2017 Annual Spring Meeting

American Bankruptcy Institute

21st Annual Great Debates

Douglas E. Deutsch, Moderator
Clifford Chance US LLP; New York

Resolved: Third-party litigation financing should be permitted.

Pro: **Justin Brass**
New York

Con: **John H. Beisner**
Skadden, Arps, Slate, Meagher & Flom LLP; Washington, D.C.

Resolved: Inquiry notice should play a role in the good-faith transferee defense.

Pro: **Catherine L. Steege**
Jenner & Block LLP; Chicago

Con: **Philip D. Anker**
WilmerHale; New York

Resolved: Wrongly decided cases like *Dewsnup* should be overturned by the Supreme Court.

Pro: **Prof. Ilya Somin**
George Mason University Antonin Scalia Law School; Arlington, Va.

Con: **Prof. Bruce A. Markell**
Northwestern University School of Law; Chicago

2017

Financing litigation is champertous if the lender exercises control.

Litigation Funding Could Be Champertous in Some States

In states where champerty and maintenance are still banned, financing litigation could prove impossible if lawyers are unwilling to undertake the case on a contingency, as shown by a decision from North Carolina.

A litigation trust had sued former officers and directors in "titanic litigation" where Bankruptcy Judge J. Craig Whitley of Charlotte, N.C., said the costs were "already monumental." Since her lawyers were unwilling to continue the suit entirely on a contingency, the trustee arranged for financing from a hedge fund.

In a Jan. 20 opinion where he said "the practice of litigation funding is in its infancy," Judge Whitley refused to approve the financing because it was champertous.

Judge Whitley said that some states, like California and Connecticut, either now allow arrangements that would have been champertous or never adopted the prohibitions in the first place. North Carolina, he said, "has retained the proscriptions against champerty and maintenance."

He described champerty and maintenance as occurring "when two or more parties make an arrangement to divide the proceeds of litigation between the owner of the chose in action and the party who either supports or acts to enforce the litigation." The "key inquiry," Judge Whitley said, is "whether that party 'exercised control over the claim.'"

In the case at hand, the hedge fund would make advances once a quarter. From proceeds of successful litigation, the hedge fund would first recover its advances and then a specified percentage of the net. The trustee's lawyers also would get a percentage of recoveries plus reduced time charges that would have been paid from quarterly advances.

Judge Whitley concluded that the funding agreement was champertous because the hedge fund could "control the litigation in a number of ways." In addition to cutting off funding at any time, the hedge fund had the right to consult over the substitution of attorneys.

The primary flaw in the arrangement was the hedge fund's right to decide every quarter whether to continue funding or not. Judge Whitley said the agreement allowed the hedge fund

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"to weigh whether its involvement continues to be a profitable endeavor and whether continued funding is in its, rather than the debtor's creditors', best interest."

The opinion is *In re Designline Corp.*, 13-31943 (Bankr. W.D.N.C. Jan. 20, 2017).

Madoff and Sixth Circuit have differing formulations about the 'good faith' defense for a recipient of a fraudulent transfer.

Sixth Circuit Pens Major Decision on Duty to Investigate Suspicions of Fraud

The Sixth Circuit handed down a fraudulent transfer opinion in a Ponzi scheme case that lays down rules for those murky situations when the recipient of a transfer should have suspicions but is short of knowing that fraud was afoot. Without citing the wealth of decisions emanating from the district and bankruptcy courts in New York, the appeals court in Cincinnati is establishing a principle similar to the "willful blindness" test adopted in the wake of the Bernard Madoff Ponzi scheme.

The case entailed a classic Ponzi scheme where the perpetrator ran two companies claiming to be in the computer services business. They created phony invoices showing they were purchasing computer equipment and defrauded equipment finance companies that had made loans to one of the fraudster's companies to enable the purchases.

Needless to say, the fraud was exposed, and the chief perpetrator committed suicide, having been in jail once before for bank fraud. Both companies ended up in bankruptcy.

The trustee sued the bank that had made loans and provided a bank account for about two years. Alleging that the bank was the recipient of transfers from an actual fraud under Section 548(a)(1)(A), the trustee sought to recover all payments the bank received to pay off the loans, along with all deposits into the bank account.

The bankruptcy court issued proposed findings and conclusions that were adopted in full by the district court. The bankruptcy court said there were two critical dates. By one date in 2004, the bank in substance knew there was fraud, thus precluding the bank from raising a good faith defense. At an earlier date in 2003, the bank was on "inquiry notice" about fraud.

The lower courts also held the bank liable for all loan repayments back to the date in 2003, ruling that "inquiry notice" destroyed the bank's good faith defense as being a transferee. The lower courts also held the bank liable for all deposits into the account, even those not used to repay the loans.

In significant part, Circuit Judge John M. Rogers reversed and remanded in an opinion on Feb. 8, holding that mere deposits into a bank account are not transfers and that inquiry notice by itself is not enough to eradicate the good faith defense.

The Deposits

Judge Rogers first addressed what he called “excess deposits,” or deposits that were not used to repay loans from the bank. To establish liability for receipt of a fraudulent transfer under Section 548, there must be a transfer. Judge Rogers therefore had to decide whether mere deposits are considered to be transfers.

He held that they were not, reversing the lower courts and absolving the bank of liability for any deposits not used to repay the loans.

Following the Seventh, Ninth and Eleventh Circuits, and the *Collier* treatise, Judge Rogers held that the deposits were not transfers because the bank did not have “dominion and control,” since the company was contractually entitled to withdraw the funds at any time. He said it was “not sufficient” that the bank could have used the deposited cash as it wished until the time came to honor a draw on the account.

The bank’s security interest in the deposit account did not change the result, because the lien did not give the bank dominion and control since the depositor could withdraw funds unless the bank had declared a default and frozen the account.

The Loan Repayments

The liability for disgorging loan repayments turned on the bank’s good faith defenses. With respect to loan repayments that were made directly, the bank would have no liability under Section 548(c) if it took “in good faith” and gave “value in exchange.”

In some instances, the bank’s loans were repaid indirectly, making the bank a subsequent transferee. In those situations, the bank would have no liability under Section 550(b)(1) for transfers for “value” made “in good faith” and “without knowledge of the voidability of the transfer.”

To determine when the bank lost its good faith defense, the lower courts settled on two critical dates. At the later date, the bank in substance would have known there was fraud had bank employees communicated with one another. Judge Rogers upheld the finding of liability for all loan repayments after a later date when the bank could have put the pieces together from its files and known there was fraud.

The lower courts went wrong, Judge Rogers said, about liability after the earlier date, when the bank only had “inquiry notice.”

Although Judge Rogers does not cite them, courts in New York in *Madoff* cases have held that recipients of actually fraudulent transfers from a Ponzi scheme will not have more liability for having suspicions and conducting investigations to determine whether there was fraud. If there is not actual knowledge of fraud, the *Madoff* courts have held that recipients lack "subjective good faith" and become liable if they have "turned a blind eye to facts that suggested a high probability of fraud." For ABI's discussion of a recent *Madoff* decision, click here.

Judge Rogers used a different formulation. He asked whether "a reasonable person, given the available information, would have been alerted to a transfer's voidability." Notably, the *Madoff* test is subjective whereas Judge Rogers' test appears to be objective. Beyond that, the tests may end up in the same place.

Inquiry notice is not enough, Judge Rogers said, because "a reasonable person may not be alerted to a transfer's voidability even if there was inquiry notice." To find liability, the facts must "place a reasonable person on notice that the transfer was illegitimate" given the "investigative avenues that existed, the reasonableness of pursuing those investigations, and the findings that those reasonable investigations would have yielded."

In that respect, the test laid down by Judge Rogers seems to turn on subjective factors, more like the *Madoff* cases.

Consequently, the "holistic review of the facts" required by Judge Rogers' opinion seems to include both subjective and objective elements: The test is objective in deciding whether the recipient should investigate, and it is subjective in deciding how the recipient could have investigated and what it could have learned.

Whatever the nomenclature, Judge Rogers remanded the case for the lower courts to make factual determinations about the extent of the bank's knowledge on the earlier date when previously they had found only "inquiry notice."

Circuit Judge Karen Nelson Moore concurred in most of the opinion, but she wrote separately to clarify what "knowledge" means. If there is no actual knowledge, she said the recipient must "also show it lacks knowledge of facts that would lead a reasonable person to investigate further and learn that the transfer was voidable."

She also said "there is no daylight" between "inquiry notice and facts that would alert a reasonable person to voidability."

Judge Moore agreed with the majority that liability depends in part on available investigative avenues and what they would have uncovered. Significantly, she said that recipients "are not required to undertake unduly onerous investigations, and that whether an investigation is unduly onerous depends on the circumstances of the case."

The opinion is *Meoli v. Huntington National Bank*, 15-2308 (6th Cir. Feb. 8, 2017).