that appeared statistically impossible. In addition, CGMI knew BLMIS lacked an independent custodian for its customers' assets, giving BLMIS sole control over customers' funds and making it more likely BLMIS could steal or misuse those funds.

Around the same time, Leon Gross, a managing director at CGMI, conducted a separate investigation of BLMIS after Harry Markopolos, a CGMI customer, asked him to analyze BLMIS's investment strategy. Gross considered possible strategies Madoff could have been using to explain BLMIS's returns. He, too, concluded that the SSC strategy was incapable of producing BLMIS's reported returns and that Madoff did not en-

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[9] Madoff falsely told customers he used the SSC investment strategy, which involved "(i) the purchase of a group or basket of equities (the 'Basket') intended to highly correlate to the S&P 100 Index, (ii) the purchase of out-of-the-money S&P 100 Index put options, and (iii) the sale of out-of-the-money S&P Index call options." No. 20-1333 J.A. 354.

gage in any options transactions. As a result, Gross discerned that "either the returns are not the returns or the strategy is not the strategy." *Id.* at 369. Markopolos submitted a report to the SEC detailing the evidence of fraud at BLMIS and identifying Gross as one of the experts the SEC should contact for more information. In June 2007, Markopolos emailed Gross about BLMIS's potential downfall, asking him if he knew about "Madoff running short of new cash." *Id.* at 374.

CGMI was unable to confirm Madoff's purported options trades. Nor did CGMI prepare questions related to its main suspicions of fraud for a meeting it held with Madoff in November 2006, when it was planning to renew its deal with Prime Fund. Instead, the meeting was a "check-the-box exercise where CGMI sought only basic information that amounted to a 'corporate overview' of BLMIS." *Id.* at 389. Nevertheless, in its deal with Prime Fund, Citi "demanded a unique contractual indemnification provision related directly to fraud at BLMIS," and insisted on it before renewing the deal. *Id.* at 374, 392. Around the same time, CGMI rejected a separate proposed deal with Tremont Partners, Inc., Prime Fund's general partner, because it lacked such indemnification.

Picard seeks to avoid and recover $343,084,590 in subsequent transfers from Prime Fund to Citi, arguing that the Citi defendants received these transfers "at a time when they were willfully blind to circumstances suggesting a high probability of fraud at BLMIS." *Id.* at 413.

B) Picard's Action Against Legacy and Khronos[10]

Legacy is a British Virgin Islands corporation that

[10] These allegations are drawn from Picard's amended complaint against Legacy and Khronos.

invested solely in BLMIS. Jimmy Mayer and his son, Rafael Mayer, run Legacy. Acting in their individual capacities, the Mayers invested in the Meritage fund, a hedge fund managed by Renaissance Technologies LLC ("Renaissance"). Meritage invested in BLMIS, and Rafael was a member of the committee responsible for overseeing Meritage's investments.

Suspicious of BLMIS's returns, Renaissance analyzed Madoff's purported SSC investment strategy and produced a report in October 2003 presenting its results, entitled the "Renaissance Proposal." The Renaissance Proposal was shared with the Meritage committee members, including Rafael. It revealed that the market could not support the options volume BLMIS purported to trade, that many of BLMIS's trades were at improbable prices, and that there was no footprint of its trades. These findings sparked email exchanges in November 2003 between Meritage committee members, who expressed concern about the risk of fraud at BLMIS; Rafael was included in these emails. When Renaissance decided to redeem Meritage's investment in BLMIS in 2004, Rafael was the only member of the Meritage committee who objected.

Rafael convinced the Meritage committee to delay redeeming half of Meritage's investment; Legacy ultimately bought that half in July 2004. Legacy then instructed Khronos, which provided accounting services to Legacy, to investigate BLMIS. Khronos was co-founded by Rafael and his brother, David Mayer, who were also the managing directors of Khronos. In addition to relying on Khronos rather than an independent third party to investigate BLMIS, Rafael and David restricted the access of Khronos's employees to Legacy and its BLMIS account statements, "[c]ontrary to Khronos's standard investment monitoring process." No. 20-1334 J.A. 102. As a result, Rafael and David, as the managers of Khronos, were the only ones permitted to review Legacy's account details. Khronos's evaluation of BLMIS's trading data confirmed that the trades were "statistically impossible" and revealed that BLMIS lacked a capable auditor and "clearly lacked the staff necessary to conduct research on the investment opportunities." *Id.* at 109, 115.

Picard seeks to avoid and recover $213,180,068 that Legacy received from BLMIS in initial transfers, and $6,601,079 that Khronos received "as investment management and accounting services fees" in subsequent transfers, arguing both defendants received these transfers with "willful blindness to circumstances suggesting a high probability of fraud at BLMIS." *Id.* at 91, 124-25.11.[11]

III. The Decisions Below

Appellees moved to withdraw their cases from the bankruptcy court to the district court to decide "whether SIPA and other securities laws alter the standard the [t]rustee must meet in order to show that a defendant did not receive transfers in 'good faith' under either 11 U.S.C. § 548(c) or 11 U.S.C. § 550(b)." *SIPC v. BLMIS*, 516 B.R. 18, 20 (S.D.N.Y. 2014) (the "*Good Faith Decision*") (citation omitted). The district court granted their motion.[12]

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[11] The relief sought from Khronos is pleaded in the alternative, to the extent that any of the $6.6 million in fees paid to Khronos included funds that were initially transferred to Legacy.

[12] The district court has the authority to withdraw, on its own or upon the motion of a party, any case referred to the bankruptcy court. *See* 28 U.S.C. § 157(d). The court must, "on timely motion of a party," withdraw the reference if it "determines that resolution of the proceeding requires consideration of both title 11 and other laws of the

The district court made two rulings on the "good faith" defense. First, the court concluded that a lack of good faith in a SIPA liquidation requires "a showing that the defendant acted with *willful blindness* to the truth, that is, he intentionally chose to blind himself to the red flags that suggest a high probability of fraud." *Id.* at 21 (internal quotation marks, alteration, and citation omitted) (emphasis added). It rejected applying an *inquiry notice* standard, "under which a transferee may be found to lack good faith when the information the transferee learned would have caused a reasonable person in the transferee's position to investigate the matter further." *Id.* (internal quotation marks and citation omitted).

Second, the court set the pleading burden for the good faith defense, finding that good faith is an *affirmative defense* and acknowledging that "in the context of an ordinary bankruptcy proceeding," the defendant bears the burden of pleading this affirmative defense under both Section 548(c) and Section 550(b)(1). *Id.* at 24. The district court nevertheless concluded that "SIPA . . . affects the burden of pleading good faith or its absence" and alters the traditional framework such that, in a SIPA liquidation, the trustee bears the burden of pleading the defendant's lack of good faith. *Id.*

The district court returned the cases to the bankruptcy court, which applied the standard articulated by the district court and dismissed both actions. The bankruptcy court denied Picard leave to amend his complaint against Citi, finding it would be futile because his proposed amended complaint does not plausibly allege willful blindness. It also dismissed Picard's amended complaint

United States regulating organizations or activities affecting interstate commerce." *Id.*

against Legacy and Khronos for failing to plausibly allege their willful blindness to the fraud committed by BLMIS.[13] Picard and SIPC appeal both judgments of the bankruptcy court.

DISCUSSION

There are two[14] issues before us: (1) the definition of "good faith" in the context of a SIPA liquidation; and (2) which party bears the burden of pleading good faith or the lack thereof.

I. Defining "Good Faith" in a SIPA Liquidation

As recounted above, the district court rejected the *inquiry notice* standard, "under which a transferee may be found to lack good faith when the information the transferee learned would have caused a reasonable person in the transferee's position to investigate the matter further." *Good Faith Decision*, 516 B.R. at 21 (internal quotation marks and citation omitted). Instead, it decided the appropriate standard is *willful blindness*, under which the defendant lacks good faith if it "intentionally [chose] to blind [itself] to the red flags that suggest a high probability of fraud." *Id.* (internal quotation marks and citation omitted).

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[13] The bankruptcy court dismissed Picard's action against Legacy in all respects "except as to the portion . . . seeking to avoid and recover fictitious profits transferred to Legacy," payments it received in excess of its principal. *See Picard v. Legacy Capital Ltd. (In re BLMIS)*, 548 B.R. 13, 17 (Bankr. S.D.N.Y. 2016).

[14] The parties also briefed a third issue: whether Picard's proposed amended complaint against Citi and amended complaint against Legacy and Khronos plausibly allege Appellees were willfully blind to fraud at BLMIS. Because we vacate the bankruptcy court's judgments based on the first two issues, we do not address this third issue.

Inquiry notice is distinct from willful blindness both in degree and intent. "[A] willfully blind defendant is one who takes *deliberate* actions to avoid confirming a *high probability* of wrongdoing and *who can almost be said to have actually known the critical facts*." *Glob.-Tech Appliances, Inc. v. SEB S.A.*, 563 U.S. 754, 769 (2011) (emphasis added). Inquiry notice requires knowledge of suspicious facts that need not suggest a "high probability" of wrongdoing but are nonetheless sufficient to induce a reasonable person to investigate. *See Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 650-51 (2010) (collecting cases). Willful blindness also imputes a heightened sense of culpability, whereas a defendant on inquiry notice who fails to investigate does not necessarily do so with the purpose of avoiding confirming the truth.

The district court reasoned that because (1) SIPA is part of the securities laws, (2) a lack of good faith under the securities laws requires fraudulent intent, and (3) SIPA "expressly provides that the Bankruptcy Code applies only '[t]o the extent consistent with the provisions of this chapter [of the federal securities laws],'" the inquiry notice standard for good faith applicable under the Bankruptcy Code "must yield" to the willful blindness standard for good faith required under the securities laws. *Good Faith Decision*, 516 B.R. at 21-22 (quoting 15 U.S.C. § 78fff(b)) (alterations in original). It also determined "in the context of securities transactions such as those protected by SIPA, the inquiry notice standard . . . would be both unfair and unworkable" because it "would impose a burden of investigation on investors totally at odds with the investor confidence and securities market stability that SIPA is designed to enhance." *Id.* at 22.

On appeal, Citi mounts an alternative defense of the district court's ruling. It argues that the ordinary meaning of good faith in the Bankruptcy Code applies a willful blindness standard to establish lack of good faith. Legacy and Khronos primarily defend the district court's "securities-law theory," arguing that because SIPA is housed within the federal securities laws, the willful blindness standard for lack of good faith in the securities context applies here. We review interpretations of a statute *de novo*, *In re BLMIS*, 654 F.3d at 234, and conclude that inquiry notice, rather than willful blindness, is the appropriate standard for determining lack of good faith in a SIPA liquidation, just as it is in an ordinary bankruptcy proceeding.

A) A Lack of Good Faith Under Sections 548(c) and 550(b) of the Bankruptcy Code Does Not Require Willful Blindness

Section 550(b) of the Bankruptcy Code, which applies to Citi and Khronos as subsequent transferees, provides that "[t]he trustee may not recover . . . from . . . a transferee that takes for value, . . . *in good faith*, and without knowledge of the voidability of the transfer avoided."[15] 11 U.S.C. § 550(b)-(b)(1) (emphasis added). Similarly, § 548 (c), which applies to initial transferee Legacy, permits a transferee that "takes for value and *in good faith* . . . [to] retain any interest transferred." *Id.* § 548(c) (emphasis added). Appellees do not contend that the definition of

[15] The "for value" defense is not at issue in this appeal. The district court assumed for the purpose of its decision that the transfers were made "for value," *see Good Faith Decision*, 516 B.R. at 20, n.1, and we do the same.

good faith differs between the sections.[16] They offer "no reason to depart from the normal rule of statutory construction that words repeated in different parts of the same statute generally have the same meaning." *Law v. Siegel*, 571 U.S. 415, 422 (2014) (internal quotation marks and citation omitted).

The Bankruptcy Code does not define "good faith." "When a term goes undefined in a statute, we give the term its ordinary meaning." *Taniguchi v. Kan Pac. Saipan, Ltd.*, 566 U.S. 560, 566 (2012). "To assess ordinary meaning, we consider the commonly understood meaning of the statute's words at the time Congress enacted the statute, and with a view to their place in the overall statutory scheme." *New York v. Nat'l Highway Traffic Safety Admin.*, 974 F.3d 87, 95 (2d Cir. 2020) (internal quotation marks and citations omitted).

Dictionary definitions and case law predating the Bankruptcy Code of 1978, "usual source[s] that might shed light on the statue's ordinary meaning," *Food Mktg. Inst. v. Argus Leader Media*, 139 S. Ct. 2356, 2363 (2019), demonstrate that "good faith" encompasses inquiry notice. At the time of the Bankruptcy Code's drafting, Black's Law Dictionary defined good faith as "[h]onesty of intention, and freedom from *knowledge of circumstances which ought to put [a party] upon inquiry*," as well as "[a]n honest intention to abstain from taking any unconscientious advantage of another, even through technicalities of law, together with absence of all information,

[16] Although Citi notes in passing that Picard relies on cases that do not "deal with Section 550," such as an Eighth Circuit decision applying the inquiry notice standard for lack of good faith under § 548, *see* Citi's Br. at 33, it does not otherwise explain or argue that good faith under § 548 takes on a different meaning from that under § 550.

notice, or benefit or belief of facts which render [a] transaction unconscientious." Black's Law Dictionary 822 (rev. 4th ed. 1968) (emphases added); *see also* Black's Law Dictionary 623 (5th ed. 1979) (same); *id.* at 624 (defining "good faith purchasers" as "[t]hose who buy without notice of circumstances which would put a person of ordinary prudence on inquiry as to the title of the seller"). Ballantine's Law Dictionary similarly defined good faith as "[f]airness and equity[,] [t]he antithesis of fraud and deceit[,] and [a]cting in the absence of circumstances placing a man of ordinary prudence *on inquiry*." Ballentine's Law Dictionary 528 (3d ed. 1969) (emphasis added). And the Oxford English Dictionary, "one of the most authoritative on the English language," *Taniguchi*, 566 U.S. at 569, explained that "[t]he Eng[lish] uses [of good faith] closely follow those of [the Latin phrase *bona fides*]," "in which the primary notion seems to have been the *objective aspect* of confidence well . . . bestowed" and defined "good faith" as "honesty of intention in entering into engagements, sincerity in professions." Oxford English Dictionary 460 (1961) (emphasis added).

Aside from dictionary definitions, "[t]he meaning—or ambiguity—of certain words or phrases may only become evident when placed in context." *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 132 (2000); *see also* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 70 (2012) (explaining that because "[m]ost common English words have a number of dictionary definitions" and "[m]any words have more than one ordinary meaning," "[o]ne should assume the contextually appropriate ordinary meaning unless there is reason to think otherwise"). Here, the context is Sections 548 and 550 of the Bankruptcy Code, which deal with the trustee's ability to avoid and recover fraudulent transfers, and these provisions derive from the law of fraudulent conveyances.[17] *See* 5 Collier on Bankruptcy ¶ 548.01 (16th ed. 2021). The concept of "good faith" as historically used in fraudulent conveyance law therefore informs our construction of the phrase in Sections 548 and 550.

Early fraudulent conveyances cases exemplify the principle that transferees of a fraudulent transfer did not act in good faith when they had inquiry notice of the debtor-transferor's fraud. *See, e.g.*, *Bentley v. Young*, 210 F. 202, 205 (S.D.N.Y. 1914) (Learned Hand, *J.*) ("It must be remembered that [the transferee's] *personal* good faith is not enough; the question is, not what he individually believed, but whether the circumstances would have put a reasonable man in his situation upon inquiry, and whether that inquiry would have led to sufficient knowledge of the facts to prevent the sale.") (emphasis added), *aff'd* 223 F. 536 (2d Cir. 1915); *Johnson v. Dismukes*, 204 F. 382, 382 (5th Cir. 1913) (affirming district court's avoidance of fraudulent transfer under the Bankruptcy Act of 1898 where "the facts and circumstances accompanying the transaction were calculated to put [the transferee] upon inquiry"); *see also Harrell v. Beall*, 84 U.S. 590, 591 (1873) (noting that the transferee not only "intentionally shut his eyes to the truth" but also "had such notice and information as made it his duty to inquire further, and that the slightest effort by him in that direction would have discovered the whole fraud").

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[17] "Originally, the body of law was known as fraudulent conveyance law, and was limited . . . to fraudulent conveyances of real property. Current fraudulent transfer law has expanded to include transfers of personal property, and the incurring of obligations." 5 Collier on Bankruptcy ¶ 548.01 n.3 (16th ed. 2021). The law of fraudulent conveyances traces its roots to the Elizabethan statutes of 1571. *See id.* ¶ 548.01.

In 1918, the National Conference of Commissioners on Uniform State Laws approved and recommended the Uniform Fraudulent Conveyance Act ("UFCA") in an attempt to end the then-existing confusion caused by a lack of uniformity between different states' fraudulent conveyances laws. *See* Nat'l Conf. of Comm'rs on Unif. State L., *Prefatory Note to* Unif. Fraudulent Conveyance Act (1918), *reprinted in* Peter A. Alces, Law of Fraudulent Transactions, App. A (2020). Several states adopted the UFCA, which provided for the transferee's lack of "good faith" as a basis for voiding fraudulent transfers. *See id.* § 9; *id.* § 3 (defining "fair consideration" to require "good faith"). Interpreting New York's version of the UFCA in a more recent case, we concluded that the transferee lacked good faith where she had "information sufficient to alert" her that the debtor-transferor "might improperly funnel to third parties the money she was advancing" and should have, but did not, "ma[ke] reasonably diligent inquiries," s*ee HBE Leasing Corp. v. Frank*, 48 F.3d 623, 637 (2d Cir. 1995)—in other words, inquiry notice. *See also Davis v. Hudson Tr. Co.*, 28 F.2d 740, 743 (3d Cir. 1928) (interpreting "good faith" under New Jersey's Uniform Fraudulent Conveyance Act as imposing an inquiry notice standard).

The Bankruptcy Act of 1938 (the "1938 Act"), predecessor of the Bankruptcy Code of 1978, built upon this established inquiry notice standard for good faith. Portions of the 1938 Act were a "federal codification" of the UFCA. *Cohen v. Sutherland*, 257 F.2d 737, 741 (2d Cir. 1958). Section 67d(6) of the 1938 Act permitted "bona-fide" transferees of fraudulent transfers to retain those transfers. S*ee* Pub. L. No. 75-696, 52 Stat. 840, 878 (1938). Courts and scholars accepted "bona-fide" as synonymous with good faith, *see Cohen*, 257 F.2d at 743 n.4, and concluded that—as with good faith under the UFCA—"the presence of any circumstances placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith," *Steel Structures, Inc. v. Star Mfg. Co.*, 466 F.2d 207, 215-16 (6th Cir. 1972) (quoting 4 Collier on Bankruptcy § 67.41, at 589-90 (14th ed.)); *see also* Paul J. Hartman, *A Survey of the Fraudulent Conveyance in Bankruptcy*, 17 Vand. L. Rev. 381, 409 (1964) ("'Good faith' on the part of the transferee, so as to be protected under section 67d(6) of the [1938] Act, seems to presuppose lack of knowledge of such facts as would put a reasonably prudent person on inquiry.").

In light of this background understanding of the term good faith in early American fraudulent conveyance law, the 1938 Act, and typical legal usage at the time of the enactment of the Bankruptcy Code, the plain meaning of good faith in Sections 548 and 550 of the Bankruptcy Code embraces an inquiry notice standard. We therefore need not consider other tools of statutory interpretation. *See Marvel Characters, Inc. v. Simon*, 310 F.3d 280, 290 (2d Cir. 2002) (finding that "we may seek guidance in the legislative history and purpose of the statute" only when there is ambiguity). However, even if we found the statute to be ambiguous, the legislative history supports our conclusion. In 1970, Congress established the Commission on the Bankruptcy Laws of the United States (the "Bankruptcy Law Commission") to analyze and recommend changes to federal bankruptcy law in a "comprehensive report." *See* Pub. L. No. 91-354, 84 Stat. 468, 468 (1970). In Part II of the report containing a draft bill implementing its recommendations, the Bankruptcy Law Commission proposed: "[t]he trustee may not recover property . . . from a subsequent transferee . . . who purchases for value in good faith without knowledge of the voidability of the initial transfer." Rep. of Comm'n on Bankr. L. of U.S., H.R. Doc. No. 93-137, Pt. II at 179 (1973). It then explained that "no attempt ha[d] been made to define" good faith because "[i]t was felt best to leave this to the courts on a case-by-case construction," but that "good faith clearly would not be present if the transferee knew facts that would lead a reasonable person to believe that the property was recoverable." *Id.* at 180.[18] This accords with inquiry notice, as it includes the "knowledge of facts" and "reasonable person" elements.[19]

Moreover, our sister circuits that have addressed the issue unanimously accept an inquiry notice standard. In *In re Nieves*, 648 F.3d 232 (4th Cir. 2011), the court held that, "[i]n determining good faith for the purposes of a § 550(b)(1) defense, . . . a transferee does not act in good faith when he has sufficient [actual] knowledge to place him on inquiry notice of the debtor's possible insolvency." *Id.* at 238 (citation omitted). "In so holding, [the court] arrive[d] at the same conclusion as . . . three other circuit courts [(the Seventh, Eighth, and Ninth Circuits)] that have addressed the issue." *Id.* (citing *In re Sherman*, 67

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[18] The report also acknowledged that this proposed section governing liability of transferees was "derived from [(*inter alia*)] . . . [§] 67d(6)" of the 1938 Act, H.R. Doc. No. 93-137, Pt. II at 179. As discussed above, courts had interpreted a "bona-fide" transferee under § 67d(6) of the 1938 Act to encompass a transferee so long as the transferee was not on inquiry notice of a debtor-transferor's fraud. *See, e.g.*, *Steel Structures, Inc.*, 466 F.2d at 215-16 (citing 4 Collier on Bankruptcy § 67.41, at 588-90 (14th ed.)).

[19] By contrast, willful blindness requires more than knowing facts that would lead a reasonable person to infer fraud: the defendant must "subjectively believe that there is a high probability that a fact exists" and "take deliberate actions to avoid learning of that fact." *Glob.-Tech Appliances*, 563 U.S. at 769. Nothing in the legislative history suggests the Bankruptcy Law Commission or Congress aimed to set such a high bar.

F.3d 1348, 1355 (8th Cir. 1995); *In re Agric. Rsch. & Tech. Grp., Inc.*, 916 F.2d 528, 535-36 (9th Cir. 1990); *Bonded Fin. Servs., Inc. v. Eur. Am. Bank*, 838 F.2d 890, 897-98 (7th Cir. 1988)).[20] The Fifth and Tenth Circuits agree. *See In re Am. Hous. Found.*, 785 F.3d 143, 164 (5th Cir. 2015), *revised* (June 8, 2015); *In re M & L Bus. Mach. Co., Inc.*, 84 F.3d 1330, 1334-38 (10th Cir. 1996).

In a prior BLMIS-liquidation opinion, we too expressed that "[t]he presence of good faith [under § 548(c)] depends upon, *inter alia*, whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose." *Marshall*, 740 F.3d at 91 n.11 (2d Cir. 2014) (internal quotation marks and citation omitted). And while the district court dismissed this language as *dictum*, *see Good Faith Decision*, 516 B.R. at 22 n.2, even before *Marshall*, we expressed that "[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." *Banner v. Kassow*, 104 F.3d 352 (2d Cir. 1996) (unpublished opinion) (quoting *In re Sherman*, 67 F.3d at 1355).[21]

The then-current dictionary definitions when the Bankruptcy Code was enacted and early case law fail to

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[20] By cherry-picking certain language from the Seventh Circuit's opinion, Citi argues that *Bonded* actually adopted a higher standard than inquiry notice for good faith. But the Seventh Circuit disagrees. *See In re Equip. Acquisition Res., Inc.*, 803 F.3d 835, 840 (7th Cir. 2015) ("The *Bonded* Court found that § 550(b)(1) codified an imputed knowledge or inquiry notice standard.").

[21] This "unpublished opinion" appears in the Federal Reporter because it was decided before the introduction of the Federal Appendix in 2001, where unpublished opinions ("summary orders") of this Circuit usually appear.

establish that the common understanding of lack of good faith in the fraudulent conveyances context was, at a minimum, willful blindness. In many of the early cases on which Citi relies, willful blindness was *sufficient*, but not *necessary*, to establish a lack of good faith. *See, e.g.*, *Dean v. Davis*, 242 U.S. 438, 445 (1917); *Wilson v. Robinson*, 83 F.2d 397, 398 (2d Cir. 1936). The few cases where the Supreme Court expressed a standard for good faith closer to willful blindness concerned the title of a holder of negotiable instruments, far removed from this context.[22] *See Goodman v. Simonds*, 61 U.S. (20 How.) 343, 363-65 (1857); *Murray v. Lardner*, 69 U.S. (2 Wall.) 110, 121-22 (1864).

Citi also fails to appreciate the distinction between *preferential* transfers, where the debtor makes payments to certain creditors and not others, and (actually) *fraudulent* transfers, where, as discussed above, the debtor possesses an intent to defraud and reduces the assets available to all creditors. *See Van Iderstine v. Nat'l Disc. Co.*, 227 U.S. 575, 582 (1913). Citi contends that the district court's willful blindness standard is supported by this Court's decision in *In re Sharp Int'l Corp.*, 403 F.3d 43 (2d Cir. 2005), which held that a transferee did not act in bad

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[22] Appellees also rely on the Uniform Commercial Code ("UCC"), which—at the time the Bankruptcy Code was enacted—defined good faith for merchants as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade," and for nonmerchants as "honesty in fact in the conduct or transaction concerned." U.C.C. §§ 2-103(1)(b), 1-201(19) (1978). Their reliance is misplaced. First, "honesty in fact" is not limited to lacking fraudulent intent. Second, because "identical language may convey varying content when used in different statutes," *Yates v. United States*, 574 U.S. 528, 537 (2015), and given the well-established use of inquiry notice under the Bankruptcy Code and the statutory schemes upon which it was directly modeled, the UCC is of limited import here.

faith under New York's UFCA where the transferee was alleged to have at least inquiry notice that the debtor had made certain preferential transfers to the defendant. *See id.* at 48, 54-55. But *In re Sharp* and the cases upon which it relies, *see id.* at 54-55 (citing, *inter alia*, *Bos. Trading Grp., Inc. v. Burnazos*, 835 F.2d 1504, 1512 (1st Cir. 1987)), do not affect the meaning of good faith here, much less support the district court's willful blindness standard. Rather, *In re Sharp* stands for the principle that a transfer is not voidable on the ground that it is constructively fraudulent under the UFCA (which requires showing a transferee's bad faith) where the transferee is aware "that the transferor is preferring him to other creditors." *Id.* at 54-55 (internal quotation marks omitted). Given the Ponzi scheme presumption establishing that BLMIS's transfers were fraudulent, the absence of an inquiry notice standard in the preferential transfers context simply has no bearing on the meaning of good faith here. Indeed, *In re Sharp* acknowledged that this Court had previously adopted an inquiry notice standard for good faith under the UFCA in *HBE Leasing*, 48 F.3d 623, but distinguished that case because it involved a fraudulent transfer, whereas *In re Sharp* concerned a preferential transfer. *See id.* at 55.[23]

[23] Citi's argument regarding the "without knowledge" prong of § 550(b) in determining the meaning of "good faith" is equally unavailing. *See* 11 U.S.C. § 550(b)(1) ("The trustee may not recover . . . from . . . a [subsequent] transferee that takes for value, . . . in good faith, and *without knowledge of the voidability of the transfer avoided*.") (emphasis added). Citi contends good faith could not mean inquiry notice because some courts have interpreted "without knowledge" as "an example of good faith" and "'without knowledge' is a standard different than notice." Citi's Br. at 24 n.7. However, Citi fails to cite to any case where a court has held that both good faith and without knowledge apply a willful blindness standard. Although

Lastly, Appellees' contention that lack of good faith requires willful blindness is premised in part on the misconception that inquiry notice is *purely objective*. Their argument goes: (1) "'[g]ood faith,' as it is plainly understood, refers to one's *subjective* intentions," Citi's Br. at 25; (2) inquiry notice is *purely objective*: what the investor knew or "should have known" about BLMIS "based on a theory of fraud by hindsight," akin to a negligence standard, *id.* at 20; (3) willful blindness, by contrast, is subjective; (4) as a result, we should reject inquiry notice in favor of willful blindness. Even assuming that premises (1) and (3) are correct, the error in premise (2) renders the conclusion invalid.

Inquiry notice is not purely objective, nor is it a negligence standard. Although some courts have characterized inquiry notice as an "objective test," under which "courts look to what the transferee objectively 'knew or should have known' in questions of good faith," *In re Bayou Grp., LLC*, 439 B.R. 284, 313 (S.D.N.Y. 2010) (citation omitted), "what the transferee *should have known* depends on what it *actually knew*, and not what it was charged with knowing on a theory of constructive notice." *In re Nieves*, 648 F.3d at 238 (emphases added). As a result, even courts that use the phrase "should have known" acknowledge that the first step in the inquiry notice analysis looks to what facts the defendant *knew*. *See, e.g., In re Sherman*,

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we do not endorse this view, we note solely for the purpose of dismissing Citi's argument that courts that have found "good faith" and "without knowledge" to be synonymous have concluded inquiry notice applies to both, not that both require willful blindness. *See, e.g.*, *In re Nieves*, 648 F.3d at 240 (noting that *Mixon*, a previous Fourth Circuit case, "discusse[d] only the knowledge prong of § 550(b)(1), not good faith," but that *Mixon* "ask[ed] if the transferee possesse[d] actual knowledge of facts that would lead a reasonable person to believe that the transferred property was voidable").

67 F.3d at 1355; *In re Bayou Grp., LLC*, 439 B.R. at 310 ("The first question typically posed is whether the transferee *had information* that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose.") (emphasis added). Our view of inquiry notice incorporates both objective and subjective components. Inquiry notice "signifies actual awareness of suspicious facts that would have led a reasonable [transferee], acting diligently, to investigate further and by doing so discover" a debtor-transferor's fraud. *In re Sentinel Mgmt. Grp., Inc.*, 809 F.3d 958, 961 (7th Cir. 2016).[24]

Thus, the good faith defense under Sections 548(c) and 550(b)(1) should be approached in a three-step inquiry. First, a court must examine what facts the defendant knew; this is a subjective inquiry and not "a theory of constructive notice." *In re Nieves*, 648 F.3d at 238. Second, a court determines whether these facts put the transferee on inquiry notice of the fraudulent purpose behind a transaction—that is, whether the facts the transferee knew would have led a reasonable person in the transferee's position to conduct further inquiry into a debtor-transferor's possible fraud. *See In re Bayou Grp., LLC*, 439 B.R. at 310. Third, once the court has determined that a transferee had been put on inquiry notice, the court

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[24] Citi argues that "the Supreme Court has rejected a good faith test that combines both subjective and objective elements as 'not entirely reconcilable.'" Citi's Br. at 13 (citing *Goodman*, 61 U.S. at 363 and *Murray* 69 U.S. at 121-22). *Goodman* and *Murray*, as explained above, concern inapposite contexts and do not wholesale reject a definition of good faith that incorporates subjective and objective elements. Indeed, the extensive case law referenced above demonstrates that courts have been successfully applying the inquiry notice standard under Sections 548 and 550 as we articulate without any perceivable difficulty.

must inquire whether "diligent inquiry [by the transferee] would have discovered the fraudulent purpose" of the transfer. *Id.* (quoting *In re Agric. Rsch. & Tech. Grp.*, 916 F.2d at 536) (emphasis omitted); *see also In re M & L Bus. Mach. Co.*, 84 F.3d at 1338. An objective "reasonable person" standard applies in the second and third steps, namely, in assessing whether (1) the suspicious facts were such that they would have put a reasonable person in the transferee's position on inquiry notice; and (2) the transferee conducted a reasonably diligent investigation after being put on inquiry notice. *See In re Bayou Grp., LLC*, 439 B.R. at 313 (collecting cases).

In sum, we join all of our sister circuits that have addressed the issue in holding that a lack of good faith under Sections 548 and 550 of the Bankruptcy Code encompasses an inquiry notice standard. The historical usage of the phrase "good faith" (particularly as used in the context of fraudulent conveyance law), this Court's prior case law, and the legislative history of the Bankruptcy Code all lead us to reject the heightened willful blindness standard that Citi argues should be applied even in ordinary bankruptcy proceedings.

B) The Securities Laws Do Not Impose a Willful Blindness Standard for Lack of Good Faith in a SIPA Liquidation

Even accepting that good faith under the Bankruptcy Code uses inquiry notice, Legacy, Khronos, and to a lesser extent Citi argue that willful blindness is required here *because SIPA is different*. They defend the district court's theory, which no court of appeals has ever adopted,[25] that

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[25] The district court relied solely on its own earlier precedent. It first articulated its securities-law theory in a prior BLMIS-liquidation case, *Picard v. Katz*, 462 B.R. 447, 455-56 (S.D.N.Y. 2011), and

because SIPA "is part of the securities laws and expressly provides that the Bankruptcy Code applies only [t]o the extent consistent with the provisions of this chapter [of the federal securities laws]," and because "good faith in the securities context implies a lack of fraudulent intent," lack of good faith in a SIPA liquidation requires willful blindness. *Good Faith Decision*, 516 B.R. at 22 (internal quotation marks and citation omitted) (alterations in original). The cornerstone of the district court's theory is that SIPA prohibits the trustee from utilizing the inquiry notice standard under the Bankruptcy Code because it is inconsistent with the willful blindness standard under federal securities laws. It reached this view through an analysis of the text and policy considerations underlying SIPA and federal securities laws.

Section 78fff of SIPA provides "[t]o the extent consistent with the provisions of *this chapter*, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under[, the Bankruptcy Code]." 15 U.S.C. § 78fff (emphasis added).[26] While the

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reaffirmed the theory in *Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012), neither of which were appealed.

[26] As explained above, SIPA specifies in a later section "[w]henever customer property is not sufficient to pay in full the [customers'] claims . . . the trustee may recover any property transferred . . . if and to the extent that such transfer is voidable or void under the provisions of Title 11," which includes Sections 548 and 550. *Id.* § 78fff-2. This provision, unlike the one on which the district court relied, is not cribbed by the "[t]o the extent consistent with the provisions of this chapter" clause. By stating that a SIPA trustee may recover "*to the extent* that such transfer is voidable or void under [the Bankruptcy Code]," this section therefore indicates that a SIPA trustee's power to avoid and recover transfers under Sections 548 and 550 should be coextensive with that of an ordinary bankruptcy trustee. *Id.* (emphasis added). The district court's *Good Faith Decision*, by contrast, nec-

district court interpreted "this chapter" to mean "this chapter [of the federal securities laws]," *Good Faith Decision*, 516 B.R. at 22—*i.e.*, Title 15—"this chapter" actually refers to *SIPA itself*—*i.e.*, Chapter 2B-1 of Title 15. *See id.* § 78aaa ("*This chapter* may be cited as the 'Securities Investor Protection Act of 1970.'") (emphasis added). Nevertheless, SIPA also provides that "[e]xcept as otherwise provided in [SIPA], *the provisions of the Securities Exchange Act of 1934* (hereinafter referred to as the "1934 Act") *apply as if [SIPA] constituted an amendment to, and was included as a section of, such Act*." *Id.* § 78bbb (emphasis added). SIPA is therefore part of the 1934 Act.

Despite this incorporation of SIPA into the 1934 Act, the securities-law theory does not hold up. By making SIPA an *amendment* to the 1934 Act, Congress intended for *SIPA* to apply if the 1934 Act is inapplicable or inconsistent with SIPA. It is a "well established canon of statutory interpretation" that "the specific governs the general." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012) (citation omitted). Moreover, when "the scope of the earlier statute is broad but the subsequent statute[] more specifically address[es] the topic at hand," there is even greater reason to assume the later statute controls. *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 143 (2000). As a result, where SIPA speaks and the 1934 Act is silent, SIPA governs.

Nothing in the 1934 Act (minus SIPA) concerns liquidation proceedings of insolvent securities broker-dealers.

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essarily puts SIPA trustees at a disadvantage compared to their ordinary bankruptcy counterparts by setting a higher bar for a transferee's lack of good faith.

"The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). Its overall goal is "to protect investors against false and deceptive practices that might injure them." *Id.* at 198. Over time, Congress enacted statutes such as SIPA to address specific aspects of the securities industry.

However, unlike the 1934 Act, SIPA does not regulate fraud on securities markets. Instead, its "primary purpose . . . is to provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." H.R. Rep. No. 91-1613, at 1 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5254, 5254. Indeed, we have previously explained that "SIPA's supposed purpose was to remedy broker-dealer insolvencies—not necessarily broker-dealer fraud." *SIPC v. 2427 Parent Corp. (In re BLMIS)*, 779 F.3d 74, 79 (2d Cir. 2015).

Accordingly, the *general* "fraudulent intent" requirement in the 1934 Act is irrelevant to the *specific* context of a SIPA liquidation.[27] The district court derived the

[27] Legacy and Khronos argue that our ruling in *Gettinger*, 976 F.3d 184, supports the securities-law theory. *Gettinger* concluded that recognizing the "for value" defense of the defendants-appellants, who received fictitious profits from BLMIS, "would conflict with SIPA" even though it would be permissible under the Bankruptcy Code. *See id.* at 199-200. However, *Gettinger* recognized that the for value defense "would place the defendants-appellants, who have no net equity and thus are not entitled to share in the customer property fund, ahead of customers who have net equity claims," which "SIPA does not permit." *Id.* at 199. Nowhere did *Gettinger* invoke "the securities laws," generally. *See id.* And, if anything, a willful blindness standard would

fraudulent intent requirement from Section 10(b) of the 1934 Act. *See Good Faith Decision*, 516 B.R. at 22 (citing *Ernst & Ernst*, 425 U.S. at 206). Section 10(b) regulates "deceptive conduct in connection with the purchase or sale of [specific] securit[ies]." *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247, 266 (2010) (internal quotation marks and citation omitted). It would be odd indeed to assume that, just because § 10(b) requires investors bringing damages actions to prove the fraudulent intent of the defendant in purchase-and-sale transactions, the same intent is necessarily required of transferees from whom a SIPA trustee seeks to recover fraudulent transfers by a broker-dealer in its liquidation. A § 10(b) action for securities fraud is meaningfully different from a SIPA liquidation.

But even if we accept for argument's sake that "this chapter" in § 78fff includes the 1934 Act, there is nothing in the 1934 Act that actually requires *willful blindness* in this context. Although the Supreme Court has never held that reckless disregard suffices for § 10(b) liability, "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the [c]ircuits differ on the degree of recklessness required." *Tellabs, Inc. v. Makor Issues & Rts., Ltd.*, 551 U.S. 308, 319 n.3 (2007); *see, e.g.*, *S. Cherry*

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hinder, rather than advance, SIPA's purpose by making it more difficult to recover customer property. *See* 6 Collier on Bankruptcy ¶ 749.02 (16th ed. 2021) (explaining that "[t]he overall purpose of [SIPA's transfer recovery provision, 15 U.S.C. § 78fff-2(c)(3),] is to prevent one or more customers from depriving other customers of assets by keeping these assets out of the pool available for distribution to customers on a ratable basis") (internal quotation marks and citation omitted).

St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 109 (2d Cir. 2009) ("This Court has . . . long held that the scienter element can be satisfied by a strong showing of reckless disregard for the truth."). Yet because "willful blindness . . . surpasses recklessness," *Glob.-Tech Appliances*, 563 U.S. at 769, the former may well be too stringent a standard under the 1934 Act. There is no need to resolve this debate. For our purpose, it suffices that the 1934 Act does not prescribe a uniform willful blindness requirement, further undermining the theory that willful blindness applies here because SIPA is part of the 1934 Act.[28]

SIPA's legislative history bolsters our conclusion. The House Report on SIPA explains the interplay between SIPA and the 1934 Act. *See* H.R. Rep. No. 91-1613, *as reprinted in* 1970 U.S.C.C.A.N. 5254. For example, it notes that certain sections of the 1934 Act "set forth current provisions of law dealing with the financial responsibility of broker-dealers," *id.* at 5266, and that "section 7(D) [of SIPA] would amend section 15(c)(3) of the [1934 Act]," *id.* at 5276. In its discussion of *SIPA liquidation proceedings*, the Report declares "[t]he bill uses certain terms defined in [the Bankruptcy Act] with the meanings there established, except as further defined in the reported bill." *Id.* at 5262. The only reference to the 1934 Act is that the trustee's reports to the court should "hav[e] regard to the recordkeeping requirements under the [1934 Act]." *Id.* at 5264. Absent from the extensive Report is *any* suggestion that Congress intended the 1934 Act's general fraudulent intent requirement to displace the Bankruptcy Code's

[28] To the extent Appellees rely on the "securities laws" generally—for which there is no textual basis in SIPA—claims under §§ 11, 12(a)(2), 17(a)(2), and 17(a)(3) of the Securities Act of 1933 do not have any scienter requirement. *See Rombach v. Chang*, 355 F.3d 164, 169 n.4 (2d Cir. 2004); *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

definition for good faith. Accordingly, the federal securities laws do not supply the definition of good faith in a SIPA liquidation; the Bankruptcy Code does.

Finally, by clarifying that inquiry notice is not a negligence standard, *see* Section I.A., *supra*, we also reject the district court's and Appellees' contentions that the inquiry notice standard is "unworkable" and contrary to SIPA's goals. *See* Citi's Br. at 30; Legacy and Khronos's Br. at 24, 42-43. Inquiry notice does not universally impose an affirmative duty to investigate. As discussed above, the duty to conduct a diligent investigation arises *only* when a transferee is actually aware of suspicious facts that would lead a reasonable investor to inquire further into a debtor-transferor's potential fraud. *See In re M & L Bus. Mach. Co., Inc.*, 84 F.3d at 1338; *In re Agric. Rsch. & Tech. Grp.*, 916 F.2d at 536. The inquiry notice standard for good faith under SIPA is therefore not overly burdensome on the customers and indirect investors of broker-dealers.

The district court criticized inquiry notice as impracticable, questioning "how could [an investor investigate his broker's internal practices] anyway?" *Good Faith Decision*, 516 B.R. at 21 (citation omitted). We cannot provide an answer for every case. The adequacy of an investigation is, of course, a fact-intensive inquiry to be determined on a case-by-case basis, which naturally takes into account the disparate circumstances of differently-situated transferees. Courts routinely conduct that inquiry seemingly without a hitch. *See, e.g., Janvey v. GMAG, L.L.C.*, 977 F.3d 422, 428 (5th Cir. 2020) (concluding that, in analyzing the good faith defense under the Texas Uniform Fraudulent Transfer Act, the record evidence did not show that the defendants-appellees "diligently investigated" the debtor-transferor's Ponzi scheme after being put on inquiry notice).

The text of SIPA and the 1934 Act, the underlying goals of SIPA, and the practical implications of an inquiry notice standard provide no reason to depart from the meaning of the good faith defense under Sections 548 and 550 as it is applied in an ordinary bankruptcy proceeding. Lack of good faith in a SIPA liquidation therefore applies an inquiry notice, not willful blindness, standard.

II. Burden of Pleading Good Faith, or the Lack Thereof

The district court found that good faith is an affirmative defense under Sections 548 and 550 of the Bankruptcy Code and acknowledged that in ordinary circumstances, the initial or subsequent transferee bears the burden of pleading good faith. *See Good Faith Decision*, 516 B.R. at 24. Indeed, Federal Rule of Civil Procedure 8(c) places the burden of pleading an affirmative defense on the defendant. *See Perry v. Merit Sys. Prot. Bd.*, 137 S. Ct. 1975, 1987 n.9 (2017) ("[A]n affirmative defense to a plaintiff's claim for relief[] [is] not something the plaintiff must anticipate and negate in her pleading.") (citing Fed. R. Civ. P. 8(c)(1)). However, the district court determined that the trustee bears the burden of pleading lack of good faith in a SIPA liquidation because of the policy goals of SIPA. *See Good Faith Decision*, 516 B.R. at 24. Like their arguments concerning the meaning of "good faith," Legacy and Khronos primarily appear to defend the district court's reasoning, while Citi raises an additional, alternative argument for affirming the district court's conclusion. Specifically, Citi disputes that good faith is an affirmative defense under § 550, even in an ordinary bankruptcy proceeding. We reject both the district court's reasoning and Citi's alternative argument on appeal. Because we conclude that good faith is an affirmative defense under Sections 548 and 550 and that SIPA does not compel departing from the well-established burden-of-pleading rules, the trustee is not required to plead a transferee's lack of good faith.

A) Good Faith is an Affirmative Defense Under Sections 548 and 550 of the Bankruptcy Code

As with the definition of good faith, Sections 548 and 550 are silent on the pleading burden. However, we and other courts have held good faith is an affirmative defense under these sections. With regard to § 548, there is little credible debate. Section 548(a)(1)(A) of the Bankruptcy Code allows a trustee to "avoid any transfer" made within two years of the debtor's filing of a bankruptcy petition, if the debtor "made such transfer . . . with actual intent to . . . defraud any entity to which the debtor was . . . indebted." 11 U.S.C. § 548(a)(1)-(a)(1)(A). Section 548(c) creates a defense, allowing transferees to "retain any interest transferred" if the transferee "takes for value and in good faith." *Id.* § 548(c). As we have previously explained:

> If a trustee establishes a *prima facie* case under the fraudulent transfer provisions, then he or she is entitled to recovery unless the transferee can establish an *affirmative defense*. One affirmative defense applies whether a trustee seeks to recover under § 548(a)(1)(A) . . . . It permits a transferee who 'takes for value and *in good faith*' to retain the transfer to the extent of the value given.

Gettinger, 976 F.3d at 190 (emphases added) (quoting 11 U.S.C. § 548(c)). As a defendant asserting an affirmative defense, the transferee bears the burden of establishing its good faith under § 548(c). Our sister circuits that have addressed this question uniformly agree. *See In re Tan–*

eja, 743 F.3d 423, 429 (4th Cir. 2014) (explaining that § 548(c) establishes "an affirmative defense" that "a defendant has . . . [the] burden of proving"); *Perkins v. Haines*, 661 F.3d 623, 626 (11th Cir. 2011) ("[Section] 548(c) provides a transferee with an affirmative defense where the transferee acts in good faith."); *In re Hannover Corp.*, 310 F.3d 796, 799 (5th Cir. 2002) ("The burden of proof is on the defendant transferee."); *In re M & L Bus. Mach. Co.*, 84 F.3d at 1338 (same); *In re Agric. Rsch. And Tech. Grp., Inc.*, 916 F.2d at 535 (same).

Citi contends that, in contrast to good faith under § 548(c), good faith is not an affirmative defense under § 550(b), which applies only to subsequent transferees.[29] Section 550(a) states "*[e]xcept as otherwise provided in this section*, to the extent that a transfer is avoided under [(*inter alia*)] section . . . 548 . . . , the trustee may recover, for the benefit of the estate, the property transferred . . . from [an initial or subsequent transferee]." 11 U.S.C. § 550(a) (emphasis added). Section 550(b) states "*[t]he trustee may not recover*" from a subsequent transferee "that takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." *Id.* § 550(b)-(b)(1). Although § 550(b) is written differently and affects a different class of transferees than § 548(c), the statutory structure, case law, and legislative history make clear that good faith under § 550(b) is an affirmative defense.

[29] Citi also argues that "under the [1934] Act—of which SIPA is a part—a plaintiff suing under Section 20(a), which imposes liability on a control person for those she controls" bears the burden of pleading lack of good faith. Citi's Br. at 53. The 1934 Act is plainly irrelevant here; nothing in SIPA purports to incorporate the pleading burden in unrelated contexts under the 1934 Act.

Section 550(a) sets out the elements a trustee must satisfy to recover transferred property: that the transfer was avoided, and that the defendant is an initial or subsequent transferee. *See* 5 Collier on Bankruptcy ¶ 550.02 (16th ed. 2021). Section 550(b) provides an exception to the trustee's general power of recovery under § 550(a). "When a proviso . . . carves an exception out of the body of a statute . . . those who set up such exception must prove it." *Meacham v. Knolls Atomic Power Lab'y*, 554 U.S. 84, 91 (2008) (alteration and citation omitted). Although *Meacham* concerned exemptions to prohibited conduct under the Age Discrimination in Employment Act, it affirms the overarching principle that when there is an exception to the general rule, the party claiming the benefit of the exception bears the burden of pleading it. *See N.Y. Univ. Med. Ctr. v. N.L.R.B.*, 156 F.3d 405, 413 (2d Cir. 1998) (citing *FTC v. Morton Salt Co.*, 334 U.S. 37, 44-45 (1948)). Because taking a transfer in good faith under § 550(b) is an exception to the general rule permitting the trustee to recover the transfer under § 550(a), it is an affirmative defense.

Citi contends that the "[e]xcept as otherwise provided" clause in § 550(a) requires the trustee to "negate that 'exception' [in § 550(b)] in his pleadings to state a claim." Citi's Br. at 47. It relies on *United States v. Cook*, 84 U.S. 168 (1872), in which the Supreme Court held that "[w]here a statute defining an offen[s]e contains an exception, in the enacting clause of the statute, which is so incorporated with the language defining the offen[s]e that the ingredients of the offen[s]e cannot be accurately and clearly described if the exception is omitted, the rules of good pleading require that an indictment founded upon the statute must allege enough to show that the accused is not within the exception." *Id.* at 173. *Cook* is inapposite; it is grounded in the interpretation of a criminal statute, and the "except as otherwise provided" language does not make § 550(b) "so incorporated with the language defining" the trustee's right to recovery under § 550(a) "that the ingredients of the [claim] cannot be accurately and clearly described" without it. *Id.*

Moreover, although § 550(b) states "[t]he trustee may not recover," while § 548(c) states "a transferee . . . may retain," Citi does not point to any authority that supports a conclusion that this difference is indicative of good faith being an element of the trustee's claim under § 550. Indeed, a more persuasive explanation for the difference is that, as stated earlier, § 550(b)(1) provides subsequent transferees a complete defense against recovery, whereas § 548(c) grants transferees "a lien to the extent value was given in good faith." 5 Collier on Bankruptcy ¶ 548.09 (16th ed. 2021).

Our reading of § 550 is consistent with precedents of this Court and others. We have declared subsequent transferees "may *assert* a good faith defense" under § 550(b). *In re Red Dot Scenic, Inc.*, 351 F.3d 57, 58 (2d Cir. 2003) (emphasis added); *see also Picard v. Fairfield Greenwich Ltd.*, 762 F.3d 199, 209 & n.8 (2d Cir. 2014). And the other circuits that have addressed the issue have uniformly concluded that "§ 550(b) offers an affirmative defense." *See In re Smith*, 811 F.3d 228, 246 (7th Cir. 2016); *see also In re Mortg. Store, Inc.*, 773 F.3d 990, 994 (9th Cir. 2014); *In re Nieves*, 648 F.3d at 237. For example, in *In re Nordic Vill., Inc.*, 915 F.2d 1049 (6th Cir. 1990), *rev'd on other grounds sub nom. United States v. Nordic Vill., Inc.*, 503 U.S. 30 (1992), the majority determined that "[t]he language of [§ 550(b)] clearly places the burden of showing value, good faith, and lack of knowledge, on the transferee as a defense." *Id.* at 1055.

The dissent sought to differentiate between initial transferees under § 549, which concerns post-petition transactions and explicitly places the burden of proof on the transferee, and subsequent transferees under § 550. *See id.* at 1063-64. It argued that because "subsequent transferees are much more likely to be innocent third parties," "[a]bsent an express rule placing the burden of proof on subsequent transferees, . . . the burden should rest on the party seeking to recover the property, at least as to the issues of the subsequent transferee's good faith and knowledge." *Id.* at 1063-64. However, as the majority explained, "[t]he way [§ 550(a)] is worded makes it clear that the trustee's right to recover is broad, by giving rights against not only the transferee, but also against transferees of the initial transferee," and "to prevent innocent third parties from being hurt by this broadly delineated right of recovery, the law gives them a defense if they show that they took for value, in good faith, and without knowledge of the voidability of the transfer." *Id.* at 1055-56. In other words, the good faith defense under § 550(b)(1)—like the good faith defense under § 548(c)—is an act of legislative grace *because* subsequent transferees might be "innocent third parties." *Id.* at 1056. But the mere possibility of a subsequent transferee's blamelessness does not suggest that the trustee must bear the burden of pleading the transferee's lack of good faith.

The legislative history further substantiates our view. The Senate Report accompanying the modern Bankruptcy Code notes that "[i]n order for the transferee to be *excepted* from liability under [§ 550(b),] he himself must be a good faith transferee." S. Rep. No. 95-989, at 90 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5876 (emphasis added). The Report also confirms that § 550(a) "permits the trustee to recover from" *any* transferee: "the initial transferee of an avoided transfer or from any immediate or mediate transferee of the initial transferee." *Id.* Its explanation accords with the concept that good faith is a defense that permits the transferee "to be excepted" from the trustee's general recovery power. *See id.* Citi's reliance on the Bankruptcy Law Commission's report explaining its proposed draft bill is misplaced. Although the report recommended removing a sentence that explicitly placed the burden of proof of establishing good faith on post-petition transferees of personal property, that context does not concern subsequent transferees of pre-petition fraudulent conveyances. *See* Rep. of Comm'n on Bankr. L. of U.S., H.R. Doc. No. 93-137, Pt. II at 164.

The legislative history also demonstrates that Congress did not intend to create a different pleading burden with respect to subsequent transferees compared to initial transferees. As expressed in the Senate Report accompanying the Bankruptcy Code, "[t]he phrase 'good faith' [under § 550] . . . 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." S. Rep. No. 95-989, at 90, *as reprinted in* 1978 U.S.C.C.A.N. at 5876 (emphasis added). Congress's concern about potential "washing" through subsequent transferees supports the conclusion that voidable subsequent transfers are presumed recoverable and that it did not intend to release subsequent transferees of the pleading burden.

Finally, the Trustee's access to discovery before filing the complaint under Rule 2004 of the Federal Rules of Bankruptcy Procedure does not affect our analysis. Rule 2004 has never been interpreted to permit shifting the pleading burden. Indeed, the fact that "good faith" concerns the transferee's knowledge of suspicious facts and other information "peculiarly within the knowledge and control of the defendant" supports the allocation of the pleading burden on the defendant-transferee. *See Gomez v. Toledo*, 446 U.S. 635, 640-41 (1980); *see also Nat'l Commc'ns Ass'n Inc. v. AT&T Corp.*, 238 F.3d 124, 130-31 (2d Cir. 2001) (explaining that "all else being equal, the burden [of proving an issue] is better placed on the party with easier access to relevant information" and that "courts should avoid requiring a party to shoulder the more difficult task of proving a negative").

The structural similarity of § 550 to § 548, the case law, and the legislative history compel us to concur with a leading treatise on bankruptcy law that "once the trustee has avoided a transfer and established that the property has been transferred to an immediate or mediate transferee, the transferee has the burden to show that it took (1) for value, (2) in good faith[,] and (3) without knowledge of the voidability of the transfer." 5 Collier on Bankruptcy ¶ 550.03 (16th ed. 2021).

B) SIPA Does Not Require the Trustee to Plead an Affirmative Defense

Federal Rule of Civil Procedure 8(c)(1) provides that, "[i]n responding to a pleading, a party must affirmatively state any avoidance or affirmative defense," placing the burden to plead on the defendant. Notwithstanding this clear language, the district court held that even though good faith is an affirmative defense, SIPA "affects the burden of pleading good faith or its absence" and that "[i]t would totally undercut SIPA's twin goals of maintaining marketplace stability and encouraging investor confidence if a trustee could seek to recover the investors' investments while alleging no more than that they withdrew proceeds from their facially innocent securities accounts." *Good Faith Decision*, 516 B.R. at 24.

The district court's policy-based justifications for departing from Rule 8(c)(1) fail on two grounds. First, the Supreme Court has held "courts should generally not depart from the usual practice under the Federal Rules on the basis of perceived policy concerns." *See Jones v. Bock*, 549 U.S. 199, 212-13 (2007). In that case, the Court reversed the Sixth Circuit for applying policy-based reasons to place the burden of negating an affirmative defense on the plaintiff to establish his Prison Litigation Reform Act claims. *See id.* at 213-14. As a result, *even if* the district court had legitimate policy concerns in allocating the pleading burden to the transferee, it should not have used those concerns to shift the traditional pleading burden.

Second, placing the burden to plead good faith on the initial and subsequent transferees does not contradict the goals of SIPA. As explained in the House Report, "[SIPA] would provide for the establishment of a fund to be used to make it possible for the public customers in the event of the financial insolvency of their broker, to recover that to which they are entitled." H.R. Rep. No. 91-1613, at 1, *as reprinted in* 1970 U.S.C.C.A.N. at 5255. "The purposes of a liquidation proceeding under [SIPA]" include "to distribute customer property and . . . otherwise satisfy net equity claims of customers" "as promptly as possible after the appointment of a trustee in such liquidation proceeding." 15 U.S.C. § 78fff(a)(1), (a)(1)(B).

A transferee's burden to plead the affirmative defense of good faith does not "undercut" SIPA's purpose of "encouraging investor confidence" by permitting the trustee to recover from investors "while alleging no more than that they withdrew proceeds from their facially innocent securities accounts." *Good Faith Decision*, 516 B.R. at 24. Indeed, requiring the trustee to plead the transferee's *lack* of good faith would do more to hinder SIPA's goal of distributing customer property "as promptly as possible after the appointment of a trustee" by delaying the trustee's actions to recover the property. *See* 15 U.S.C. § 78fff(a)(1). And, regardless, perceived policy concerns related to SIPA do not permit us to reconfigure bankruptcy law.

Nothing in SIPA compels departure from the well-established rule that the defendant bears the burden of pleading an affirmative defense. Accordingly, the district court erred by holding that the trustee bears the burden of pleading a lack of good faith under Sections 548(c) and 550(b)(1).

CONCLUSION

We **VACATE** the judgments of the bankruptcy court and **REMAND** for further proceedings consistent with this opinion.

MENASHI, Circuit Judge, concurring.

The court's decision in this case might appear counterintuitive. Citibank received a repayment of a loan it made to a fund that invested with Bernard L. Madoff Investment Securities ("BLMIS"). Legacy Capital received back the principal it invested with BLMIS.[1] Yet the court holds that each party's receipt of funds it was owed amounts to a fraudulent transfer accepted in bad faith.

Normally, when a creditor receives a payment from a debtor—even if the creditor knows that the debtor is insolvent and the payment will prevent other creditors from being repaid—that payment is considered a preference,

[1] Legacy has already returned the $79 million it received in net profits. *See* Special App'x 93-94.

not a fraudulent transfer. *See Sharp Int'l Corp. v. State St. Bank & Trust Co.* (*In re Sharp Int'l Corp.*), 403 F.3d 43, 54 (2d Cir. 2005) ("A conveyance which satisfies an antecedent debt made while the debtor is insolvent is neither fraudulent nor otherwise improper, even if its effect is to prefer one creditor over another.") (alteration omitted) (quoting *Ultramar Energy Ltd. v. Chase Manhattan Bank, N.A.*, 191 A.D.2d 86, 90-91 (N.Y. App. Div. 1st Dep't 1993)). Under these normal principles, creditors such as Citibank and Legacy would be able to retain the repayments despite knowledge of the debtor's insolvency as long as the transfers occurred outside the relatively brief period in which preferential transfers may be avoided[2] and the creditor is not participating in a fraudulent scheme by holding the funds on the debtor's behalf.[3]

I

In this case, however, we do not follow normal principles because we have applied the "Ponzi scheme presumption." Accordingly, we presume that transfers from a

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[2] *Compare* 11 U.S.C. § 547(b)(4)(A) (providing ninety-day period for avoiding preferential transfers), *with id.* § 548(a)(1) (providing two-year period for fraudulent transfers); *see also Picard v. Katz*, 462 B.R. 447, 451 (S.D.N.Y. 2011) (noting that because "the Bankruptcy Code also adopts for these purposes the 'applicable [state] law' . . . fraudulent transfers can be avoided if they occurred within 6 years" of BLMIS's bankruptcy filing), *abrogated in part by Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 437, 442 (S.D.N.Y. 2014).

[3] *See Twyne's Case*, 76 Eng. Rep. 809, 811 (Star Chamber 1601) (holding that a conveyance of goods from a debtor to a creditor was fraudulent when it was made "in satisfaction of his debt" but the debtor nevertheless "continued in possession of the said goods"); *see also Dean v. Davis*, 242 U.S. 438, 444 (1917) (noting that a "transaction may be invalid both as a preference and as a fraudulent transfer" if there exists both "the intent to prefer and the intent to defraud").

debtor in furtherance of a Ponzi scheme are made with fraudulent intent rather than to satisfy an antecedent debt.[4] Some courts have rejected the Ponzi scheme presumption on the ground that it improperly treats preferences as fraudulent transfers. *See, e.g.*, *In re Unified Com. Cap., Inc.*, 260 B.R. 343, 350 (Bankr. W.D.N.Y. 2001) ("[T]he fraudulent conveyance statutes cannot and should not be utilized by courts as a super preference statute to effect a further reallocation and redistribution that should be specifically provided for in a statute enacted by Congress."); *Finn v. Alliance Bank*, 860 N.W.2d 638, 647 (Minn. 2015) (concluding that "there is no statutory justification for relieving the Receiver of its burden of proving—or for preventing the transferee from attempting to disprove—fraudulent intent" under the "Ponzi-scheme presumption" and that a creditor must "prove the elements of a fraudulent transfer with respect to each transfer, rather than relying on a presumption related to the form or structure of the entity making the transfer").[5]

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[4] *See SEC v. Res. Dev. Int'l, LLC*, 487 F.3d 295, 301 (5th Cir. 2007) ("In this circuit, proving that [a transferor] operated as a Ponzi scheme establishes the fraudulent intent behind the transfers it made."); *In re Slatkin*, 525 F.3d 805, 814 (9th Cir. 2008) ("We hold that once the existence of a Ponzi scheme is established, payments received by investors as purported profits—i.e., funds transferred to the investor that exceed that investor's initial 'investment'—are deemed to be fraudulent transfers as a matter of law."); *Klein v. Cornelius*, 786 F.3d 1310, 1320 (10th Cir. 2015) ("[B]ecause Ponzi schemes are insolvent by definition, we presume that transfers from such entities involve actual intent to defraud.").

[5] *See also Janvey v. Golf Channel, Inc.*, 487 S.W.3d 560, 567 n.27 (Tex. 2016) ("Though we need not consider the validity *vel non* of the Ponzi-scheme presumptions, we note that [the Texas Uniform Fraudulent Transfer Act] provides only one express presumption: 'A debtor who is generally not paying the debtor's debts as they become due is

Under normal principles, fraudulent transfer law prevents pre-insolvency transfers to non-creditors or colluding creditors, not bona fide creditors; "[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 try to choose among them." *Boston Trading Grp., Inc. v. Burnazos*, 835 F.2d 1504, 1509 (1st Cir. 1987); *see also In re Sharp,* 403 F.3d at 54; *Bonded Fin. Servs., Inc. v. Eur. Am. Bank*, 838 F.2d 890, 892 (7th Cir. 1988). It is "the preference provisions," by contrast, that serve the "policy of equality of distribution among creditors of the debtor." *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) (quoting H.R. REP. NO. 95-595, at 177-78 (1977)). By treating preferential transfers to creditors as fraudulent transfers in the context of a Ponzi scheme, the Ponzi scheme presumption obscures the essential distinction between fraudulent transfers and preferences. It uses fraudulent transfer law rather than the law relating to preferences to promote an equal distribution among creditors.

This use of the fraudulent transfer statute is questionable. *See In re Unified*, 260 B.R. at 350 ("By forcing the square peg facts of a 'Ponzi' scheme into the round holes of the fraudulent conveyance statutes in order to accomplish a further reallocation and redistribution to implement a policy of equality of distribution in the name of equity, I believe that many courts have done a substantial injustice to these statutes and have made policy decisions that should be made by Congress.").[6] But as the court

presumed to be insolvent.'") (quoting TEX BUS. & COM. CODE § 24.003(b)).

[6] *See also* Amy J. Sepinwall, *Righting Others' Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds*, 78 BROOK. L. REV. 1, 23-24 (2012) (arguing that Ponzi scheme

notes, no party to this case challenges the Ponzi scheme presumption. *See ante* at 11 ("[T]he parties do not dispute the applicability of the Ponzi scheme presumption here."). Therefore, we apply that presumption.[7]

By treating debt repayments as fraudulent transfers and not as preferences, the Ponzi scheme presumption assumes that creditors of a Ponzi scheme are not owed a valid contractual antecedent debt like bona fide creditors. *See Finn*, 860 N.W.2d at 651 ("[C]ourts that adopt the Ponzi-scheme presumption effectively deem a contract between the operator of a Ponzi scheme and an investor to be unenforceable as a matter of public policy."). Thus, we do not apply the normal rule that, when the transferee is a creditor, "a lack of good faith '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.'" *In re Sharp,* 403 F.3d at 54 (quoting *Boston*

"clawback actions" are unsupported by "the history and text of § 548" because "the purpose of the fraudulent transfer provision is to prevent the debtor from secreting away his assets, typically for his own benefit, such that they are beyond the reach of his creditors" and not "to ensure the most even distribution of assets as possible by conferring upon each creditor his pro-rata share of the recovered resources"); Melanie E. Migliaccio, Comment, *Victimized Again: The Use of an Avoidability Presumption and the Objective Standard for Good Faith to Deprive Ponzi Victims of Their Defenses*, 8 LIBERTY U.L. REV. 209, 258 (2013) (arguing that the Ponzi scheme presumption "ignores that Congress distinguishes between preferences and fraudulent transfers") (capitalization omitted).

[7] Our court has similarly applied the Ponzi scheme presumption in prior cases when its application was uncontested. *See, e.g.*, *In re Bernard L. Madoff Inv. Sec. LLC*, 976 F.3d 184, 190 (2d Cir. 2020) ("It is undisputed that BLMIS made the transfers at issue with 'actual intent to hinder, delay, or defraud . . . creditors.'") (quoting 11 U.S.C § 548(a)(1)(A)). We do not appear to have held directly that the presumption is well-founded.

Trading, 835 F.2d at 1512). Normally, "the law will not charge" a creditor who "may know the fraudulent purpose of the grantor" with "fraud by reason of such knowledge," even though the law assumes that an arm's-length "purchase[r] for a present consideration . . . enters [the transaction] for the purpose of aiding that fraudulent purpose" if the purchaser knows "the fraudulent purpose of the grantor." *English v. Brown*, 229 F. 34, 40 (3d Cir. 1916) (quoting *Atl. Refin. Co. v. Stokes*, 75 A. 445, 446-47 (N.J. Ch. 1910)). Yet the Ponzi scheme presumption necessarily treats a creditor-transferee's inquiry notice of the debtor's operation of a Ponzi scheme as indicating a lack of good faith.

That level of notice must be the same as normally required when evaluating the good faith of a transferee under the Bankruptcy Code. In this case, the district court's decision to adopt a different standard from the securities laws might have helped to avoid the counterintuitive results of treating a payment to a creditor as a fraudulent transfer. *See Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (*In re Madoff Sec.*), 516 B.R. 18, 22 (S.D.N.Y. 2014) ("[W]here the Bankruptcy Code and the securities laws conflict, the Bankruptcy Code must yield."). But that approach would add an additional departure from the statutory scheme. Accordingly, I concur in the court's opinion.

II

Some courts have suggested that repayments such as those Citibank and Legacy Capital received "occur as part of the fraud" and therefore do not qualify as "repayment of a debt that was antecedent to the company's fraud." *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 11 (S.D.N.Y. 2007). In other words, there was no valid antecedent debt. Yet here, even the Trustee refers to the Madoff victims as "creditors," *see, e.g.*, Trustee's Br. 4, and indeed the purpose of SIPA is to treat each "customer" as a "creditor," *In re Bernard L. Madoff Inv. Sec. LLC*, 440 B.R. 243, 272 (Bankr. S.D.N.Y. 2010) (quoting 15 U.S.C. § 78fff-2(c)(3)). In our "net equity" decision, we described BLMIS profits as fictitious but treated the investments of principal, as are at issue in this case, as valid contractual antecedent debts. *See In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 233, 242 (2d Cir. 2011) (approving the "Net Investment Method," which "credit[s] the amount of cash deposited by the customer into his or her BLMIS account [i.e. the investment of principal], less any amounts withdrawn from it"); *see also id.* at 235 ("[A]ny dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested.") (quoting *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC*), 424 B.R. 122, 141 (Bankr. S.D.N.Y. 2010)).

Other courts have suggested that these sorts of "redemption payments . . . were necessarily made with intent to 'hinder, delay or defraud' present and future creditors" because those payments "constituted an integral and essential component of the fraudulent Ponzi scheme." *In re Bayou Grp., LLC*, 362 B.R. 624, 638 (Bankr. S.D.N.Y. 2007).[8] But it is unclear that the statutory phrase "intent to hinder, delay, or defraud" would by itself include repayments to creditors simply because such repayments are a critical part of the Ponzi scheme. Preferences generally "hinder" payments to other creditors yet are not for that reason considered fraudulent transfers. *See Richardson*

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[8] *See also Katz*, 462 B.R. at 453 ("[I]t is patent that all of Madoff Securities' transfers during the two-year period were made with actual intent to defraud present and future creditors, *i.e.*, those left holding the bag when the scheme was uncovered.").

v. Germania Bank, 263 F. 320, 325 (2d Cir. 1919) ("A very plain desire to prefer, and thereby incidentally to hinder creditors, is (1) not as a matter of law an intent obnoxious to [the fraudulent transfer provision]; and (2) is not persuasive in point of fact that such intent, evil in itself, ever existed."). A contrary argument would "obliterate" the preferential transfer provision "from the statute." *Irving Trust Co. v. Chase Nat'l Bank*, 65 F.2d 409, 411 (2d Cir. 1933). Moreover, when a statutory phrase—here, "hinder, delay, or defraud"—has a "well-established common-law meaning," we generally respect that meaning. *Moskal v. United States*, 498 U.S. 103, 126 (1990) (Scalia, J., dissenting). This phrase dates to the Statute of 13 Elizabeth, enacted by Parliament in 1571. *See* Fraudulent Conveyances Act of 1571, 13 Eliz. ch. 5, §§ I, V (Eng.) (prohibiting transfers made to "delaye hynder or defraude" creditors except for transfers in exchange for "good Consyderation, & bona fide"); *In re Goldberg*, 277 B.R. 251, 291-92 (Bankr. M.D. La. 2002). The Statute of 13 Elizabeth prevented debtors from shortchanging creditors by squirreling away assets out of their creditors' reach.[9] The phrase refers to keeping assets away from all creditors rather than

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[9] *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L REV. 829, 829 (1985) ("[T]he Statute of 13 Elizabeth . . . was intended to curb what was thought to be a widespread abuse. Until the seventeenth century, England had certain sanctuaries into which the King's writ could not enter. A sanctuary was not merely the interior of a church, but certain precincts defined by custom or royal grant. Debtors could take sanctuary in one of these precincts, live in relative comfort, and be immune from execution by their creditors. It was thought that debtors usually removed themselves to one of these precincts only after selling their property to friends and relatives for a nominal sum with the tacit understanding that the debtors would reclaim their property after their creditors gave up or compromised their claims. The Statute of 13 Elizabeth limited this practice.") (footnote omitted).

preferences among creditors, and courts presumably ought to follow "the specialized legal meaning that the term . . . has long possessed." *Moskal*, 498 U.S. at 121 (Scalia, J., dissenting).

It may be that there are better arguments for the Ponzi scheme presumption, but consideration of that issue must await an appropriately contested case.[10] Because the parties do not raise the issue here, I concur.

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[10] We generally do not address arguments not raised by the parties. *See, e.g.*, *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393, 435 n.53 (2d Cir. 2004). Yet we commonly identify issues that merit further consideration. *See, e.g.*, *United States v. Ingram*, 721 F.3d 35, 38 (2d Cir. 2013) (Calabresi, J., concurring) (calling "attention to a procedural challenge that has been strangely absent from this case").

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Misc. No. 12-115

SECURITIES INVESTOR PROTECTION CORPORATION, PLAINTIFF,

v.

BERNARD L. MADOFF INVESTMENT SECURITIES LLC, DEFENDANT

IN RE: MADOFF SECURITIES

Filed: April 27, 2014

OPINION AND ORDER

RAKOFF, United States District Judge.

Under section 548(a)(1) of the Bankruptcy Code, the trustee of a bankruptcy estate is empowered to, *inter alia*, "avoid any transfer . . . of an interest of the debtor in property . . . that was made . . . on or within 2 years before the date of the filing of the petition, if the debtor . . . made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted." 11 U.S.C. § 548(a)(1)(A). However, this authority is limited by subsection (c) of the same statute, which provides that "a transferee . . . of such a transfer . . . that takes for value *and in good faith* has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer . . . ." *Id.* § 548(c) (emphasis supplied). Section 550(a)(2) of the Bankruptcy Code provides, in turn, that a trustee may recover avoided property or the value of such property from "any immediate or mediate transferee of such initial transferee." *Id.* § 550(a)(2). But, similarly to the restrictions on avoidance in section 548, section 550(b)(1) provides that a "trustee may not recover" under section 550(a)(2) from "a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, *in good faith*, and without knowledge of the voidability of the transfer avoided." *Id.* § 550(b)(1) (emphasis supplied). The Bankruptcy Code does not define "good faith" in the context of section 548(c) or section 550(b), and it is that definitional question to which the instant consolidated proceeding is primarily directed, along with related questions of standards of pleading.[1]

In this proceeding, various defendants in actions brought against them by Irving Picard (the "Trustee")—the trustee appointed under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa-78*lll*, to administer the estate of Bernard L. Madoff Investment Securities LLC ("Madoff Securities")—have moved to dismiss the Trustee's avoidance and recovery actions against them. These defendants argue that the Trustee has failed to plead their lack of good faith such that they are entitled to retain the transfers they have received from Madoff Securities (or some portion thereof). Defendants previously moved to withdraw the reference of their actions to the

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[1] For purposes of this Opinion and Order, it is assumed that the transfers at issue were made "for value."

Bankruptcy Court, which the Court granted with respect to the following issue: "whether SIPA and other securities laws alter the standard the Trustee must meet in order to show that a defendant did not receive transfers in 'good faith' under either 11 U.S.C. § 548(c) or 11 U.S.C. § 550(b)." Order at 3, No. 12 Misc. 115, ECF No. 197 (S.D.N.Y. June 25, 2012). The Court received consolidated briefing and oral argument from the defendants (including separate briefs from various subgroups of defendants who raised issues relevant to their particular situations), and responding briefing and argument from the Trustee and the Securities Investor Protection Corporation ("SIPC"). The matter is therefore ripe for ruling.

In ruling, the Court assumes familiarity with the underlying facts of the Madoff Securities fraud and ensuing bankruptcy and recounts only those facts that are relevant to the instant proceeding. It is undisputed that Madoff Securities, a registered securities broker-dealer, engaged in a decades-long Ponzi scheme in which it accepted investments from various customers and then issued false monthly statements to those customers indicating consistent, favorable returns on securities transactions purportedly conducted by Madoff Securities on their behalf. In actuality, Madoff Securities undertook few, if any, securities transactions, and simply used other customers' investment funds to satisfy any customers' withdrawals of funds. Some withdrawing customers were individuals, and others were investment funds that in turn transferred the withdrawn funds to their customers. Additionally, some of these funds transferred some of the withdrawn monies to money managers and other professionals who were owed fees in connection with these transactions. The defendants in these consolidated proceedings are drawn both from direct customers of Madoff Securities and from these various subsequent transferees.

Underlying the complaints here in issue is the Trustee's central contention that all these defendants were sophisticated market participants who, even though they lacked actual knowledge of Madoff Securities' fraud, failed to act in good faith because they were aware of suspicious circumstances that should have led them to investigate the possibility of such fraud. Previously, however, in *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011), this Court held that, in a SIPA proceeding such as this, a lack of "good faith" requires a showing that a given defendant acted with "'willful blindness' to the truth," that is, he "intentionally [chose] to blind himself to the 'red flags' that suggest a high probability of fraud." *Id.* at 455. In adopting this standard, this Court rejected the Trustee's alternative "inquiry notice approach," under which a transferee may be found to lack good faith "when the 'information the transferee learned would have caused a reasonable person in the transferee's position to investigate the matter further.'" *Id.* (brackets omitted) (quoting *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 23 (S.D.N.Y. 2007)). The Court reasoned that, although the inquiry notice approach

> is not without some precedent in ordinary bankruptcies, it has much less applicability . . . in a context of a SIPA trusteeship, where bankruptcy law is informed by federal securities law. Just as fraud, in the context of federal securities law, demands proof of scienter, so too "good faith" in this context implies a lack of fraudulent intent. A securities investor has no inherent duty to inquire about his stockbroker, and SIPA creates no such duty. If an investor, nonetheless, intentionally chooses to blind himself to the "red flags" that suggest a high probability of fraud, his "willful blindness" to the truth is tantamount to a lack of good faith. But if, simply confronted with suspicious circumstances, he

> fails to launch an investigation of his broker's internal practices—and how could he do so anyway?—his lack of due diligence cannot be equated with a lack of good faith, at least so far as section 548(c) is concerned as applied in the context of a SIPA trusteeship.

Id. (citations omitted); *see also Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012) ("[T]o establish a lack of 'good faith' on the part of securities customers under § 548(c) in the context of a SIPA bankruptcy, the trustee must show that the customer either actually knew of the broker's fraud or 'willfully blinded' himself to it.").

Nonetheless, in a fashion that the Court has learned is typical of the Trustee's litigation strategy, the Trustee here seeks to litigate once again the issue of whether "good faith" should be judged by a subjective standard of willful blindness or by an objective standard of inquiry notice. But nothing in the intervening time has changed the analysis and conclusion that the Court reached in *Katz* and reiterated in *Avellino*.[2] *See Katz*, 462 B.R. at 455; *Avellino*, 469 B.R. at 412; *see also In re Dreier*, 452 B.R. 391, 449-50 (Bankr. S.D.N.Y. 2011) ("To be eligible for the good faith defense under § 548(c) . . . , a transferee should not be able to 'consciously avoid' facts within its knowledge that would suggest that the transfers were not made in good faith."). As *Katz* recognized, SIPA proceedings are informed by federal securities law. Although SIPA expressly incorporates the Bankruptcy Code's

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[2] The Court is mindful that a comment in a footnote in a recent Second Circuit opinion might be read to suggest that good faith should be judged under the inquiry notice standard. *See In re Bernard L. Madoff Inv. Sec. LLC*, 740 F.3d 81, 90 n.11 (2d Cir. 2014). However, as its relegation to a footnote indicates, the statement in question is pure dictum, because the appeal did not raise any issue with respect to good faith or under what standard that question should be judged.

avoidance and recovery provisions, *see* 15 U.S.C. § 78fff-2(c)(3), SIPA nonetheless is part of the securities laws and expressly provides that the Bankruptcy Code applies only "[t]o the extent consistent with the provisions of this chapter [of the federal securities laws]," 15 U.S.C. § 78fff(b). Accordingly, where the Bankruptcy Code and the securities laws conflict, the Bankruptcy Code must yield.

It is well established that "good faith" in the securities context "implies a lack of fraudulent intent." *See Katz*, 462 B.R at 455; *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (suggesting that a lack of good faith requires a mental state more culpable than negligence under the securities laws). From the perspective of an investor withdrawing funds from his account, any payments from Madoff Securities merely constituted the proceeds of a securities transaction on that customer's behalf. In these ordinary circumstances, it is undisputed that a "securities investor has no inherent duty to inquire about his stockbroker," and nothing in SIPA creates such a duty. *Katz*, 462 B.R. at 455; *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("[T]he fundamental purpose of the 1934 [Securities Exchange] Act [is] 'to substitute a philosophy of full disclosure for the philosophy of caveat emptor.'" (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972))); *In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 87 (2d Cir. 2004) (rejecting "greater investor vigilance" as a goal of SIPA and noting that "the drafters' emphasis was on promoting investor confidence in the securities markets and protecting broker-dealer customers"). Absent a duty to investigate, a customer's failure to do so does not equate with a lack of good faith. *See Avellino*, 469 B.R. at 412 ("[B]ecause the securities laws do not ordinarily impose any duty on investors to investigate their brokers, those laws foreclose any interpretation of 'good faith' that creates liability for a negligent failure to so inquire."); *In re Dreier*, 452 B.R. at 449 (applying a conscious avoidance standard where the investors-defendants "do not appear to have owed a duty to anyone (other than perhaps their own investors) to investigate Dreier's fraud").

The Trustee's approach would impose a burden of investigation on investors totally at odds with the investor confidence and securities market stability that SIPA is designed to enhance. This does not mean that an investor may purposely close her eyes to what is plainly to be seen. As stated in *Katz*, "[i]f an investor intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith." 462 B.R. at 455. But, in the context of securities transactions such as those protected by SIPA, the inquiry notice standard that the Trustee seeks to impose would be both unfair and unworkable.

Although the subsequent transferees involved in these proceedings—including not only indirect investors but also individuals and entities who received fees for services provided to investment funds that were customers of Madoff Securities—were not themselves investors with Madoff Securities itself, the same standard applies to them under both section 548(c) and section 550(b). Not only does this outcome make sense as a matter of statutory interpretation, but it also reflects the impracticality of imposing a heightened duty of investigation on a securities market participant even further removed from Madoff Securities itself. *See In re Schick*, 223 B.R. 661, 663 (Bankr. S.D.N.Y. 1998) (finding that subsequent transferees are somewhat more insulated from liability because initial transferees have a "greater ability to monitor [the] debtor and the assets used to pay the debt").

This subjective standard also matches well with Congress's intent to limit the exception to recovery from subsequent transferees to those individuals who themselves acted in good faith. *See* S. Rep. No. 95-989, at 90 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5876 ("The phrase 'good faith' in [section 550(b)(1)] is intended to prevent a transferee from whom the transferee 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.").[3] In sum, the Court finds that, in the context of this litigation and with respect to both section 548(c) and section 550(b)(1), "good faith" means that the transferee neither had actual knowledge of the Madoff Securities fraud nor willfully blinded himself to circumstances indicating a high probability of such fraud.

The Court turns next to the related question of which party bears the burden of pleading a defendant's good faith or lack thereof. If one looks at the question simply in terms of the Bankruptcy Code, without reference to SIPA or other considerations, "good faith" appears to be an affirmative defense that must in the first instance be pleaded by defendants. Accordingly, section 548(a)(1)(A) of the Bankruptcy Code permits a trustee to "avoid *any* transfer" made within two years of the debtor's filing of a

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[3] The Court is unpersuaded by the Trustee's suggestion that the third phrase in section 550(b)(1)—"without knowledge of the voidability of the transfer"—implies that "good faith" in this context should be an objective test. In light of the legislative history, the most plausible reading is that this third requirement is merely one specific type of subjective knowledge required and does not preclude a subjective standard for good faith.

bankruptcy petition, if the debtor (here, Madoff Securities) "made such transfer . . . with actual intent to . . . defraud any entity to which the debtor was . . . indebted." 11 U.S.C. § 548(a)(1)(A) (emphasis supplied), while section 548(c) allows a transferee to retain "any interest transferred" to the extent he received value for the transfer and if he can show that he took the transfer in good faith, 11 U.S.C. § 548(c). The structure of this language suggests that section 548(c) provides an affirmative defense to recovery of an otherwise avoided transfer under section 548(a)(1)(A). *See, e.g.*, *In re Actrade Fin. Techs. Ltd.*, 337 B.R. 791, 805 (Bankr. S.D.N.Y. 2005) (finding that section 548(c) creates an affirmative defense).

Although section 550's language differs to some degree, the structure of the relevant provisions is largely analogous to section 548. Section 550(a) provides that "[e]xcept as otherwise provided in this section, to the extent that a transfer is avoided . . . , the trustee may recover, for the benefit of the estate, the property transferred" from either an initial transferee or "any immediate or mediate transferee of such initial transferee." 11 U.S.C. § 550(a). However, under section 550(b), "[t]he trustee may not recover" from a subsequent transferee who "takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." 11 U.S.C. § 550(b)(1). While the onus of section 550(b)(1) appears to be placed on the Trustee—contrary to section 548(c), which focuses on when a transferee may retain a transfer—this small difference in wording is overshadowed by the structural similarities of the two provisions. Accordingly, in the context of an ordinary bankruptcy proceeding, section 548(c) and section 550(b)(1) both provide an affirmative defense that must be raised by defendants in the first instance.

But, just as SIPA affects the meaning of "good faith" when a SIPA proceeding is involved, so too it affects the burden of pleading good faith or its absence. It would totally undercut SIPA's twin goals of maintaining marketplace stability and encouraging investor confidence if a trustee could seek to recover the investors' investments while alleging no more than that they withdrew proceeds from their facially innocent securities accounts. Put differently, this would not accord with the Supreme Court's requirement that, on a motion to dismiss for failure to state a claim, a court must assess whether the complaint "contain[s] sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). Without particularized allegations that the defendants here either knew of Madoff Securities' fraud or willfully blinded themselves to it, the Trustee's complaints here cannot make out a plausible claim that he is entitled to recover the monies defendants received from their securities accounts. *See also Picard v. Grieff*, 476 B.R. 715, 723 (S.D.N.Y. 2012) ("[D]efendants can prevail on their motion to dismiss . . . if they prove that, 'on the face of the complaint[s],' they can invoke the affirmative defense provided by § 548(c)." (quoting *Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998)).[4] Accordingly, the Court concludes that, in a SIPA proceeding such as this, a defendant may succeed on a motion to dismiss by

[4] As with the willful-blindness standard set forth above, the same rule applies to subsequent transferees who received transfers from customers and thus are entitled to the same presumptions arising from securities transactions.

showing that the complaint does not plausibly allege that that defendant did not act in good faith.[5]

Because this determination must be made on the basis of the specific allegations in the Trustee's various complaints, the Court, having set out the general framework, hereby leaves it to the Bankruptcy Court to determine in any given instance whether the foregoing standards have been met. Accordingly, the Court directs that the following adversary proceedings be returned to the Bankruptcy Court for further proceedings consistent with this Opinion and Order: (1) those cases listed in Exhibit A of item number 197 on the docket of 12 Misc. 115; and (2) those cases listed in the schedule attached to item number 468 on the docket of 12 Misc. 115 that were designated as having been added to the "good faith" consolidated briefing.

SO ORDERED.

Dated: New York, NY
April 27, 2014

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[5] The Trustee has extensive discovery powers under Rule 2004 of the Federal Rules of Bankruptcy Procedure through which he may gather information before he ever files a complaint. *See In re Lehman Bros. Inc.*, No. 08-01420, 2008 WL 5423214, at *3 (Bankr. S.D.N.Y. Nov. 26, 2008) ("The broad scope of Rule 2004 is well recognized."). It is thus not unreasonable to require that the Trustee provide a plausible basis to claim that a defendant lacked good faith in his initial complaint.

APPENDIX C

UNITED STATES BANKRUTPCY COURT
SOUTHERN DISTRICT OF NEW YORK

Adv. Proc. No. 08-1789

SECURITIES INVESTOR PROTECTION CORPORATION, PLAINTIFF,

v.

BERNARD L. MADOFF INVESTMENT SECURITIES LLC, DEFENDANT

IN RE: BERNARD L. MADOFF

Adv. Proc. No. 10-5345

IRVING H. PICARD, TRUSTEE FOR THE LIQUIDATION OF BERNARD L. MADOFF SECURITIES LLC, PLAINTIFF

v.

CITIBANK, N.A., CITICORP NORTH AMERICA, INC., AND CITIGROUP GLOBAL MARKETS LIMITED, DEFENDANTS

Filed: October 18, 2019

MEMORANDUM DECISION DENYING TRUSTEE'S MOTION FOR LEAVE TO FILE AMENDED COMPLAINT

BERNSTEIN, United States Bankruptcy Judge.

Plaintiff Irving H. Picard ("Trustee"), the trustee for the liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS") under the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa, *et seq*. ("SIPA") seeks to recover $343,084,590 in subsequent transfers made to Defendants Citibank, N.A. ("Citibank") and Citicorp North America, Inc. ("Citicorp") made by a BLMIS feeder fund.[1] He has moved ("Motion") for leave to file and serve a *Proposed Amended Complaint*, dated Dec. 14, 2018 ("*PAC*")[2] (ECF Doc. # 150-1).[3] Defendants oppose the Motion. (*Memorandum of Law in Opposition to Trustee's Motion for Leave to File an Amended Complaint*, filed Mar. 29, 2019 ("*Opposition*") (ECF Doc. # 158).) For reasons that follow, the Motion is denied.

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[1] Citigroup Global Markets Limited ("CGML") is also joined as a defendant but Exhibit C attached to the Proposed Amended Complaint does not list any subsequent transfers to CGML.

[2] *See Memorandum of Law in Support of Trustee's Motion for Leave to File an Amended Complaint* ("*Trustee Memo*"), dated Dec. 14, 2018 (ECF Doc. # 149); *see also Reply Memorandum of Law in Further Support of Trustee's Motion for Leave to File an Amended Complaint*, dated May 7, 2019 ("*Trustee Reply*") (ECF Doc. # 162). The *PAC* is attached as Exhibit A to the *Declaration of Seanna R. Brown in Support of the Trustee's Motion for Leave to File an Amended Complaint*, dated Dec. 14, 2018 ("*Brown Declaration*") (ECF Doc. # 150).

[3] "ECF Doc. # _" refers to documents filed on the docket of this adversary proceeding. References to other dockets include the case number.

BACKGROUND

The background information is derived from the well-pleaded factual allegations of the PAC and other information the Court may consider in determining whether the pleading is legally sufficient.

A. The Ponzi Scheme

At all relevant times, Bernard Madoff operated the investment advisory arm of BLMIS as a Ponzi scheme. (¶ 79.)[4] Beginning in 1992, Madoff told investors that he employed the "split-strike conversion" strategy ("SSC Strategy"), under which BLMIS purported to purchase a basket of stocks intended to track the S&P 100 Index, and hedged the investments by purchasing put options and selling call options on the S&P 100 Index. (¶¶ 85, 87.) In reality, BLMIS never purchased any securities on behalf of its investors and sent monthly statements to investors containing falsified trades typically showing fictitious gains. (¶¶ 85, 86.) All investor deposits were commingled in a JPMorgan Chase Bank account held by BLMIS, and the funds were used to satisfy withdrawals by other investors, benefit Madoff and his family personally, and prop-up BLMIS's proprietary trading department. (¶ 85.)

The BLMIS Ponzi scheme collapsed when redemption requests overwhelmed the flow of new investments, (¶ 101), and Madoff was arrested by federal agents for criminal violations of federal securities laws on December 11, 2008 ("Filing Date"). (¶ 17.) The Securities and Exchange Commission ("SEC") contemporaneously commenced an

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[4] References to paragraphs in the *PAC* will be denoted as "(¶ _)," except where overt reference to the *PAC* is necessary to avoid confusion.

action in the United States District Court for the Southern District of New York, and that action was consolidated with an application by the Securities Investor Protection Corporation ("SIPC") asserting that BLMIS's customers needed the protections afforded by SIPA. (¶¶ 17, 18.) On December 15, 2008, the District Court granted SIPC's application, appointed the Trustee and his counsel, and removed the SIPA liquidation to this Court. (¶ 19.)

At a plea hearing on March 12, 2009, Madoff pleaded guilty to an eleven-count criminal information and admitted that he "operated a Ponzi scheme through the investment advisory side of [BLMIS]." (¶¶ 22, 102.)

B. Defendants and Relevant Affiliates

Citibank is a commercial bank with it principal place of business in New York, and is a wholly-owned subsidiary of Citigroup, Inc. ("Citigroup"). (¶ 29.) Citicorp is a non-bank holding company registered in Delaware and an indirect subsidiary of Citigroup. (¶ 37.) Citibank uses Citicorp to book and assign capital for leveraged and bridge loans. (¶ 37.) Non-party Citigroup Global Markets, Incorporated ("CGMI") is an indirect, wholly-owned subsidiary of Citigroup whose focus and expertise relate to derivative products, including exchange-listed ("OEX") and over-the-counter ("OTC") options. (¶¶ 52, 59.) Defendants conducted their BLMIS-related business and diligence primarily through CGMI. (¶¶ 5, 107.) Non-party CAFCO, LLC ("CAFCO"), a wholly-owned subsidiary of Citigroup, is a conduit commercial lender. (¶ 58.)

C. The Fairfield Deal—Deal No. 1

On April 28, 2005, CGML entered into an offshore swap transaction with Auriga International Limited ("Auriga"), a British Virgin Islands hedge fund that invested almost all its assets with Fairfield Sentry Limited ("Fairfield Sentry"). Auriga provided CGML with $140 million in collateral in return for leverage that would allow Auriga to recover two-times the returns on a hypothetical direct investment in Fairfield Sentry ("Fairfield Deal"). (¶¶ 72, 105, 106.) To generate the returns it might have to pay Auriga, CGML invested the $140 million in collateral plus an equivalent amount of its own funds, directly in Fairfield Sentry, (¶ 106), effecting a "perfect hedge." *See Picard v. ABN AMRO Bank (Ireland) Ltd.* (*In re BLMIS*), 505 B.R. 135, 138 (S.D.N.Y. 2013). The investment by CGML of an equal amount of its own funds provided it with protection if the Fairfield Sentry investment increased in value and required CGML to pay two times the returns. In the meantime, CGML earned fees. (¶ 106.)

CGMI's Global Hybrid Trading Desk summarized the proposed terms of the Fairfield Deal in a March 10, 2005 internal memorandum. ("*March 10 Memo*").[5] (¶ 111.) The *March 10 Memo* also detailed the SSC Strategy and attached a due diligence questionnaire for its investors prepared by Fairfield Sentry's operator, Fairfield Greenwich Group ("FGG"), that claimed BLMIS executed its options trades on the OTC market. (¶¶ 112, 116; *see also March 10 Memo* at ECF pp. 4, 7-42 of 132.)[6]

1. CGMI's Due Diligence

Diligence for the Fairfield Deal was spearheaded by CGMI, specifically Samir Mathur, a managing director,

[5] The *March 10 Memo* is filed as Attachment A to the *Letter from Seanna R. Brown*, dated July 23, 2019 ("*Brown (7/23) Ltr.*") (ECF Doc. # 167-1).

[6] "ECF p. _" refers to the page number imprinted on the top of the page by the Court's electronic filing system.

and Rajiv Sennar, an employee in the Fund and Multi-Asset Derivatives Group. (¶ 107.) CGMI could not verify BLMIS's option transactions or identify the relevant options counterparties which, together with BLMIS's lack of an independent custodian, "concerned" CGMI. (¶¶ 108, 110.) On March 11, 2005, Marc Fisher told FGG's Kim Perry that Citibank was afraid the assets in Fairfield's BLMIS account could disappear. (¶ 118.) An internal FGG email from Perry relayed Citibank's "credit concerns" that "the money [could] disappear from the account in any one day," and advised that Citibank "would feel more comfortable if there were some sort of control on money leaving the account." (¶ 118.) Citibank's main concern, according to Perry, was the lack of an independent custodian to prevent BLMIS from stealing Fairfield Sentry's assets. (¶ 119.) On or around March 22, 2005, Fisher, Mathur, Ramesh Gupta and other CGMI employees visited Fairfield's New York office for further diligence. Two days later, Fisher advised FGG (Perry) that Citibank had lingering concerns about the "theoretical fraud risk given that Madoff is the custodian of the assets," but Perry nonetheless informed his Fairfield colleagues that Citicorp's trading head agreed to assume the risk and the final "senior sign-off" was a mere formality. (¶ 120.)

CGMI asked Fairfield to arrange a meeting with BLMIS before finalizing the Fairfield Deal because "the more [Citibank] could find out more directly it's better," but Fairfield explained that a meeting was not possible. (¶ 123.) In lieu of a meeting, Mathur asked Fairfield for public information about BLMIS that he could distribute to the CGMI credit committee to help consummate the deal. (¶ 124.) But the information did not alleviate CGMI's concerns. (¶ 125.) On March 30, Mathur requested a telephone call with Amit Vijayvergiya, Fairfield's Head of Risk Management, to discuss CGMI's concerns that

BLMIS was not making options trades it purported to make and that the money under Madoff's control could disappear. (¶ 126.) According to Vijayvergiya, CGMI wanted to revisit (1) whose name the stock/option positions were held in at the Depository Trust and Clearing Corporation; (2) what happens to the assets in event of bankruptcy; (3) the name of BLMIS's accountant; and (4) the number of option counterparties. (¶ 127.)

On March 30, 2005, CGMI's Global Hybrid Trading Desk issued a memorandum ("*March 30 Memo*") to the Fast Track Capital Markets Approval Committee, whose purview was reviewing structured financing products and identifying risks. (¶¶ 128- 130.)[7] The *March 30 Memo* stated that "[t]here should be no counterparty risk associated with this transaction. There is a fraud risk" but did not amplify the nature of the fraud or the risk. (*March 30 Memo* at ECF p. 8 of 28.) The memo also noted that "Madoff is both Prime Broker and Custodian of the SSC assets of Sentry." (¶ 131; *March 30 Memo* at ECF p. 7 of 28.)

2. CGMI's Quantitative Analysis

CGMI also performed a quantitative analysis ("Quantitative Analysis"), circulated internally with the *March 10* and *March 30 Memos*, that compared BLMIS's stated investment returns to the returns that an SSC Strategy would be expected to yield. (¶¶ 136, 137.)[8] The Quantitative Analysis showed that from December 1990 through

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[7] The *March 30 Memo* is filed as Attachment B to the *Brown (7/23) Ltr.* (ECF Doc. # 167-2).

[8] The Quantitative Analysis is attached to the *March 30 Memo* at ECF pp. 9-28 of 28 and is entitled "Risk Analysis." The Quantitative Analysis is captured in a spreadsheet entitled "Fairfield Analysis.xls." (*See March 30 Memo* at ECF p. 6 of 28.)

January 2005 ("Sample Period"), BLMIS stated positive returns for Fairfield in 164 out of 170 months. (¶¶ 137, 142.) By contrast, the S&P 100 Index posted positive returns in only 107 months in the Sample Period. (¶ 143.) The Quantitative Analysis revealed that BLMIS outperformed the S&P 100 across a number of metrics and that Fairfield's returns were superior to the S&P 100 Index even though the SSC Strategy presumptively had the same risk profile as the S&P 100 Index. (¶¶ 145, 146, 149, 150-153.)

3. Leon Gross's Analysis[9]

Leon Gross, a managing director at CGMI, also ran an analysis of BLMIS's SSC Strategy ("Gross Analysis"), at the behest of a CGMI customer, Harry Markopolos. (¶ 155.)[10] Markopolos asked Gross to analyze BLMIS's returns and determine whether the data was possible given BLMIS's purported SSC Strategy. (¶¶ 155, 159-60.)[11] The

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[9] The *PAC* does not state when Gross made the analysis discussed in the succeeding text. However, its placement in the *PAC* suggests that it was done around the time that CGMI was conducting its due diligence in connection with the Fairfield Deal.

[10] According to the Trustee's counsel, the Gross Analysis was never reduced to writing. However, Gross confirmed at his Rule 2004 examination that he did in fact analyze BLMIS's returns under circumstances resembling those described in the *PAC*. (*Rule 2004 Examination of Leon J. Gross*, dated Oct. 22, 2010, at 34:8-18 ("*Gross Tr.*").) Excerpts of the transcript are attached as Exhibit F to the *Declaration of Carmine D. Boccuzzi, Jr. in Opposition to Trustee's Motion for Leave to File an Amended Complaint*, filed Mar. 29, 2019 ("*Boccuzzi Declaration*") (ECF Doc. # 157).

[11] In Markopolos' s November 2005 submission to the SEC accusing BLMIS and Madoff of fraud, Markopolos identified Gross as a derivatives expert the SEC should interview. (¶¶ 169-70.) Markopolos also emailed Gross in June 2007 asking if Gross had heard anything about the imminent collapse of Madoff's Ponzi scheme. (¶ 174.)

Gross Analysis considered six or seven scenarios that weighed different variables (*e.g.*, market timing, buying or selling individual options, etc.) in an attempt to replicate BLMIS's returns. (¶¶ 162-63.) Gross concluded that "either the returns are not the returns or the strategy is not the strategy." (¶ 155; *Gross Tr.* at 116:13-14.) He was "skeptical that [the SSC Strategy] as described could generate those returns," but attempted to "reconcile" the "discrepancy between the strategy and the returns . . . ." (¶ 161.) Gross determined "that the returns weren't generated by the strategy, they were either generated by something else—that something was amiss there." (¶ 164; *Gross Tr.* at 35:19-22.) Gross also asked traders at CGMI's index options desk if they were familiar with Madoff trading index options—none were. (¶¶ 165-166.)[12]

Despite these numerous "concerns," the Fairfield Deal closed and CGML invested $140 million of its own funds.

D. Prime Fund Deal—Deal No. 2

CGMI began negotiating the terms of a $300 million revolving credit facility ("Prime Fund Deal") with Tremont Partners, Inc. ("Tremont") in March 2005. (¶ 175.) Tremont served as the general partner and investment advisor to several BLMIS feeder funds (collectively, the "Rye Funds"), including the Rye Select Broad Market Prime Fund, L.P. ("Prime Fund"), and was liable for their debts under Delaware law. (Complaint, dated Dec. 7, 2010 ("*Tremont Complaint*"), at ¶¶ 47-48, 61-62 (ECF Adv.

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[12] The *PAC* alleges that Gupta made similar inquiries with respect to BLMIS's counterparties and that Gupta knew Gross, but there is no allegation that Gupta and Gross coordinated efforts or shared any findings with respect to BLMIS. (*See* ¶ 167.)

Pro. No. 10-05310 Doc. # 1.))[13] In addition, Tremont managed, advised and/or oversaw a group of sub-feeder funds that invested with BLMIS through the Rye Funds. (*Tremont Complaint* ¶ 66.) The Funds invested close to 100% of their assets with BLMIS, (*Tremont Complaint* ¶ 8), and Tremont earned substantial fees acting as their investment manager. (*Tremont Complaint* ¶¶ 104-08.) The parties contemplated that Prime Fund would use all or substantially all of the funds it borrowed from Citibank to invest with BLMIS. (¶ 178.)

1. Tremont Indemnity

According to the *PAC*, CGMI's approval of the Prime Fund Deal was contingent on an agreement to indemnify Defendants and CAFCO against fraud by BLMIS and specifically, to ensure that the Defendants and CAFCO would be repaid if BLMIS misappropriated Prime Fund's assets or was not trading securities. (¶ 177.) Before entering into the Prime Fund Deal, Defendants conducted substantial due diligence as reflected in the *Transaction Memo*, dated May 31, 2005 ("*Transaction Memo*").[14] Defendants acknowledged the risk of fraud because BLMIS maintained physical control of Prime Fund's account and had full discretion over account activity, (*Transaction Memo* at 5), but viewed the risk as "remote," (*id.* at 2), and noted BLMIS's "strong industry reputation with over 40 years experience, over $500 million in capital, its responsibilities and obligations as a registered broker-dealer, and its historical relationship with Tremont and, more recently, Citigroup." (*Id.* at 3.) BLMIS had managed Prime

[13] The *PAC* incorporates by reference the factual allegations in the *Tremont Complaint*. (¶ 261.)

[14] A copy of the *Transaction Memo* is annexed as Exhibit C to the *Boccuzzi Declaration.*

Fund's assets since 1997, and although BLMIS was not contractually required to adhere to its SSC Strategy, the failure to do so would be an event of default that would likely lead to Tremont's redemption of its BLMIS investment. "Given its historical track record of maintaining the Investment Strategy since inception of the Fund, it appears remote that the Investment Advisor would deviate from the Investment Strategy." (*Id.* at 2.)

However, the Defendants viewed certain guarantees by Tremont (the "Tremont Indemnity") and Tremont Capital Management, Inc. ("TCM") (the "Parent Guarantee"), Tremont's parent, as the "primary mitigant of fraud" by BLMIS.[15] (*Id.* at 3.) Under the Tremont Indemnity, Tremont agreed to answer for the debts of Prime Fund, and under the Parent Guarantee, TCM agreed to guarantee the timely payment of Tremont's obligations with the exception of the obligation to support Prime Fund's repayment of advances as a result of a decline in the market value of the assets purchased in adherence to the SSC Strategy. (*Id.* at 2, 7.) Tremont, as Prime Fund's general partner, was liable anyway for all of Prime Fund's debts, but the Tremont Indemnity would permit the Defendants to proceed directly against Tremont without first exhausting its remedies against Prime Fund as required by Delaware law. (*Id.* at 6-7 (citing DELAWARE REVISED UNIFORM LIMITED PARTNERSHIP ACT ("RULPA") § 17-403).)

2. Oppenheimer Proviso

TCM, Tremont's parent, was a wholly-owned subsidiary of Oppenheimer Acquisition Corp., the parent of Oppenheimer Funds, Inc. (collectively, "Oppenheimer" or

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[15] CGMI also required Prime Fund to pledge its assets as collateral for the *RCA*. (¶ 206.)

"OFI"). (*Transaction Memo* at 2.) Oppenheimer was a majority owned subsidiary of Massachusetts Mutual Life Insurance Company. Mass Mutual had a AAA rating from S&P and an Aa1 rating from Moody's. (*Id.* at 3.) In addition to the Tremont Indemnity and the Parent Guarantee, TCM had to remain a wholly-owned subsidiary of Oppenheimer. (*Id.*) CGMI's Marc Adelman noted just days before the *RCA*[16] was executed that Tremont's relationship with OFI was a material component of the deal and that CGMI "would want the right to reconsider that if Tremont were no longer an affiliate of OFI." (¶ 185.) However, the *PAC* does not allege that Oppenheimer guaranteed the obligations of Prime Fund, Tremont or TCM incurred in connection with the Prime Fund Deal.

On June 15, 2005, Defendants Citibank and Citicorp as lenders and CAFCO as conduit lender on the one hand, and Prime Fund as borrower and Tremont, as General Partner, on the other, entered into the *RCA*. The *RCA* granted Prime Fund a revolving credit facility in the sum of $300 million to be invested with BLMIS. The *PAC* does not allege and there is no evidence that the Defendants received the Parent Guarantee.

E. Proposed Tremont Deal—Deal No. 3

Tremont emailed CGMI in December 2005 to explore another Madoff-related deal in which Defendants would own shares directly in a Tremont feeder fund in exchange

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[16] "*RCA*" refers to the *Revolving Credit and Security Agreement among American Masters Broad Market Prime Fund, L.P. as Borrower, Tremont Partners, Inc. as General Partner, CAFCO, LLC as Conduit Lender, Citibank, N.A. as Secondary Lender and Citicorp North America, Inc. as Agent, dated as of June 15, 2005*. The *RCA* is attached as Exhibit A to the *Boccuzzi Declaration*.

for approximately $300 million in leveraged financing ("Proposed Tremont Deal"). (¶¶ 187-88, 201.)

1. CGMI's Due Diligence

CGMI's Matthew Nicholls, along with Mathur and Sennar, were involved in diligence efforts for the Proposed Tremont Deal. (¶ 190.) On January 30, 2006, Sennar reminded Tremont's Darren Johnston via email that any deal was contingent upon "address[ing] the due diligence questions our internal control functions have." (¶ 191.) By February 2006, CGMI and Tremont had held several conference calls and at least two due diligence sessions to discuss CGMI's concerns about fraud surrounding the Proposed Tremont Deal but Tremont was unable to satisfy CGMI that BLMIS maintained segregated customer accounts or that the assets even existed. (¶ 192.) On February 16, Tremont sent Sennar a copy of the Prime Fund Pledge Agreement between Prime Fund and Citicorp that purported to show, along with Johnston's explanatory email, that Prime Fund's BLMIS account was held as a segregated customer account, but did not otherwise provide any other form of independent verification. (¶¶ 193-94.) On February 27, Johnston, Tremont CEO Robert Schulman, and CGMI's Sennar participated in a phone call to discuss BLMIS's custody of Prime Fund's assets and internal controls to prevent fraud or misappropriation of assets. (¶ 195.) After the call, Johnston forwarded copies of an "Independent Auditors' Report on Internal Control" and BLMIS's "Statement of Financial Condition" prepared by BLMIS's auditors, Friehling & Horowitz ("F&H") but the reports did not concern BLMIS's investment advisory business or explain whether BLMIS segregated customer assets in the customer accounts. The reports "did not quell CGMI's fraud concerns." (¶ 196.)

CGMI continued to inquire about Madoff's options trading but was unable to confirm from its due diligence starting in March 2005 and continuing through 2006 that it actually took place. (¶¶ 197-98.) Mathur knew that BLMIS purported to execute billions of dollars of S&P 100 Index options trades as part of the SSC Strategy, but CGMI's trading desk informed Mathur that it had "not been counterparties to these kind of options, and they did not know of anybody else who would be the counterparties for these kind of options." (¶ 199.) CGMI "agreed to seek a meeting directly with Madoff in an attempt to resolve CGMI's long-standing concerns of fraud at BLMIS." (¶ 201.)

In March 2006, CGMI identified discrepancies between certain October 21, 2005 options prices that BLMIS had reported to Fairfield Sentry and those reported by Bloomberg. (¶ 202.) On March 23, 2006, CGMI's Vishal Mishra asked Vijayvergiya of Fairfield about the discrepancies, leading to a telephone call and subsequent requests to both FGG and Tremont for records of BLMIS's options transactions. (¶¶ 202-203.) CGMI also asked Fairfield for one or two names of counterparties that traded options with BLMIS and inquired about a visit to FGG's offices to inspect options trade confirmations from BLMIS. (¶ 203.) An internal Tremont email indicates that Defendants asked Tremont to identify BLMIS's counterparties after they were unable to "find anyone who admits to being a counterparty." (¶ 204.)

Citibank later received the results of a KPMG Independent Accountants' Report, dated April 17, 2006 ("KPMG Report"), required in connection with the Prime

Fund Deal for the purpose of valuing the collateral securing the *RCA*. (¶ 206.)[17] Among other things, the KPMG Report featured a "Portfolio Data Integrity Test"; it selected twenty-five securities at random from Prime Fund's BLMIS portfolio and compared BLMIS's reported transaction prices for those securities on October 31, 2005 and December 31, 2005 to the prices reported by Bloomberg and Interactive Data Corporation ("IDC") for those dates. (¶ 207; KPMG Report at 1.) The Portfolio Data Integrity Test flagged a number of discrepancies in Prime Fund's records, including a U.S. Treasury Bill with an incorrect maturity date, an option security—"Viacom Inc-B"—that was not a component of the OEX index and several differences between the market prices of trades listed on Prime Fund's records and the independent market prices reported by IDC or Bloomberg. (KPMG Report at 2-3.)

On April 18, Mishra emailed Vijayvergiya, copying Mathur and Gupta, to outline discussion topics for an upcoming April 20 meeting with FGG. (¶ 208.) First, CGMI sought to confirm options with counterparties; it had not seen any documents that identified the counterparties. (¶¶ 210-13.) Second, CGMI wanted the auditor's verification of OTC options details with counterparties and verification of the presence and segregation of securities and option trades in Fairfield's BLMIS account. (¶ 214.) CGMI also sought records from PricewaterhouseCoopers LLP ("PWC"), Fairfield's auditor, "to make sure that those securities exist or the options exist in that particular account." (¶ 215.) According to CGMI's Mathur, the April 20th Meeting "did not raise any new flags," but "did not

[17] The KPMG Report is attached as Attachment D to the *Brown (7/23) Ltr.* (ECF Doc. # 167-4). It is not alleged when Citibank received the results of the KPMG Report.

give us [CGMI] the answer we were looking for." (¶ 216; *see also* ¶ 213 ("Mathur testified, '[we] never got to know who the eventual counterparties are on the options. So that part never got resolved.'") (alterations in original).)

2. Meeting with Madoff

On December 20, 2005, a Tremont employee had emailed Tremont's CEO, Robert Schulman, noting that Citibank wanted "an initial DDQ meeting" and subsequent update meetings with Madoff. (¶ 189.) With respect to "[w]hat type of access" Citibank could have to Madoff, Schulman responded, "[c]an't do it." (¶ 189.) CGMI pursued the due diligence described in the preceding section and on March 27, 2006, Tremont's Johnston emailed Schulman regarding CGMI's request to meet with Madoff. (¶ 219.) The email explained that the identity of BLMIS's counterparties was a "critical issue" from CGMI's perspective and discussed Defendants' efforts to close the loop on BLMIS's options counterparties:

> [A] new hire from Credit Suisse did not know of trades and they have even asked around a little trying to find out. They mentioned trying to get proof such as a sample confirm or even talking to the counterparty if they are unable to find out directl[y].

(¶ 219.)

Tremont first refused to arrange the meeting but eventually, a meeting between CGMI personnel and Madoff was scheduled for April 26, 2006 at BLMIS. (¶ 221.) However, shortly after the April 20th meeting at Fairfield, CGMI informed Tremont that it would not go forward with the Proposed Tremont Deal, citing "insurmountable" concerns of fraud with BLMIS. (¶¶ 224, 225.) Tremont's Darren Johnston documented CGMI's concerns in an internal email, identifying the two "fundamental roadblocks" to closing the deal: Madoff's custody of the account and the lack of transparency regarding how Madoff executed his volume of options. (¶ 226.)

The Proposed Tremont Deal was never consummated and fell through in April 2006.

F. Subsequent Dealings With Tremont

After the Proposed Tremont Deal fell through, Johnston emailed Schulman to reiterate CGMI's continued enthusiasm for the Prime Fund Deal, (¶ 229), which was set to expire on June 13, 2006. (¶ 232.) Tremont wanted to increase the size of the facility from $300 million to $450 million and CGMI agreed to consider the proposal along with a one-year renewal of the Prime Fund Deal subject to another credit due diligence review that CGMI expected it could "comfortably" wrap up in two to four weeks. (¶¶ 236-38.) As part of the diligence, Defendants requested Tremont's 2004 and 2005 audited financial statements. (¶ 238.) However, Tremont did not yet have the requested financial statements. (¶ 239.) An internal May 9, 2006 Tremont email noted, "Citi [was] concerned about the delay in the 2004 audited financials." (¶ 239.) Tremont did send along its unaudited financials to CGMI, but acknowledged that CGMI was "becoming increasing uncomfortable" and "very unsettled that the 2004 audit is not yet completed." (¶ 240.)

1. Madoff Meeting

According to the *PAC*, CGMI had "already concluded there was a high probability of fraud at BLMIS," (¶ 231), and refused to meet with Madoff or confirm its "suspicions," (¶¶ 232, 233), because it might jeopardize the Fairfield and Prime Fund Deals. In particular, CGMI might lose a minimum profit of $8 million on the Fairfield Deal if the deal was terminated. (¶¶ 231-33.) In June 2006, CGMI nevertheless expressed renewed interest in meeting with Madoff. (¶¶ 241-42.) An internal Tremont email explained that CGMI had not relaxed its demand for Tremont's audited financials and was "now seeking a Madoff meeting." (¶ 242.) CGMI wanted to "'resolve internal wonder' [sic] remaining from their due diligence related to 3X leverage on how Madoff executes the trades." (¶ 243.) After CGMI followed up with Tremont in September about the meeting request, Tremont advised CGMI to prepare a list of proposed questions to Madoff for Tremont's review but would not commit to arranging a meeting. (¶ 244.) On October 11, CGMI's Matthew Nicholls sent Tremont a proposed agenda ("*Agenda*").[18] (¶ 245.) The *Agenda* did not expressly focus on BLMIS's options trades or assets. (¶ 245.) CGMI's focus was "the competitive environment," "key financial and business risks facing [BLMIS]" and other high-level overview issues. (¶ 248.) CGMI's Nicholls further explained that the *Agenda* "essentially boils down to a corporate overview." (¶ 248.)

On November 27, 2006, CGMI met with Madoff at BLMIS's offices. (¶ 251.) Representing CGMI were Thomas Fontana, Bruce Clark and Nicholls, all of whom, the Trustee alleges on information and belief, had a direct economic interest in renewing and increasing the Prime Fund Deal. (¶¶ 250-51.) Shortly after the meeting with Madoff, the Prime Fund Deal was renewed for one month from November 30, 2006 to December 29, 2006, and later to December 13, 2007 and increased to $400 million. (¶ 252.)

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[18] The *Agenda* is attached as Exhibit B to the *Boccuzzi Declaration*.

2. Defendants Terminate the Prime Fund Deal

In October 2007, two months before the Prime Fund Deal was set to expire, Tremont proposed new terms that would "eradicate" the Tremont Indemnity without which Defendants and CAFCO's recovery in the event of fraud at BLMIS would be limited to Prime Fund's assets. (¶ 254.) An internal Tremont email, dated November 7, 2007, reflected that negotiations between CGMI and Tremont were breaking down over a "limited recourse issue;" that is, Tremont's demand to remove the Tremont Indemnity from the *RCA* and insert a provision stating that Defendants and CAFCO would have "no recourse" against Tremont for Prime Fund's obligations. (¶ 255.) The parties renewed the Prime Fund Deal for three months on December 13, 2007, but could not agree on the continuation of the Tremont Indemnity. (*See* ¶¶ 256-58.) A March 10, 2008 internal Tremont email noted that "Citi needs indemnification from manager fraud." (¶ 258.)

Tremont and Citibank could not break the impasse, and on March 12, 2008, Tremont informed CGMI that it would repay the loan on March 26, five days before the March 31 expiration date. (¶ 259.) On March 25, 2008, Prime Fund withdrew $475 million from its BLMIS account and transferred $301 million to Defendants the next day. (¶ 260.) The parties executed a termination agreement on March 26.

G. Allegations Against Tremont

On December 7, 2010, the Trustee filed a complaint against Tremont and several Tremont funds, including Prime Fund, to avoid and recover $2.1 billion of initial transfers from BLMIS. The substance of the allegations included in the *Tremont Complaint* and supplemented by the *PAC* is that Tremont knew that BLMIS was not trading securities and was operating a Ponzi scheme. In light of the Court's determination, I assume that the Trustee has adequately pled Tremont's knowledge.

H. The Adversary Proceeding

The Trustee seeks to recover subsequent transfers aggregating $343,084,590 under section 550(a)(2) of the Bankruptcy Code made to the Defendants by Prime Fund, the initial transferee.[19] (¶ 335.) The date and amount of each subsequent transfer is set out in Exhibit C to the *PAC*. The Trustee has moved for leave to amend the original complaint filed in December 2010, to meet the more rigorous pleading requirements relating to allegations of bad faith imposed by the District Court after that date.

The Defendants oppose the Motion. They argue, in the main, that the *PAC* does not allege that the Defendants willfully blinded themselves to Madoff's Ponzi scheme and does allege that they gave value to the Prime Fund. Consequently, the Defendants have a complete defense under 11 U.S.C. § 550(b). (*Opposition* at 19-34.) The Defendants also contend that the Trustee's claims violate the "single satisfaction" rule under 11 U.S.C. § 550(d) because the BLMIS estate has already recovered the initial transfers through a settlement with Tremont, (*id.* at 13-16), the transfers to the Prime Fund that were subsequently transferred to the Defendants did not deplete the estate because Prime Fund replaced the Defendants' funds with

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[19] According to the *PAC*, BLMIS sent approximately $1.01 billion in initial transfers to Prime Fund. Of that amount, the Prime Fund received approximately $945 million within six years of the Filing Date and approximately $495 million within two years of the Filing Date. (¶¶ 331-33; *accord PAC* at Exhibit A.)

an alternative source and reinvested those sums with BLMIS, (*id.* at 16-19), and the safe harbor in 11 U.S.C. § 546(e) bars any subsequent transfers originating from initial transfers to the Prime Fund made more than two years before the Filing Date because Prime Fund lacked actual knowledge that BLMIS was not trading securities. (*Id.* at 34-40.)

DISCUSSION

A. Standards Governing the Motion

Rule 15(a) of the Federal Rules of Civil Procedure governs motions for leave to amend pleadings. Generally, leave should be freely granted, but the court may deny the motion in instances of undue delay, bad faith, dilatory motive, undue prejudice to the opposing party or futility. *Foman v. Davis*, 371 U.S. 178, 182 (1962). The Defendants' sole contention is that the *PAC* is futile. (*See Opposition* at 1.) "An amendment to a pleading is futile if the proposed claim could not withstand a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6)." *Lucente v. Int'l Bus. Machs. Corp.*, 310 F.3d 243, 258 (2d Cir. 2002).

"To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (citation omitted); *accord Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 556 U.S. at 678; *accord Twombly*, 550 U.S. at 556. It is not sufficient for the complaint to plead facts that "permit the court to infer . . . the mere possibility of misconduct," *Iqbal,* 556 U.S. at 679; he must state "the grounds upon which his claim rests through factual allegations sufficient 'to raise a right to relief above the speculative level.'" *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007) (quoting *Twombly,* 550 U.S. at 555). Determining whether a complaint states a plausible claim is a "context-specific task that requires the reviewing court to draw on its judicial experience and common sense." *Iqbal*, 556 U.S. at 679. The court should assume the veracity of all "well-pleaded factual allegations," and determine whether, together, they plausibly give rise to an entitlement of relief, *id.*, but where the amended pleading directly contradicts the facts alleged in an earlier pleading, the Court may accept the allegations in the original pleading as true. *See Vasquez v. Reilly*, No. 15-CV-9528 (KMK), 2017 WL 946306, at *3 (S.D.N.Y. Mar. 9, 2017); *Colliton v. Cravath, Swaine & Moore LLP*, No. 08 Civ 0400 (NRB), 2008 WL 4386764, at *6 (S.D.N.Y. Sept. 24, 2008), *aff'd*, 356 F. App'x 535 (2d Cir. 2009).

In deciding the motion, "courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 322 (2007). The court may also consider documents that the plaintiff relied on in bringing suit and that are either in the plaintiff's possession or that the plaintiff knew of when bringing suit. *Chambers v. Time Warner, Inc.*, 282 F.3d 147, 153 (2d Cir. 2002); *Brass v. Am. Film Techs., Inc.,* 987 F.2d 142, 150 (2d Cir. 1993); *Cortec Indus., Inc. v. Sum Holding L.P.,* 949 F.2d 42, 47-48 (2d Cir. 1991), *cert. denied,* 503 U.S. 960 (1992); *McKevitt v. Mueller,* 689 F. Supp. 2d 661, 665 (S.D.N.Y. 2010). Where the complaint cites or quotes from excerpts of a document, the court may consider other parts of the same document submitted by the parties on a motion to dismiss. *131 Main St. Assocs. v. Manko,* 897 F. Supp. 1507, 1532 n. 23 (S.D.N.Y. 1995). If "the documents contradict the allegations of a plaintiff's complaint, the documents control and the [c]ourt need not accept as true the allegations in the complaint." *2002 Lawrence R. Buchalter Alaska Tr. v. Philadelphia Fin. Life Assurance Co.*, 96 F. Supp. 3d 182, 199 (S.D.N.Y. 2015) (quoting *Bill Diodato Photography LLC v. Avon Prods., Inc.,* No. 12-CV-847, 2012 WL 4335164, at *3 (S.D.N.Y. Sept. 21, 2012)) (citing authorities).

Here, the *PAC* relies on and/or quotes from, *inter alia*, the *March 10 Memo*, the *March 30 Memo*, the *Transaction Memo*, the *RCA*, the KPMG Report, and the *Agenda*.

B. Claims To Recover Subsequent Transfers

Section 550(a)(2) of the Bankruptcy Code allows the Trustee to recover an avoidable transfer from "any immediate or mediate transferee of" the initial transferee. To plead a subsequent transfer claim, the Trustee must plead that the initial transfer is avoidable, and the defendant is a subsequent transferee of that initial transferee, that is, "that the funds at issue originated with the debtor." *Picard v. Legacy Capital Ltd.* (*In re BLMIS*), 548 B.R. 13, 36 (Bankr. S.D.N.Y. 2016) ("*Legacy I*"); *accord Silverman v. K.E.R.U. Realty Corp.* (*In re Allou Distribs., Inc.*), 379 B.R. 5, 30 (Bankr. E.D.N.Y. 2007). As noted, the Court assumes that the *Tremont Complaint* as supplemented by the *PAC* alleges that Tremont knew that BLMIS was not actually trading securities and was operating a Ponzi scheme. Accordingly, the safe harbor, 11 U.S.C. § 546(e), does not apply and the initial transfers are avoidable. In addition, Defendants have not disputed that the funds that were subsequently transferred to them by Prime Fund originated with BLMIS.

Section 550(b) provides a defense to a subsequent transferee who "[took] for value, . . . in good faith, and without knowledge of the voidability" of the initial transfer. Ordinarily, the transferee must raise the affirmative defense under section 550(b). *Legacy I*, 548 B.R. at 36. In addition, an objective, reasonable person test usually applies to determine a transferee's good faith. *See Marshall v. Picard* (*In re BLMIS*), 740 F.3d 81, 90 n. 11 (2d Cir. 2014) ("The presence of 'good faith' depends upon, *inter alia*, 'whether the transferee had information that put it on inquiry notice that the transferor was insolvent or that the transfer might be made with a fraudulent purpose.'") (quoting *Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC* (*In re Bayou Grp., LLC*), 439 B.R. 284, 310 (S.D.N.Y. 2010)). However, in *SIPC v. BLMIS* (*In re BLMIS*), 516 B.R. 18 (S.D.N.Y. 2014) ("*Good Faith Decision*"), the District Court ruled that good faith should be determined under a subjective standard, *id.* at 21-23, and placed the burden of pleading a lack of good faith on the Trustee. *Id.* at 23-24. Before addressing good faith, I briefly consider the other component of Defendants' defense, "value."

1. Value

The burden of pleading lack of value remains on the transferee who is in the better position to identify the value he gave for the subsequent transfer. *Picard v. BNP Paribas S.A.* (*In re BLMIS*), 594 B.R. 167, 206 (Bankr. S.D.N.Y. 2018) ("*BNP*"). Where the burden of pleading rests on the defendant, the Court may nevertheless dismiss the claim pursuant to Rule 12(b)(6) if the defense is apparent on the face of the complaint. *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP,* 322 F.3d 147, 158 (2d Cir. 2003); *accord Picard v. ABN AMRO Bank (Ireland) Ltd.,* 505 B.R. at

141. "Value" within the meaning of section 550(b) is "merely consideration sufficient to support a simple contract, analogous to the 'value' required under state law to achieve the status of a bona fide purchaser for value." 5 RICHARD LEVIN & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 550.03[1] at 550-25 (16th ed. 2019); *accord Enron Corp. v. Ave. Special Situations Fund II, LP* (*In re Enron Corp.*), 333 B.R. 205, 236 (Bankr. S.D.N.Y. 2005); KATHY BAZOIAN PHELPS & HON. STEVEN RHODES, THE PONZI BOOK § 4.03[2] at 4-42 (2012).

The *PAC* pleads that the Defendants loaned Prime Fund at least $300 million and Prime Fund or Tremont repaid that loan through the subsequent transfer. The remaining subsequent transfers coincide with the life of the loan and appear from Exhibit C to the *PAC* to be monthly payments of fees or interest, or both. Accordingly, the *PAC* pleads that the Defendants gave value in the form of the loan for the subsequent transfers.

2. Knowledge and Good Faith

As stated, the Trustee must plead that the Defendants took the subsequent transfers in good faith and without knowledge of the avoidability of the initial transfer. The two concepts represent separate elements under section 550(b), but they are related.

a. Good Faith

To satisfy his burden of pleading a lack of good faith, the Trustee must allege that each Defendant willfully blinded itself to facts suggesting that BLMIS was not actually trading securities.[20] *Good Faith Decision*, 516 B.R.

[20] The Trustee contends that it is sufficient to allege that the Defendants willfully blinded themselves to fraud generally rather than to the fact that BLMIS was not trading securities and was operating a Ponzi scheme. (*Trustee Reply* at 4-5.) But the fraud on which the

at 22-23; *Picard v. Merkin* (*In re BLMIS*), 563 B.R. 737, 752 (Bankr. S.D.N.Y. 2017). Willful blindness consists of two elements: "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact." *Global-Tech Appliances, Inc. v. SEB S.A.*, 563 U.S. 754, 769 (2011) ("*Global- Tech*"). If a person who is not under an independent duty to investigate "nonetheless, intentionally chooses to blind himself to the 'red flags' that suggest a high probability of fraud, his 'willful blindness' to the truth is tantamount to a lack of good faith." *Picard v. Katz*, 462 B.R. 447, 455 (S.D.N.Y. 2011), *abrogated on other grounds by SIPC v. BLMIS*, (*In re BLMIS*), 513 B.R. 437 (S.D.N.Y. 2014).

Neither recklessness nor negligence constitutes willful blindness. "[A] reckless defendant is one who merely knows of a substantial and unjustified risk of such wrongdoing, see ALI, Model Penal Code § 2.02(2)(c) (1985), and a negligent defendant is one who should have known of a similar risk but, in fact, did not, see § 2.02(2)(d)." *Global-Tech*, 563 U.S. at 770. Acting in the face of a "known risk"

PAC relies was BLMIS's operation of a Ponzi scheme. (¶ 104 ("Throughout the due diligence it conducted in connection with these deals, CGMI recognized indicia of fraud and repeatedly expressed two primary concerns: the first was that BLMIS was not and could not be trading options; the second was that the money invested and left under BLMIS's unfettered control could be stolen and disappear—*two of the fundamental elements of BLMIS's Ponzi scheme*.") (emphasis added); *accord Trustee Reply* at 5 ("The Trustee adequately alleges Defendants learned of facts causing them to believe there was a high probability BLMIS was not making trades as purported and misappropriating its customers' assets (*i.e.*, *running a Ponzi scheme*).") (emphasis added).) The *PAC* does not allege another type of fraud at BLMIS that the Defendants believed was highly probable.

does not establish willful blindness. *Id.* Furthermore, "deliberate indifference" to the risk does not establish willful blindness. *See id.*

b. Knowledge of Avoidability

To plead that a Defendant knew that it was receiving the proceeds of an avoidable transfer, the Trustee must plausibly allege that the Defendant "possess[ed] knowledge of facts that suggest a transfer may be fraudulent." *Banner v. Kassow*, 104 F.3d 352, 1996 WL 680760, at *3 (2d Cir. Nov. 22, 1996) (summary order) (quoting *Brown v. Third Nat'l Bank* (*In re Sherman*), 67 F.3d 1348, 1357 (8th Cir. 1995)). Section 550(b)(1) does not impose a duty to investigate or monitor the chain of transfers that preceded the subsequent transfer, but "[s]ome facts strongly suggest the presence of others; a recipient that closes its eyes to the remaining facts may not deny knowledge." *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 898 (7th Cir. 1988) (Easterbrook, J.). This standard "essentially defines willful blindness which, the District Court has held, is synonymous with lack of good faith." *Legacy I*, 548 B.R. at 38; *see also id.* at 38-39 (noting that some courts and commentators have suggested that the good faith and knowledge elements of 11 U.S.C. § 550(b)(1) are one and the same). Here, the parties have not identified a distinction between the two elements of § 550(b)(1).

3. Allegations of Willful Blindness

a. The First Prong

The *PAC* alleges that the Defendants developed a subjective belief in the high probability that BLMIS was running a Ponzi scheme as a result of its due diligence in connection with the three deals.[21] (¶ 104.) These suspicions arose early. The Trustee argued in his briefing that by the time that the Defendants entered into the Prime Fund Deal they already entertained "well-founded suspicions" that BLMIS was not trading securities and was misappropriating assets. (*Trustee Reply* at 5.) Not surprisingly, virtually all of the "red flags" the Trustee points to predate the Prime Fund Deal.[22] (*See* ¶¶ 105-74.)

At oral argument, however, the Trustee's counsel conceded that the Defendants did not entertain a subjective belief in the high probability that BLMIS was a fraud when they loaned $300 million to Prime Fund in June 2005. (Transcript of 7/18/19 Hr'g ("Tr.") at 16:8-13 (ECF

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[21] I assume for the purposes of analysis that everything that CGMI or its employees learned is imputed to the Defendants.

[22] The Trustee cites *In re Optimal U.S. Litig.*, No. 10 Civ. 4095(SAS), 2011 WL 4908745, at *7 (S.D.N.Y. Oct. 24, 2011) in support of his argument that Defendants willfully blinded themselves after critical questions were raised about the risk that Madoff was running a Ponzi scheme but failed to investigate further. *Optimal* is not apposite. First, *Optimal* was addressing *scienter* under section 20(a) of the Securities Exchange Act of 1934, not willful blindness. A plaintiff can plead *scienter* for purposes of section 20(a) by alleging at a minimum that the defendant was reckless, *i.e.*, that it "knew or should have known" that the primary violator was engaging in fraudulent conduct. *In re MF Glob. Holdings Ltd. Sec. Litig.*, 982 F. Supp. 2d 277, 307-08 (S.D.N.Y. 2013); *In re Global Crossing, Ltd. Sec. Litig.*, No. 02 Civ. 910(GEL), 2005 WL 1907005, at *12 (S.D.N.Y. Aug. 8, 2005); *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 417-18 (S.D.N.Y. 2001). Under *Global-Tech*, recklessness and "should have known" do not satisfy the first prong of willful blindness. Second, for the reasons described in the text, the Trustee has implicitly conceded that the red flags the Defendants identified in connection with the Fairfield and Prime Fund Deals did not yield Defendants' subjective belief in the high probability that BLMIS was a Ponzi scheme.

Doc. # 169).) By then, Defendants had already learned or become aware through their due diligence on the Fairfield and Prime Fund Deals that they could not verify BLMIS's option trades or its option counterparties and BLMIS's role as broker-dealer and custodian raised a risk of fraud and the disappearance of assets in the BLMIS accounts. (¶¶ 108, 110, 118-20, 125, 126.) In addition, CGMI had already performed a Quantitative Analysis showing that BLMIS had inexplicably outperformed the S&P 100 Index even though the SSC Strategy presumptively had the same risk profile as the S&P 100 Index. (¶¶ 145, 146, 149, 150-153.) Also, Leon Gross had performed his own analysis of BLMIS at the instigation of Harry Markopolos and concluded that "either the returns are not the returns or the strategy is not the strategy," (¶ 155; *Gross Tr.* at 116:13-14), and "that the returns weren't generated by the strategy, they were either generated by something else—that something was amiss there." (¶ 164; *Gross Tr.* at 35:19-22.) Moreover, the traders at CGMI's index options desk and the equity derivatives salespeople had already gone on record that they were unfamiliar with Madoff trading index options. (¶¶ 165-166.) Despite everything that Defendants knew, learned, suspected or concerned them regarding the inability to confirm BLMIS's option trades, the identity of its counterparties, its custody of its assets, the risk of fraud and its improbably consistent returns through a strategy that could not be replicated, the Trustee concedes that the Defendants did not entertain a subjective belief in the high probability that BLMIS was not trading securities when it loaned Prime Fund $300 million.

What did Defendants learn after June 2005 when they closed the Prime Fund Deal? More of the same. CGMI continued to inquire about Madoff's options trading but was unable to confirm from its due diligence starting in

March 2005 and continuing through 2006 that it actually took place, (¶¶ 197-98), and could not discover the identity of BLMIS's options counterparties. (¶ 199.) In addition, during the due diligence on the Proposed Tremont Deal, Tremont was unable to satisfy CGMI's concerns that BLMIS maintained segregated customer accounts or that the assets even existed. (¶ 192.) Those concerns were always based on a perceived risk that BLMIS, as the broker-dealer and custodian, could steal the customers' assets; the *PAC* does not allege facts suggesting that the Defendants believed that Madoff was actually stealing customer assets. In addition, Tremont forwarded an "Independent Auditors' Report on Internal Control" and BLMIS's "Statement of Financial Condition" prepared by BLMIS's auditors, F&H. The report "did not quell CGMI's fraud concerns," (¶ 196), but these were the same "fraud concerns" the *PAC* attributes to the Defendants when they entered into the Prime Fund Deal.

The one additional piece of information Defendants acquired—in March 2006—was that there were some price discrepancies between options prices reported by BLMIS to Fairfield Sentry and those reported by Bloomberg. (¶ 202.) In addition, on April 17, 2006, Defendants learned through the KPMG Report about discrepancies, including price discrepancies, reported by BLMIS. (¶ 207.) However, these discrepancies did not seem to matter much; the insurmountable obstacles remained the option trades, the identity of the counterparties and the concern that Madoff could steal the assets. These were the subjects that Defendants wanted to discuss with FGG, (*see* ¶¶ 208-15), and "[w]hile the April 20, 2006 meeting with FGG 'did not raise any new flags,' . . . 'it did not give us [CGMI] the answer we were looking for.'" (¶ 216.) On April 20, 2006, shortly after CGMI left the due diligence meeting with

FGG without having resolved any of their concerns, it informed Tremont that Defendants could not proceed with the Proposed Tremont Deal. (¶ 225.)

I stop here because the Trustee's counsel also conceded at oral argument that the Trustee could not establish the second element of willful blindness prior to April 20, 2016, when Tremont allegedly told the Defendants that their concerns with fraud at BLMIS were insurmountable roadblocks. (Tr. at 4:5-25; *see Trustee Reply* at 9 ("After learning of the high probability of fraud at BLMIS, by April 20, 2006, Defendants ceased their efforts to verify BLMIS was making its purported trades.").) According to the *PAC*, CGMI was leery of meeting with Madoff because it had already concluded there was a high probability of fraud at BLMIS and a meeting with Madoff could jeopardize the Defendants' existing deals because it would confirm the fraud and "upset or spook Madoff." (¶ 231.) The Prime Fund Deal was set to expire in December 2006, and the Defendants and CGMI were prepared to renew the Prime Fund Deal without any further due diligence contingent, however, on a review of Tremont's audited financial statements for 2004 and 2005, (¶ 238), which the *PAC* implies were never forthcoming.

b. The Second Prong

The second element of willful blindness involves deliberate efforts to avoid learning the truth. "Deliberate indifference" is not enough, but the *PAC* does not even allege that. Rather, it alleges CGMI's continuing efforts to confirm the option trades and the segregation of assets, its two concerns. Furthermore, although the Trustee argues that he satisfied the second prong on and after April 20, 2006 because the Defendants abandoned any efforts to confirm their suspicions that BLMIS was a fraud, and only attended a subsequent, *pro forma* meeting with Madoff in November 2006 as a check-the-box exercise to justify a foregone conclusion, the *PAC* alleges the Defendants' continuing due diligence and the original complaint contradicts the Trustee's contention.

According to the *PAC*, CGMI renewed its interest in meeting with Madoff based on concerns raised by Tremont's inability to provide audited financial statements. (¶ 241.) Tremont asked CGMI to send a list of proposed questions. In response, CGMI sent Tremont a proposed due diligence agenda that did not expressly ask "any questions concerning CGMI's two primary concerns of fraud at BLMIS, namely details regarding options trades and verification of the assets." (¶ 245.)

CGMI and Madoff met on November 27, 2006 but the *PAC* downplays the significance of the meeting alleging that CGMI was no longer interested in getting answers to the questions it had raised, (¶ 248), and sent three people, Thomas Fortuna, Bruce Clark and Nicholls, to the meeting who, "upon information and belief . . . had a direct economic interest in renewing and increasing the Prime Fund Credit Deal." (¶ 250.) The *PAC* describes the meeting with Madoff as a "check-the-box exercise," (¶¶ 241, 251), suggesting that CGMI had already decided to renew the Prime Fund Deal and the meeting was window dressing. (*See* ¶ 251 ("[T]hree days before the meeting took place, CGMI had already instructed its lawyers to draft the requisite renewal and increase documentation for the Prime Fund Credit Deal.").) Shortly after the meeting, the Defendants renewed the Prime Fund Deal for one month from November 30, 2006 to December 29, 2006, and subsequently renewed it for another year to December 13, 2007 with an increase in the limit from $300 million to $400 million. (¶ 252.)

The Trustee's original complaint, (*Complaint*, dated Dec. 8, 2010 ("*Complaint*") (ECF Doc. #1-1)), pleads a different story. As the maturity date for the Prime Fund Deal approached, Tremont asked the Defendants to renew the Prime Fund Deal and increase the facility from $300 million to $400 million. (*Complaint* ¶ 77.) To satisfy the Defendants' prior due diligence request, in August 2006, Tremont provided the Defendants with the 2004 and 2005 *audited* financial statements.[23] (*Complaint* ¶ 79.) The *PAC* alleges that CGMI wanted to meet with Madoff because Tremont was unable to provide audited financial statements, (¶ 241), but CGMI continued to press for a meeting with Madoff even after it received the audited financial statements.[24] In the face of their own due diligence concerns, the Defendants agreed to extend the facility until November 30, 2006 and table the issue of increasing it by $100 million "until it got comfortable that its due diligence questions were satisfactorily resolved." (*Complaint* ¶ 77.) One of the conditions to extending and increasing the credit facility was a meeting with Madoff. (*Complaint* ¶ 77.)

The meeting with Madoff took place on November 27, 2006. Far from the pretextual meeting described in the *PAC*, the original complaint alleges that "[f]ollowing the meeting with Madoff, Citi not only decided against extending additional credit to Tremont, upon information and belief, it also made a high-level decision to terminate

[23] The Trustee's brief acknowledges that Tremont delivered audited financial statements, (*Trustee Reply* at 10), but the *PAC* does not mention it.

[24] The *PAC* also implies that CGMI cancelled the April 26 meeting with Madoff after it terminated the Proposed Tremont Deal, a meeting it did not want in the first place. The original complaint alleged that Tremont cancelled the meeting. (*Complaint* ¶ 76.)

the Prime Fund loan." (*Complaint* ¶ 83.) Obviously, the import of these allegations, which I credit, is that the Defendants held a substantive meeting with Madoff as a condition to extending and increasing the credit facility, Madoff was unable to satisfy their concerns, and as a consequence, they decided at that point to terminate the Prime Fund Deal.[25] The original complaint does not indicate what changed the Defendants' mind after the meeting, initially to extend the credit facility for one month and then to extend it for another year and increase it by $100 million.

In light of the foregoing, the Court concludes that the *PAC* fails to allege anything more than that the Defendants assumed the "remote" risk that BLMIS was not trading securities and might be a fraud and at most, were reckless and deliberately indifferent to that risk. The Trustee concedes that the due diligence conducted in connection with the Fairfield and Prime Fund Deals did not raise the subjective belief in the high probability that BLMIS was a fraud, *i.e.*, operating a Ponzi scheme. Furthermore, the *PAC* does not allege that they learned anything more regarding their principal concerns relating to the segregation of assets and option trading after they closed the Prime Fund Deal.

The Defendants continued to conduct due diligence after the April 20, 2006 meeting with FGG. The original complaint alleges that after CGMI received Tremont's audited financial statements it still insisted on meeting with Madoff, and was only willing to extend the Prime Credit Deal until the end of November 2006. CGMI met with

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[25] This also contradicts the *PAC*'s allegation that the Defendants did not want to meet with Madoff because they were afraid of "upsetting" and "spooking" him and losing business.

Madoff in November 2006, and according to the original complaint, it was a substantive meeting that led to the initial conclusion not to renew the Prime Fund Deal. The Defendants nevertheless extended it briefly and increased the facility, but the Prime Fund Deal ultimately terminated when, according to the *PAC*, Tremont refused to continue the Tremont Indemnity.

Plainly, the original complaint alleges that the Defendants did not turn a blind eye to their concerns and continued to pursue answers, insisting on a meeting with Madoff as part of their due diligence. The Trustee nevertheless contends that the Defendants took deliberate actions to avoid learning the critical facts surrounding Madoff's Ponzi scheme by "consciously decid[ing] to act without confirming them." (*Trustee Memo* at 28 (quoting *United States v. Fofanah*, 765 F.3d 141, 150 (2d Cir. 2014) (Leval, J., concurring.) This argument equates recklessness with willful blindness and eviscerates the distinction between "deliberate actions to avoid learning" facts, *Global-Tech v. SEB*, 563 U.S. at 769, and "deliberate indifference." Under the Trustee's formulation, a person who acts in the face of a known risk he cannot confirm despite his best efforts is willfully blind. However, the defendant that is deliberately indifferent to a known risk and acts anyway is not willfully blind under *Global-Tech*.

4. Implausibility

In the end, the notion that the Defendants would loan Prime Fund $300 million and increase the loan by $100 million at a time when they entertained a subjective belief in the high probability that BLMIS was an illegal, criminal enterprise is utterly implausible. The Trustee concedes the "facial appeal" of this argument , (*Trustee Reply* at 1), but it is not just facially appealing. In *Buchwald Capital Advisors LLC v. JP Morgan Chase Bank, N.A.*

(*In re M. Fabrikant & Sons, Inc.*), 480 B.R. 480 (S.D.N.Y. 2012), *aff'd*, 541 F. App'x 55 (2d Cir. 2013), then-District Judge Sullivan characterized a similar argument as "nonsensical" and "bordering on the absurd." *Id.* at 489. There, the defendant banks (the "Banks") made prepetition secured loans to two entities that operated a jewelry business (the "Debtors"). *Id.* at 483-84. The Debtors then allegedly transferred the loan proceeds to entities unaffiliated with the Debtors but affiliated with and owned and controlled by the Debtors' owners, the Fortgangs (the "Affiliates"), *id.* at 484, leaving the Debtors with encumbered assets but without the loan proceeds.

In subsequent litigation commenced against the Banks to avoid the Banks' loans and liens, the unsecured creditors committee sought to collapse the first leg of the transaction (the Banks' loans to the Debtors) with the second leg (the Debtors' transfer of the loan proceeds to the Affiliates) under the collapsing principles discussed in *HBE Leasing Corp. v. Frank*, 48 F.3d 623 (2d Cir. 1995), contending that the Banks knew or should have known that the loans were part of a fraudulent scheme by which the Debtors would transfer the loan proceeds to the Affiliates.[26] According to the plaintiff, the Banks were aware of the Debtors' poor financial condition, the transfers to the Affiliates, the Affiliates' lack of any relationship to the Debtors and the poor loan documentation. *Id.* at 488-89. They nevertheless made loans to raise their profiles and earn commissions. After this Court dismissed the complaint for failure to state a claim, the plaintiff appealed.

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[26] Following the confirmation of the chapter 11 plan, the GUC Trustee was substituted for the committee as the plaintiff.

Judge Sullivan affirmed, stating that the plaintiff's theory "requires an inference that is highly implausible, bordering on the absurd":

> In essence, [the plaintiff] alleges that the Banks took the massive risk of continuing their lending relationships with the [Debtors and Affiliates] on the speculative hope that there may be sufficient liquidity in the 'Fabrikant Empire' . . . as a whole to enable the Banks to obtain repayment through personal guarantees and other pressure. Such an assertion would be nonsensical if the Banks were in fact aware that Debtors and the Affiliates had to use the same dollars to repay separate obligations. *Put simply, drawing all inferences in favor of the [plaintiff], it is difficult to see what benefit the Banks could hope to obtain by lending ever-larger amounts of money to failing companies. The [complaint's] wholly conclusory allegations that the Banks were clouded in judgment due to lavish commissions is equally implausible, since the loss of principal would have far outweighed the commissions earned on the loans[.]*

Id. at 489 (record citations and corresponding quotation marks omitted) (emphasis added).

More recently, this Court reached the same conclusion in a case that bears striking similarities to the present one. In *BNP*, 594 B.R. 167, the Trustee brought fraudulent transfer claims against a bank that provided leverage to feeder funds and other entities that invested in BLMIS. The bank received roughly $156 million in subsequent transfers from various Tremont funds, including Prime Fund, in repayment. *Id.* at 185. Summarizing the Trustee's theory, the Court explained:

> The crux of the Trustee's argument is that the Defendants engaged in the leverage business while entertaining a belief that there was a high probability that BLMIS was not actually trading securities, the reported BLMIS trades were fictitious and their collateral was therefore fictitious, and their obligors' sole assets, at least in the case of feeder funds fully invested with BLMIS, were non-existent. The reason: the Defendants wanted to earn fees, "to establish their reputation as a leverage provider in a highly-competitive market, to grow the brand of BNP Paribas's Fund Derivatives Group, to compete with its biggest rival, SocGen, and to cross-sell services to BNP Paribas's institutional clients." (¶ 139.) In other words, BNP Bank made billions of dollars of risky and possibly uncollectible loans to those investing with BLMIS or BLMIS feeder funds in order to make tens of millions of dollars in fees and build its profile.

Id. at 202.

Relying on *Fabrikant*, the Court rejected the claim as implausible:

> The Defendants' ability to collect on whatever leverage BNP Bank extended to direct investors in BLMIS or investors in BLMIS feeder funds ultimately depended on the value of the BLMIS investments. If BLMIS was a Ponzi scheme, the securities listed in the BLMIS customer statements were non-existent and BNP Bank's collateral was as worthless as its borrowers' investments in BLMIS or a BLMIS feeder fund. According to the PAC, BNP Bank nonetheless engaged in billions of dollars of risky transactions, including loans and extensions of credit that ultimately depended on the value of BLMIS accounts, to earn

> "tens of millions of dollars in fees and interest payments," (¶ 64), and raise BNP Bank's position as a world leader in the fast-moving derivatives market. (¶ 151.) This theory is as preposterous as the scheme alleged by the plaintiff in *Fabrikant*, and it is implausible to suggest that the Defendants would make loans or engage in the transactions described in the PAC if they subjectively believed that there was a high probability that BLMIS was not actually trading securities.

Id. at 203-04 (footnote omitted).

The *PAC* implies that the Defendants entered into the Prime Fund Deal to earn interest and fees. (*See* ¶¶ 176, 256.) The interest and fees aggregated approximately $43 million over the roughly three year life of the loan. (*See PAC*, Ex. C; *accord Trustee Reply* at 2.) The idea that the Defendants would loan $400 million to a borrower to invest the proceeds in a criminal, fraudulent enterprise in order to earn between $14 million and $15 million in annual fees and interest is absurd for the same reasons discussed in *Fabrikant* and *BNP*.

Furthermore, it is equally implausible for the same reasons that Defendants would ignore BLMIS's fraud if they subjectively believed in the high probability that BLMIS was a fraud. A court may consider a defendant's motive for shutting its eyes to a subjective belief in a high probability of fraud. *See Global-Tech*, 563 U.S. at 771 ("[W]e cannot fathom what motive Sham could have had for withholding this information other than to manufacture a claim of plausible deniability in the event that his company was later accused of patent infringement."); *Hart v. Internet Wire, Inc.*, 145 F. Supp. 2d 360, 365 (S.D.N.Y. 2001) ("Nor is there any pleading of a motive for deliberately remaining ignorant of the facts in question to render any plausible suggestion of a characterization of willful blindness."); *In re Fischbach Corp. Sec. Litig.*, No. 89 CIV. 5826 (KMW), 1992 WL 8715, at *6 (S.D.N.Y. Jan. 15, 1992) ("[P]laintiff has not alleged that defendants had any motive for deliberately shutting their eyes to the facts, and, indeed, the defendants had no interest in being defrauded, and thus, obviously had no interest in remaining ignorant that they were in the process of being defrauded."). The Defendants had no motive to turn a blind eye to the BLMIS Ponzi scheme and agree to add an additional $100 million in credit to the outstanding $300 million in order to earn the fees and interest that they did.

The Trustee argues that the Defendants were nevertheless willing to lend up to $400 million to Prime Fund to invest with BLMIS "because Defendants were not exposed to that risk. Defendants were indemnified, allowing them to enter into the transaction and earn their fees—$43 million dollars in three years—without fear of losing," (*Trustee Reply* at 2), because the Tremont Indemnity was the "primary mitigant" of fraud by BLMIS. (*See Trustee Memo* at 1 ("During the diligence process, Defendants became concerned that BLMIS was not trading securities as it purported to do and was instead misappropriating its customers' assets. Instead of investigating these concerns, Defendants obtained an indemnification from Prime Fund's general partner, Tremont Partners, protecting them against fraud by BLMIS. Once indemnified, Defendants refused to act on their suspicions of fraud at BLMIS even when confronted with more and more evidence that, as would soon become known to the world, BLMIS was fabricating trades and misappropriating assets."); *accord id.* at 10 ("The indemnity enabled Defendants to turn a blind eye to their well-founded suspicions of fraud at BLMIS."); ¶ 186 ("The indemnity enabled Defendants to turn a blind eye to the substantiated fraud risk at BLMIS while repeatedly renewing and increasing the Prime Fund Credit Deal.").)

The Trustee misunderstands the significance of the Tremont Indemnity and the distinction between Tremont and TCM. According to the *Transaction Memo* which the *PAC* quotes but only in part, the "primary mitigant" of the "remote" risk of BLMIS's fraud was "an indemnity from the General Partner *supported by a Parent Guarantee from TCM.*" (*Transaction Memo* at 3 (emphasis added); *accord id.* at 6 ("The Global Credit Center and Global Portfolio Management unit will co-approve 10%, $30MM, in Seller Risk to recognize the unique reliance on the General Partner's indemnity and the Parent Guarantee from TCM.").) The Tremont Indemnity, standing alone, did not provide any additional financial security. The *Transaction Memo* recognized that as a Delaware limited partnership, Tremont, the general partner, was already liable for Prime Fund's debts, (*Transaction Memo* at 6 (citing RULPA § 17-403)), "regardless of whether [Prime Fund's] failure to make any such payments resulted from market value declines, fraud or other malfeasance by any party, including the Investment Advisor, the failure to comply with the Investment Strategy, or *any* other reason." (*Id.* (emphasis in original); *accord id.* at 7 ("Under the Credit Agreement, the Fund and the General Partner have agreed pursuant to the indemnification provision that they are jointly and severally liable for all losses, liabilities and damages arising out of or in connection with the Facility, including, without limitation (i) any breach or alleged breach of any covenant by the Fund, the General Partner or the Investment Advisor. . . .").) The benefit of the Tremont Indemnity was procedural; it allowed Defendants to sue Tremont without first exhausting its remedies against Prime Fund as otherwise required by RULPA. (*Id.* at 7.)

The Parent Guarantee would have guaranteed Tremont's obligations, "with the exception of the obligation to support the Fund's failure to repay Advances that resulted from a decline in the fair market value of the assets purchased in adherence to the Investment Strategy." (*Id.* at 7; *accord id.* at 5 ("As more fully set forth below, the General Partner will be liable for all of the payment obligations of the Fund, which, with the exception relating to the Fund's failure to repay advances under the Facility due to a decline in the fair market value of the assets purchased in adherence to the Investment Strategy, will be supported by a Parent Guarantee from TCM.").) The *PAC* incorrectly attributes this limit on indemnity to the Tremont Indemnity rather than the Parent Guarantee. (*See* ¶¶ 7, 182.)

Not surprisingly, the *Transaction Memo* focused on TCM's financial wherewithal. The *Transaction Memo* sometimes referred to Tremont Partners and TCM collectively as "Tremont," (*Transaction Memo* at 2), but Appendix A to the *Transaction Memo* zeroed in on the financial strength of TCM. (*See id.* at 11 ("Tremont Capital Summary Financials").) It was TCM, not Tremont the general partner, that was "a diversified, global alternative investment manager concentrating on investment fund management and development, consultancy, and database sales and information services." (*Id.* at 9.) It was TCM, not Tremont, that was a wholly-owned subsidiary of OFI and had an obligor risk rating of 4, (*id.* at 2; *see id.* at 9), with $13 billion in alternative investments, (*see id.* at 9 ("Tremont was established in 1984 and currently advises more than U.S.$13 billion in alternative investments.");

id. at 12 (bar graph showing "Tremont Capital Assets under Management" in excess of $13 billion as of the first quarter of 2005).) It was TCM, not Tremont, that "as a subsidiary of OFI, generates strong cash flows with little need for debt financing," and when it needed funding, "OFI has provided inter-company loans at attractive rates." (*Id.* at 10.)

In contrast, the *Transaction Memo* did not discuss the financial condition of Tremont, the general partner. Tremont's entire financial model was built on investments with BLMIS. It served as general partner to the Prime Fund and the other Rye Funds and as investment manager to the Rye Funds as well as a group of sub-feeder funds.[27] If BLMIS was a Ponzi scheme, its general partner interests would be worthless and its lucrative investment fees would end. The Tremont Indemnity only had value if BLMIS stole Prime Fund's assets but not the assets of the other Rye Funds, an unlikely scenario if BLMIS was actually operating as a Ponzi scheme. In fact, "Tremont's profitability and, as it turned out, its very existence, depended on BLMIS." (¶ 319.) The Trustee argues that the Defendants did not know this at the time but in light of Tremont's business model, they could not have known otherwise. That the Defendants ultimately closed the Prime Fund Deal and subsequently extended it solely on

[27] The Trustee incorrectly states, "that at the time they entered into the indemnification, Defendants believed that Tremont Partners was invested with hundreds of asset managers and in at least a dozen different strategies." (*Trustee Reply* at 1.) This describes TCM. Tremont's only strategy was to raise money from investors, turn the money over to BLMIS and collect fees for "managing" that investment.

the strength of the Tremont Indemnity implies the opposite of what the Trustee contends: the Defendants did not believe that BLMIS was a fraudulent operation.

The *PAC* also incorrectly suggests that the Defendants ultimately refused to renew the Prime Fund Deal because Tremont would not extend the Tremont Indemnity:

> For the first time [in October 2007], Tremont proposed to renew the credit facility, but without the terms CGMI had previously acknowledged were the "primary mitigant of fraud" for Defendants and CAFCO. Without such an indemnification, the extent of Defendants and CAFCO's recovery under the Prime Fund Credit Deal in the event of fraud at BLMIS would be limited to Prime Fund's assets. This was unacceptable to Defendants because they subjectively believed there was a high probability of fraud at BLMIS in that it was misappropriating these assets.

(¶ 254; *accord* ¶¶ 258-60.)

In the first place, the "primary mitigant of fraud" was the Tremont Indemnity backed by the Parent Guarantee, not the Tremont Indemnity standing alone. More important, the Trustee confuses a loan minus the Tremont Indemnity with a nonrecourse loan. Even without the Tremont Indemnity, Tremont was liable for the repayment of the credit facility under RULPA. Tremont refused to renew the Prime Fund Deal unless it was nonrecourse, *i.e.* without contractual, statutory or common law recourse against Tremont. As the *PAC* makes clear, "the 'limited recourse issue' referred to Tremont's demand to remove the Tremont Partners indemnification from the Prime Fund Credit Deal *and include a provision specifically stating that Defendants and CAFCO would* *have 'no recourse' against Tremont Partners for any obligations Prime Fund owed to them.*" (¶ 255 (emphasis added).)

In the end, the Trustee's response to the otherwise implausible notion that the Defendants would agree to lend up to $400 million to invest in a venture they subjectively believed was probably a Ponzi scheme is based on a misunderstanding of the Tremont Indemnity as the "primary mitigant of fraud." The Trustee misreads the *Transaction Memo*, misunderstands the scope of Tremont's liability without the Tremont Indemnity and confuses Tremont and TCM. Given Tremont's dependence on BLMIS, the Defendants' willingness to enter into the Prime Fund Deal and renew and increase it by $100 million through March 2008 solely on the strength of the Tremont Indemnity implies that they considered the risk of fraud to be "remote," precisely what the *Transaction Memo* stated.

Accordingly, the Trustee's motion for leave to amend his original complaint is denied. In light of this determination, the Court does not address the other arguments raised by the Defendants in opposition to the motion for leave to amend. Settle order on notice.

Dated: New York, New York
October 18, 2019

APPENDIX D

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Adv. Proc. No. 08-1789

SECURITIES INVESTOR PROTECTION CORPORATION, PLAINTIFF-APPLICANT,

v.

BERNARD L. MADOFF INVESTMENT SECURITIES LLC, DEFENDANT

IN RE: BERNARD L. MADOFF, DEBTOR

Adv. Proc. No. 10-5345

IRVING H. PICARD, TRUSTEE FOR THE LIQUIDATION OF BERNARD L. MADOFF SECURITIES LLC AND THE ESTATE OF BERNARD L. MADOFF, PLAINTIFF

v.

CITIBANK, N.A., CITICORP NORTH AMERICA, INC., AND CITIGROUP GLOBAL MARKETS LIMITED, DEFENDANTS

Filed: November 19, 2019

ORDER DENYING THE TRUSTEE'S MOTION FOR LEAVE TO AMEND AND ENTERING PARTIAL FINAL JUDGMENT UNDER FEDERAL RULE OF CIVIL PROCEDURE 54(b)

BERNSTEIN, United States Bankruptcy Judge.

WHEREAS, on December 8, 2010, Irving H. Picard (the "Trustee"), as Trustee for the liquidation of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa-*lll*, and the substantively consolidated Chapter 7 estate of Bernard L. Madoff ("Madoff") filed a complaint against Defendants Citibank, N.A. ("Citibank"), Citicorp North America, Inc. ("Citicorp")[1] (together, the "Citibank Defendants"), and Citigroup Global Markets Limited ("CGML") seeking to recover avoidable transfers from BLMIS under section 550 of the Bankruptcy Code;

WHEREAS, on May 15, 2012 and June 7, 2012, respectively, the United States District Court for the Southern District of New York entered orders in which it withdrew the reference in certain adversary proceedings pursuant to 28 U.S.C. § 157(d) to determine whether SIPA or the Bankruptcy Code apply extraterritorially, permitting the Trustee to avoid initial transfers that were received abroad or to recover from initial, immediate, or mediate foreign transferees (the "Extraterritoriality Issue"), *SIPC v. BLMIS*, No. 12-mc-0115 (JSR), ECF Nos. 97 and 167;

WHEREAS, on June 25, 2012 the District Court withdrew the reference under 28 U.S.C. § 157(d) to determine whether SIPA or the securities laws alter the standard the Trustee must meet in order to determine good faith under either 11 U.S.C. § 548(c) or 11 U.S.C. § 550(b) (the

[1] The Trustee's complaint names as a defendant "Citibank North America, Inc.," an entity that does not exist.

"Good Faith Issues"), *SIPC v. BLMIS*, No. 12-mc-115 (JSR), ECF No. 197;

WHEREAS, on April 27, 2014, the District Court ruled on the Good Faith Issues (the "Good Faith Decision"), holding that good faith should be determined under a subjective standard and placed the burden of pleading a lack of good faith on the Trustee, *SIPC v. BLMIS*, 516 B.R. 18, 21-24 (S.D.N.Y. 2014);

WHEREAS, on July 6, 2014 and July 28, 2014, respectively, the District Court issued an opinion on extraterritoriality and comity (the "District Court ET Decision"), which returned certain matters to the Bankruptcy Court for further proceedings consistent with the District Court ET Decision, *SIPC v. BLMIS (In re Madoff)*, 513 B.R. 222, 232 n.4 (S.D.N.Y. 2014);

WHEREAS, on November 22, 2016, the Bankruptcy Court issued a Decision Regarding Claims to Recover Foreign Subsequent Transfers (the "Bankruptcy Court Comity Decision") dismissing certain claims to recover subsequent transfers received from, *inter alia*, Fairfield Sentry Limited on the ground of comity ("Fairfield-Related Claims"), *SIPC v. BLMIS*, Adv. Pro. No. 08-01789 (SMB), 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016);

WHEREAS, on January 18, 2017, the Bankruptcy Court entered a stipulation to allow CGML to participate in the appeal of the decisions on extraterritoriality and comity (the "Joinder Stipulation"), *Picard v. Citibank, N.A.*, Adv. Pro. No. 10-05345 (SMB), ECF No. 105;

WHEREAS, pursuant to the Joinder Stipulation, the Bankruptcy Court Comity Decision dismissed the Trustee's claims to recover subsequent transfers from defendant CGML, which it received from Fairfield Sentry Limited, contained in Counts 7, 8, 9, 10, 11, 12, and 13 of the operative complaint in this adversary proceeding (the "Comity Claims"), *Picard v. Citibank, N.A.*, Adv. Pro. No. 10-05345 (SMB), ECF No. 107;

WHEREAS, the Trustee and CGML consented and requested that the Bankruptcy Court enter a final judgment solely as to the Comity Claims under Rule 54(b) of the Federal Rules of Civil Procedure, consistent with the Bankruptcy Court Comity Decision in this adversary proceeding, and on the ground that immediate appellate review of the Bankruptcy Court Comity Decision would be efficient for the courts and the Parties;

WHEREAS, on March 9, 2017, this Court entered a final order and judgment solely as to the Comity Claims under Rule 54(b) of the Federal Rules of Civil Procedure dismissing CGML, *Picard v. Citibank, N.A.*, Adv. Pro. No. 10-05345 (SMB) ECF No. 107;

WHEREAS, on March 21, 2017, the Trustee appealed to the United States Court of Appeals for the Second Circuit on the extraterritoriality and comity issues;

WHEREAS, because the Bankruptcy Court Comity Decision did not dismiss all claims or defendants in this action, the Trustee and the Citibank Defendants (collectively, the "Parties") agreed to litigate the Trustee's remaining claims against the Citibank Defendants (the "Dismissed Claims"), which were unaffected by the District Court ET Decision and the Bankruptcy Court Comity Decision, while the Trustee's appeal on extraterritoriality and comity was pending. Accordingly, the Trustee moved for leave to file an amended complaint on December 14, 2018 (the "Motion for Leave to Amend"); the Citibank Defendants filed their opposition on March 12, 2019;

the Trustee filed his reply on May 7, 2019; and the Bankruptcy Court heard oral argument on the Motion for Leave to Amend on July 18, 2019;

WHEREAS, while the Trustee's Motion for Leave to Amend was pending before the Bankruptcy Court, on February 25, 2019, the Second Circuit issued an opinion vacating the District Court ET Decision and the Bankruptcy Court Comity Decision and remanding the case to this Court for further proceedings consistent with its ruling, *In re Picard*, No. 17-2992 (2d Cir. Feb. 25, 2019), ECF No. 1311;

WHEREAS, on April 23, 2019, the Second Circuit stayed issuance of the mandate pending the disposition of a petition for writ of certiorari on its decision, *In re Picard*, No. 17-2992 (2d Cir. Feb. 25, 2019), ECF No. 1503;

WHEREAS, on August 29, 2019, CGML (among others) filed a petition for writ of certiorari with the Supreme Court;

WHEREAS, on October 18, 2019, the Bankruptcy Court issued a decision denying the Trustee's Motion for Leave to File Amended Complaint (the "Decision Denying Leave to Amend") regarding the Dismissed Claims, *Picard v. Citibank, N.A.*, Adv. Pro. No. 10-05345 (SMB), ECF No. 170;

WHEREAS, the Parties have agreed to consent to the Bankruptcy Court's entry of a final order and judgment as it relates to the Dismissed Claims consistent with the Decision Denying Leave to Amend; and

WHEREAS, the Parties further request that the Bankruptcy Court enter a final judgment as to the Dismissed Claims under Rule 54(b) of the Federal Rules of Civil Procedure on the ground that immediate appellate review of the Decision Denying Leave to Amend will be efficient for the courts and the Parties;

Accordingly, for the reasons set forth in the Decision Denying Leave to Amend **IT IS HEREBY ORDERED** that:

1. The Bankruptcy Court has subject matter jurisdiction over this adversary proceeding under 28 U.S.C. § 1334(b) and (e)(1) and 15 U.S.C. § 78eee (b)(2)(A) and (b)(4).

2. The Parties expressly and knowingly grant their consent for the Bankruptcy Court to enter final orders and judgments solely with respect to the Decision Denying Leave to Amend, whether the underlying claims are core under 28 U.S.C. § 157(b)(2) or non-core under 28 U.S.C. § 157(c)(2), subject to appellate review, including under 28 U.S.C. § 158. Notwithstanding the above grant of consent, the Citibank Defendants reserve all other jurisdictional, substantive, or procedural rights and remedies in connection with this adversary proceeding, including with respect to the Bankruptcy Court's power to finally determine any other matters in this adversary proceeding.

3. The Trustee's Motion for Leave to Amend under Federal Rule of Civil Procedure 15 is **DENIED** on the ground of futility.

4. The Trustee's claims as to Citibank and Citicorp are **DISMISSED** with prejudice.

5. To permit entry of a final order and judgment under Fed. R. Civ. P. 54(b), there must be multiple claims or multiple parties, at least one claim decided within the

meaning of 28 U.S.C. § 1291, and an express determination that there is no just reason for delay. *In re AirCrash at Belle Harbor, N.Y.*, 490 F.3d 99, 108-09 (2d Cir. 2007).

6. The operative complaint filed in this adversary proceeding alleges multiple claims (the Comity Claims and the Dismissed Claims) and names multiple defendants (Citibank, Citicorp, and CGML). The entry of a partial final order and judgment will finally decide and ultimately dispose of the Dismissed Claims against defendants Citibank and Citicorp.

7. At least one claim has been decided within the meaning of 28 U.S.C. § 1291. The Decision Denying Leave to Amend effectively ended the litigation of the Dismissed Claims on the merits, left nothing for the court to do but execute a judgment entered on those claims, and amounts to a final judgment satisfying the finality requirements of Rule 54(b).

8. There is no just reason for delay of entry of a final order and judgment on the Dismissed Claims against defendants Citibank and Citicorp. While there is some overlap on the Good Faith Issues in the claims against defendants CGML, Citibank and Citicorp, the Comity Claims and the Dismissed Claims are sufficiently separable such that the interests of sound judicial administration and the realization of judicial efficiencies are properly served by the entry of this final order and judgment dismissing the Dismissed Claims. If the Trustee's claims against CGML are reinstated, the Trustee will stay the prosecution of such claims pending the determination of the appeal of the Decision Denying Leave to Amend, and the Trustee agrees to dismiss his claims against CGML if the Decision Denying Leave to Amend is affirmed on appeal.

9. The Parties consent to direct appeal of the Decision Denying Leave to Amend to the United States Court of Appeals for the Second Circuit and certify that direct appeal is warranted under 28 U.S.C. § 158(d)(2)(A).

10. The Parties' request that the Bankruptcy Court enter a partial final order and judgment as to the Dismissed Claims against defendants Citibank and Citicorp under Rule 54(b) of the Federal Rules of Civil Procedure is **GRANTED**.

Dated: November 19, 2019