

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.

Debtors

CASE NO. 96-61376

Chapter 11

Substantively Consolidated

RICHARD C. BREEDEN as Trustee for THE
BENNETT FUNDING GROUP, INC.

Plaintiff

vs.

ADV. PRO. NO. 98-70528

FIRST NATIONWIDE

Defendant

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

Presently before the Court is a motion by First Nationwide Bank (“Defendant”), seeking dismissal of an adversary complaint filed against it by Richard C. Breedon, the Chapter 11 trustee

(“Trustee”) of the consolidated estates of the Bennett Funding Group (collectively, the “Debtors”).¹ The motion was argued before the Court on November 12, 1998 and immediately thereafter submitted for decision, both parties having previously filed memoranda of law.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334, 157(a), (b)(1), (b)(2)(F), and (H).

FACTUAL BACKGROUND

In 1990 and 1991, Defendant allegedly received eight payments totaling \$92,036.00 from the Debtors, who filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code (11 U.S.C. §§ 101-1330)(“Code”) on March 29, 1996. The Trustee’s complaint seeks to avoid these and other payments pursuant to the actual and constructive fraudulent conveyance provisions of Code § 548(a) and §§ 271-278 of the New York Debtor and Creditor Law (“NYD&CL”). Defendant asserts that this complaint must be dismissed in its entirety for failure to state a claim upon which relief may be granted and for failure to plead fraud with particularity under Rules 9(b) and

¹ The Debtors are eight related entities which filed for bankruptcy under Chapter 11 between March 29 and July 25, 1997, on which date the debtor estates were consolidated pursuant to an order of this Court. The entities within the Consolidated Estate are The Bennett Funding Group; Bennett Receivables Corporation; Bennett Receivables Corporation II; Bennett Management & Development Corporation; The Processing Center, Inc.; Resort Service Company, Inc.; American Marine International, Ltd.; and Aloha Capital Corporation.

12(b)(6) of the Federal Rules of Civil Procedure (“Fed.R.Civ.P.”), incorporated by reference into Rules 7009 and 7012(b) of the Federal Rules of Bankruptcy Procedure (“Fed.R.Bankr.P.”).

The apparent basis for the Trustee’s causes of action is an allegation, described in some detail in the complaint, that the Debtors were operating an elaborate “Ponzi scheme” from at least 1990 onwards.² No specific allegations are made about the conduct or culpability of Defendant, apart from a statement that “[o]ne or more Debtors made payments to Defendant in the amounts and on or about the dates set forth on Exhibit A hereto, which is incorporated herein by reference and made a part of this Complaint (collectively, the “Transfers.”).” (Comp. at ¶ 14). Exhibit A, in turn, contains a list of payments allegedly received by Defendant from the Debtors in 1990 and 1991. In addition, the complaint later contains a statement that “Transfers occurred on or within one year before March 29, 1996.” (Comp. at ¶¶ 18, 33). It is not entirely clear whether this statement refers to the “Transfers” of paragraph 14, in which case the complaint is self-contradictory, or other, unspecified payments that occurred after March 29, 1995. The complaint does not contain any allegations as to why these payments were made, or what role they played in the Debtors’ allegedly fraudulent scheme.

DISCUSSION

² “A ponzi scheme is a scheme whereby a corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors.” *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1088 at n.3 (2d Cir. 1995) (citing *In re Huff (McHale v. Huff)*, 109 B.R. 506, 512 (S.D. Fla. 1989)).

Defendant has raised three essentially separate arguments in support of its motion to dismiss the Trustee's complaint in its entirety. Initially, Defendant notes that the payments listed on Schedule A of the complaint all took place before March 29, 1995, and that the Trustee has, therefore, failed to state a claim under either subsection of Code § 548, which has a reachback period limited to one year before the petition date. Secondly, Defendant asserts that because Trustee alleges no specific wrongdoing on the part of Defendant, his complaint fails to plead his state law actual fraud claim with particularity as required by Fed.R.Civ.P. 9(b). Finally, Defendant asserts that because it will be able to establish that the transfers were for fair consideration for purposes of NYD&CL § 278, it will have a complete defense to the state law constructive fraud cause of action.

In an adversary proceeding arising out of this same case that involved a nearly identical complaint, the Court concluded, *inter alia*, that knowledge by the transferee is not a prima facie element of a NYD&CL constructive fraudulent conveyance cause of action, and moreover that the "fair consideration" defense of NYD&CL § 278 presented questions of fact that did not appear on the face of the Trustee's complaint. *Breeden v. Walnut Street Securities*, Adv. No. 98-70256A, at 9, 11 (November 24, 1998). On this point, the present adversary proceeding is indistinguishable, and accordingly Defendant's motion to dismiss the Trustee's NYD&CL constructive fraudulent conveyance cause of action must fail.

In *Walnut Street*, this Court also rejected the defendant's Fed.R.Civ.P. 9(b) challenge to the Trustee's NYD&CL actual fraudulent conveyance cause of action, noting that the complaint contained "specific allegations about the Debtor's allegedly fraudulent behavior, including the manner in which the Ponzi scheme was operated, the means by which it defrauded investors of

their money, *and the relationship between the transfers to the Defendants and the operation of the scheme.*” *Id* at 7 (emphasis added). Based on this finding, the Court concluded that the Trustee’s complaint provided the *Walnut Street* defendants with “notice of the exact facts which the Trustee will attempt to prove in support of his allegation of actual fraud,” that the Defendants were in a position to begin preparing a defense on the merits, and that the requirements of Fed.R.Civ.P. 9(b) were thus fully satisfied. *Id.*

Applying the same standard to the present action, the Court must reach an opposite result. In *Walnut Street*, the Trustee’s complaint alleged that the defendants were brokers who sold fraudulent interests in the Debtors’ Ponzi operation, and that accordingly every commission payment to the defendants had the indirect effect of prolonging and expanding the Ponzi scheme. While the Court declined to rule on whether this theory (if true) would have amounted to a cognizable cause of action under Code § 548(a)(1) or NYD&CL § 276, it concluded that the defendants had been given information adequate to allow for effective litigation on the Trustee’s theory as a question of law. *Id.* at 7-8.

The adversary proceeding complaint presently before the Court differs from *Walnut Street* in that the Trustee has merely alleged the payment of money by the Debtors to Defendant. Nothing is alleged about why this money was paid, what services or property Defendant provided in exchange, or how this transaction operated to defraud present or future creditors of the Debtors. Although the Court agrees that the Trustee is not required to allege any particular bad faith on the part of Defendant, *see Meeks v. Greenville Casino Partners, L.P. (In re Armstrong)* 217 B.R. 569, 573 (Bankr. E.D. Ark. 1998), the mere invocation of the phrase “Ponzi scheme” does not by itself satisfy the requirements of Fed.R.Civ.P. 9(b).

As courts in this circuit have repeatedly held, Fed.R.Civ.P. 9(b) requires that a complaint do more than merely allege that some transaction was fraudulent; instead, it must also set forth the plaintiff's theory of exactly *why* it was fraudulent. *See Pilarczyk v. Morrison Knudsen Corp.*, 965 F.Supp. 311, 320 (N.D.N.Y. 1997). At most, the Trustee's complaint can be read to allege that the Debtors conducted a systematic fraud on their investors and creditors. Missing from the complaint is any factual allegation that even remotely suggests a nexus between this fraud and the alleged payments to Defendant. Without a more precise description of this nexus, Defendant cannot fairly be expected to prepare a coherent answer to the Trustee's allegation of fraud, and the complaint accordingly does not comply with Fed.R.Civ.P. 9(b) and Fed.R.Bankr.P. 7009.³

The Court further finds that both causes of action arising under Code § 548(a) must be dismissed. Under this section, a bankruptcy trustee may avoid a fraudulent transfer or obligation "that was made or incurred on or within one year before the date of the filing of the petition." Because Debtors filed the first of their petitions on March 29, 1996, the Trustee may use this section only to avoid those transfers that took place on or after March 29, 1995-- a date over four years later than the last payment listed on Schedule A.

In his supporting memorandum of law, the Trustee does not dispute that Code § 548(a) is inapplicable to the particular transfers listed on Schedule A. However, while asserting that he "is not in a position to determine as a matter of fact whether any transfers from debtors to

³ Moreover, because nothing in the complaint suggests that the operation of the Debtors' alleged fraud is a fact within the particular knowledge of Defendant, the Trustee is not entitled to plead fraud under a relaxed version of Fed.R.Bankr.P. 7009. *See Glinka v. Dartmouth Banking Co. (In re Kelton Motors, Inc.)*, 121 B.R. 166, 187 (Bankr. D. Vt. 1990) (holding that liberalized pleading standard does not apply where a trustee has "extensive access to records and files of the bankrupt corporation.").

defendants occurred during the one year period prior to the filing of the bankruptcy petition,” the Trustee urges that he should be allowed to proceed to discovery on these causes of action, where evidence of transfers falling within Code § 548's reachback period may or may not turn up. (Tr.mem. at 3).

Under Fed.R.Bankr.P. 9011, a party in an adversary proceeding must certify that its pleadings are grounded in known fact, or a belief formed after reasonable inquiry. Simply stated, the Trustee’s proposed litigation strategy is anathema to both the letter and spirit of this rule. *See Clinton v. Jones*, ___ U.S. ___, 117 S.Ct. 1636, 1652 n.42, 137 L.Ed.2d 945 (1997) (describing Rule 11 as a safeguard against litigants who use discovery to uncover unknown wrongs). While the Court agrees that the present Chapter 11 case is not a typical one, this observation does not relieve the Trustee of his obligations under Fed.R.Bankr.P. 9011, nor does it deprive Defendant of its right not to be sued unless the Plaintiff can present some reasonable basis for doing so. Accordingly, the Trustee’s Code § 548 causes of action must be dismissed.

Pursuant to Fed.R.Civ.P. 15(a), incorporated by reference in Fed.R.Bankr.P. 7015, leave to amend a defective complaint “shall be freely given when justice so requires.” Applying this standard to the present case, the Court finds that the Trustee should be entitled to amend his NYD&CL actual fraudulent transfer in accordance with this Decision, but that both Code § 548 causes of action must be dismissed with prejudice. *See Hassett v. Zimmerman (In re O.P.M.Leasing Services, Inc)*, 32 B.R. 199, 205 (Bankr. S.D.N.Y. 1983) (dismissing without leave to amend a Code § 548 cause of action that failed to plead the existence of any transfer within the statutory reachback period).

ORDER

Based on the foregoing, Defendant's motion to dismiss the Trustee's adversary complaint is hereby

DENIED with respect to the Trustee's fourth and fifth claims for relief, alleging a constructive fraudulent transfer cause of action pursuant to NYD&CL §§ 271-275 and turnover;

GRANTED with respect to the Trustee's first and third claims for relief, alleging fraudulent transfers pursuant to Code § 548(a)(1) and (2), both of which claims are hereby dismissed with prejudice; and

GRANTED conditionally with respect to the Trustee's second claim for relief, alleging an actual fraudulent transfer cause of action pursuant to NYD&CL § 276, unless the Trustee shall within thirty (30) days of this order file and serve an amended complaint in accordance with this Decision.

IT IS SO ORDERED.

Dated at Utica, New York

this 25th day of November 1998

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge