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

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

Plaintiff

vs. ADV. PRO. NO. 98-70256A

WALNUT STREET SECURITIES AND JOHN DOES 1-100

Defendants

APPEARANCES:

BLACKWELL SANDERS PEPER MARTIN LLP Attorneys for Defendants 2300 Main Street, Suite 1000 Kansas City, Missouri 64141	BENJAMIN F. MANN, ESQ. Of Counsel
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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

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

This is an adversary proceeding which seeks to recover certain brokerage commissions as fraudulent or preferential transfers, brought against Walnut Street Securities and its affiliated

persons (collectively, the "Defendants") by Richard C. Breeden ("Trustee"), as Chapter 11 trustee of the consolidated estates of The Bennett Funding Group, Inc. (collectively, the "Debtors").[1] The Trustee's complaint alleges five separate causes of action, asserting that the commissions may be avoided as (1) actual fraudulent transfers pursuant to § 548(a)(1) of the United States Bankruptcy Code (11 U.S.C. §§ 101-1330) ("Code"); (2) actual fraudulent transfers pursuant to § 276 of the New York Debtor and Creditor Law ("NYD&CL") and the strong-arm provisions of Code § 544(b); (3) constructively fraudulent transfers pursuant to Code § 548(a)(2); (4) constructively fraudulent transfers pursuant to Code § 544(b) and NYD&CL §§ 273, 274, and 275; and (5) preferential transfers pursuant to Code § 547.

In a motion filed with this Court on June 17, 1998, the Defendants have moved to dismiss the Trustee's complaint in its entirety. Defendants argue, first, that each of the Trustee's actual and constructive fraud causes of action must be dismissed for failure to plead fraud with particularity as mandated by Rule 9(b) of the Federal Rules of Civil Procedure ("Fed.R.Civ.P."), incorporated by reference into Rule 7009 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."). Second, the Defendants argue that the two causes of action arising under the NYD&CL must be dismissed for failure to plead a necessary fact under New York law. Third, the Defendants have argued that the Trustee's constructive fraud and preferential transfer causes of action fail to state a claim on which relief can be granted, and that those counts of his

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[1] The Debtors are eight related entities, all of 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 Inc.; 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.

complaint should accordingly be dismissed under Fed.R.Civ.P. 12(b)(6), incorporated by reference into Fed.R.Bankr.P. 7012(b). Finally, the Defendants have asserted that if the fifth cause of action is not dismissed outright, the Court should in the alternative require the Trustee to provide a more definite statement pursuant to Fed.R.Civ.P. 12(e) and Fed.R.Bankr.P. 7012(b).

The Court heard argument on the Defendants' motion on August 27, 1998, after which time the parties were given an opportunity to prepare memoranda of law. On September 28, 1998, this matter was submitted for decision.

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

To the extent that the Defendants' motion seeks to dismiss the Trustee's adversary complaint on the basis of the pleadings, the Court must accept as true all of the Trustee's factual allegations and may consider only those facts raised in the complaint. *See Paulemon v. Tobin*, 30 F.3d 307, 308 (2d Cir. 1994). Accordingly, the following will be assumed true solely for the limited purpose of this motion:

For at least six years before filing for bankruptcy on March 29, 1996, the Debtors

operated an elaborate "Ponzi scheme" in the guise of an equipment-leasing business.[2] Although the Debtors purported to maintain a portfolio of leases which would be pledged to individual investors and institutional lenders in exchange for capital, many of these leases were in fact nonexistent, while others were pledged several times over to different creditors. The funds obtained in this way from new investors would be co-mingled in a single account known as the "honeypot," out of which the operators of the scheme would pay entirely fictitious profits to the earlier investors. In reality, the Debtors were at all times insolvent during the operation of this scheme, and became more insolvent with each successive transaction.

The Defendants were among the brokers employed by the Debtors in their transactions with investors and lenders, receiving a total of $365,924 in payments during the six years prior to March 29, 1996. The Trustee asserts that because of the nature of the Debtors' Ponzi scheme, the services provided by the Defendants in exchange for their commissions are worthless as a matter of law. However, the Trustee further asserts that the commissions would have exceeded the fair value of Defendants' services even had the Debtors not been operating a Ponzi scheme. (Compl. at ¶ 15). The complaint does not allege that the Defendants had actual knowledge of the Debtors' fraud, nor does it specifically allege that the Debtors and the Defendants ever transacted on anything other than arms-length business terms.

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[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)).

DISCUSSION

a. Motion to Dismiss for Failure to Plead Fraud With Particularity (Code § 548(a) and NYD&CL Causes of Action)

The particularity requirement of Fed.R.Civ.P. 9(b) serves the double function of discouraging frivolous litigation while ensuring that defendants have a fair opportunity to reply to the allegations raised against them. *See Eisenberg v. Feiner (In re Ahead by a Length, Inc.)*, 100 B.R. 157, 166 (Bankr. S.D.N.Y. 1989). This requirement is procedural, not substantive, and applies to both state and federal causes of action brought in federal courts. *See Stern v. General Electric Co.*, 924 F.2d 472, 476 (2d Cir. 1991).

As an initial matter, the Court notes that there is some disagreement over whether the reach of Fed.R.Civ.P. 9(b) extends to causes of action that allege only constructive fraud, such as the third and fourth causes of action of the Trustee's complaint. *Compare* *Nisselson v. Drew Industries, Inc. (In re White Metal Rolling and Stamping Corp.)*, 222 B.R. 417, 428 (Bankr. S.D.N.Y. 1998) (holding that Fed.R.Civ.P. 9(b) is not applicable to NYD&CL §§273-275); *General Electric Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1079 (7th Cir. 1997) (holding that constructive fraudulent transfer causes of action must comply with Fed.R.Civ.P. 9(b)).

The Court finds that the reasoning of *White Metal Rolling and Stamping Corp*. is better in accord with the purpose of Code § 548(a)(2) and NYD&CL §§ 273-275. In spite of its name, constructive fraud is not really fraud in the ordinary sense at all. Instead, it is a results-oriented

substitute for fraud typically employed for transactions (such as the fraudulent transfer) in which proof of the fraudulent scheme may be difficult to uncover directly. *See Mutuelle Generale Francaise Vie v. Life Assurance Company of Pennsylvania*, 688 F.Supp. 386, 396 (N.D. Ill. 1988); *Lindsay v. Beneficial Reinsurance Company (In re Lindsay)*, 98 B.R. 983, 988 (Bankr. S.D. Cal. 1989). A prima facie case under Code § 548(a)(2) thus requires the plaintiff to show only that the debtor made the transfer, that the debtor received less than reasonably equivalent value and that the debtor either was insolvent at the time of the transaction, became insolvent as a result of the transaction, was engaged in a business with unreasonably small capital or acted with the intention or belief that it would default on its debts. Substantially similar elements of the Plaintiff's case are to be found in NYD&CL §§ 273 (conveyances by an insolvent), 273-a (conveyances by defendants in an action for money damages), 274 (conveyances by business persons with unreasonably small capital), and 275 (conveyances by a person about to incur debts). Because the preceding causes of action do not require the Trustee to prove that an intentional fraud even existed, it would be absurd to require him to nevertheless plead the circumstances constituting that fraud under Fed.R.Civ.P. 9(b). Moreover, since a constructively fraudulent transfer cause of action can be proved only by objectively ascertainable facts, a particularity requirement should not be needed to discourage strike suits or allow responsive pleadings. *See White Metal Rolling and Stamping Corp.*, 222 B.R. at 429 (noting that "[c]oncerns over the defendant's reputation or strike suits have little place" in a constructive fraud action). Accordingly, the third and fourth causes of action in the Trustee's complaint cannot be dismissed on the basis of Fed.R.Civ.P. 9(b).

The Court further finds that the Trustee has met the pleading requirements of Fed.R.Civ.P.

9(b) with respect to his first and second causes of action, which allege actual fraudulent transfers. Under the actual fraudulent transfer provision of Code § 548(a)(1), a prepetition transfer will be avoidable if the debtor "made such transfer . . . with the actual intent to hinder, delay, or defraud" a present or future creditor. Similarly, NYD&CL § 276 provides that "[e]very conveyance made . . . with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." Under either statute, the fraud which must be pleaded with particularity is that of the debtor-transferor; knowledge of the fraud or other misconduct on the part of the transferee is not an element of the plaintiff's proof. *See Meeks v. Greenville Casino Partners, L.P. (In re Armstrong)*, 217 B.R. 569, 573 (Bankr. E.D. Ark. 1998); *Brody v. Pecoraro*, 250 N.Y. 56, 62, 164 N.E. 741, 742 (1928).

The Defendants argue that the Trustee's complaint does little more than parrot the elements of the fraudulent conveyance statutes, and that it accordingly fails to comply with Fed.R.Civ.P. 9(b). *See Hassett v. Zimmerman (In re O.P.M. Leasing Services, Inc.)*, 32 B.R. 199, 203 (Bankr. S.D.N.Y. 1983). The Court disagrees with this characterization of the complaint. In contrast to the skeletal complaint dismissed in *O.P.M.*, which the bankruptcy court likened to "multiple choice or menu pleading," the complaint in the present action contains specific allegations about the Debtors' 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. In short, this complaint provides the Defendants with notice of the exact facts which the Trustee will attempt to prove in support of his allegation of actual fraud. As the pleadings filed in connection with this motion themselves make abundantly clear, these facts are furthermore stated concretely

enough that the Defendants can formulate reasonable arguments attacking both the truth and the legal sufficiency of the Trustee's allegations.[3] In evaluating a motion to dismiss for failure to plead fraud with particularity, this Court must look principally to whether the movant has been given enough information to begin preparing a defense. *See Tobais v. First City National Bank and Trust Company*, 709 F.Supp. 1266, 1276 (S.D.N.Y. 1989). Because that standard is met here, the remainder of the Defendants' motion to dismiss under Fed.R.Civ.P. 9(b) must be denied.[4]

b. Motion to Dismiss for Failure to Plead a Necessary Fact (NYD&CL Causes of Action)

The Defendants next assert that the Trustee's second and fourth causes of action, alleging actual and constructive fraudulent transfers under the NYD&CL, are defective in that they do not specifically allege that the Defendants were aware of the Debtors' fraudulent scheme.

The Defendants' argument necessarily rests on the premise that the transferee's state of mind is among the facts that must be proven by a plaintiff in a fraudulent transfer action brought under New York law, and it is on this premise that the Defendants' argument fails. As explained above, the whole purpose of the constructive fraud doctrine is to allow plaintiffs to avoid

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[3] The Court emphasizes, however, that the question of whether a claim survives a Fed.R.Civ.P. 9(b) motion is analytically distinct from the question of whether it would survive a motion to dismiss under Fed.R.Civ.P. 12(b)(6). *See Midwest Commerce Banking Company v. Elkhart City Centre*, 4 F.3d 521 (7th Cir. 1993). Since Defendant has not moved to dismiss the first two counts of Trustee's complaint for failure to state a claim, the Court will not at this time determine the legal adequacy of the Trustee's actual fraudulent transfer theory.

[4] The Trustee has also argued that as a stranger to the underlying fraudulent transactions, he is entitled to plead fraud under a relaxed version of Fed.R.Civ.P. 9(b). Because the Trustee's complaint would satisfy the requirements of Fed.R.Civ.P. 9(b) even under a non-relaxed standard, the Court does not reach this issue.

fraudulent transfers without proving--or pleading--the facts of the actual fraud itself. But it is highly unlikely (if not absolutely impossible) that a plaintiff could prove a defendant's knowledge of fraud without first proving that the fraudulent scheme existed. Taken at face value, application of the Defendants' argument to constructive fraud would make all of NYD&CL §§ 273-275 a practical nullity, since the only plaintiffs who could succeed under the constructive fraud causes of action would be those who already had a winning case under actual fraud. For these reasons, New York courts have consistently found the transferee's state of mind to be completely irrelevant in actions brought under §§ 273-275. *See Gallagher v. Kirschner*, 632 N.Y.S.2d 857, 858, 220 A.D.2d 948, 949 (N.Y. App. Div. 1995); *Schmitt v. Morgan*, 471 N.Y.S.2d 365, 98 A.D.2d 934 (N.Y. App. Div. 1983).

While the transferee's intent or knowledge might sometimes be relevant in an action to recover an actually fraudulent transfer under NYD&CL § 276, it is not a part of the Plaintiff's prima facie case. Instead, it becomes relevant only to the extent that the transferee seeks protection as a bona fide purchaser for value under NYD&CL § 278, which gives the transferee a complete defense to the avoidance action only if it both lacked knowledge of the fraud and paid fair consideration. *See Brody*, 250 N.Y. at 62. Several of the allegations in the Trustee's complaint amount to an assertion that the Defendants' services were not fair consideration for the commission payments; if this is proved, the Defendants will be unable to assert the status of a bona fide purchaser regardless of whether their knowledge of the fraud is proved. As a result, the Defendants' state of mind is not at this time a necessary element of the Trustee's NYD&CL § 276 cause of action.

In arguing against these seemingly uncontroversial points of New York law, the

Defendants rely on a recent decision of the Second Circuit in *HBE Leasing Corp. v. Frank,* 48 F.3d 623 (2d Cir. 1995). *HBE Leasing* involved an action to set aside a complicated multi-lateral transaction between related entities, which the plaintiffs attempted to "collapse" into a single transaction for analysis under NYDCL §§ 271-278.[5] Although the *HBE Leasing* court required the plaintiffs to prove that the ultimate transferee had knowledge of the fraudulent scheme, this requirement--notwithstanding the Defendants' repeated assertions to the contrary--had nothing to do with the fraudulent transfer cause of action. Instead, it was relevant only to the preliminary issue of whether the transaction could be collapsed in the first place. Taken in context, the relevant part of the *HBE Leasing* opinion reads as follows:

> Second, and contrary to the approach taken by the District Court, the transferee in the leg of the transaction sought to be avoided must have actual or constructive knowledge of the entire scheme that renders her exchange with the debtor fraudulent. [Citations omitted]. *In deciding whether to collapse the transaction* and impose liability on particular defendants, the courts have looked frequently to the knowledge of the defendants of the structure of the entire transaction and to whether its components were part of a single scheme.

HBE Leasing Corp., 48 F.3d at 635-36 (citing *In re Best Products Co.*, 168 B.R. 35, 56-57 (Bankr. S.D.N.Y. 1994) (emphasis added).

Nothing in the *HBE Leasing* decision suggests an intention by the Second Circuit to depart from an interpretation of New York law already firmly established by the New York state courts. Accordingly, the Court concludes that knowledge by the Defendants of the Debtors'

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[5] In general, a transaction may be collapsed where "one transferee gives fair value to the debtor in exchange for the debtor's property, and the debtor then gratuitously transfers the proceeds of the first exchange to a second transferee. The first transferee thereby receives the debtor's property, and the second transferee receives the consideration, while the debtor retains nothing." *HBE Leasing Corp.*, 48 F.3d at 635.

fraud was not a necessary allegation of the Trustee's complaint.[6]

c. Motion to Dismiss for Failure to State a Claim (Code §§ 548(a)(2), 547(b), and NYD&CL §§ 273-275 Causes of Action)

The Defendants have also moved for dismissal pursuant to Fed.R.Civ.P. 12(b)(6) of the Trustee's third, fourth and fifth causes of action, which allege constructive fraud and preferential transfers. In essence, the Defendants argue that they will be able to assert a complete defense to each of these actions on the grounds that they provided value to the Debtors and that their commissions were received in the ordinary course of business. *See* Code §§ 547(c)(2), 548(a)(2)(A), NYD&CL § 272. Although both the Trustee and the Defendants devote much space in their memoranda of law to the question of whether these defenses may be asserted by brokers for Ponzi schemes, the Court believes that the resolution of this issue would be premature. In the first place, Defendants' ordinary course of business argument is an affirmative defense, *see Weaver v. Kellogg*, 216 B.R. 563, 578 (S.D. Tex. 1998), and may not be considered on a motion to dismiss unless it appears on the face of the complaint. *See Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998). While the Trustee's complaint does characterize the transfers as "commissions or salaries," the Court does not believe that this precludes the factual question of whether the transfers were made according to ordinary business terms, even assuming arguendo that such a defense is available to Ponzi brokers. Secondly, while

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[6] The Court does not perceive any inconsistency between this holding and *Gala Enterprises v. Hewlett Packard Co.*, 989 F.Supp. 525 (S.D.N.Y. 1998), a recent decision interpreting *HBE Leasing*. Although the court in *Gala* concluded that a transfer was not avoidable under NYD&CL § 276 where the transferee had no knowledge of the fraud, the court also made a finding that the transferees had provided fair consideration, a fact which remains in dispute in the present case. *Gala Enterprises*, 989 F.Supp. at 525.

the Trustee raises the argument that a broker cannot provide value to a Ponzi scheme operator as a matter of law, the complaint also includes the factual allegation that the Defendants' services would not have been reasonably equivalent value for purposes of Code § 548(a)(2)(A) and NYD&CL § 272 even had the Ponzi scheme not existed. As a result, the Court finds that the Trustee's constructive fraud and preferential transfer causes of action survive the Defendants' Fed.R.Civ.P. 12(b)(6) motion to dismiss.

d. Motion for a More Definite Statement (Code § 547 Cause of Action)

Finally, the Defendants assert that the Trustee should be required to amend his fifth cause of action to include a more definite statement pursuant to Fed.R.Civ.P. 12(e) about each of transfers that are allegedly preferential under Code § 547. In its current form, the section of the complaint dealing with this cause of action realleges the basic facts of the Ponzi scheme, states the statutory requirements for avoidance under Code § 547, and alleges the following additional facts: that at least some of the transfers to the Defendants were made from the honeypot within ninety days of the petition date, and that these transfers allowed Defendants to recover more than they would have recovered in a Chapter 7 liquidation of the Debtors' assets. (Compl. ¶¶ 47-51). The Defendants have argued that this count is defective in that it lacks specific facts about "the dates of the commissions, which of the consolidated debtors made the payments, when the payments were due, and the other facts which describe the transactions." (Def. Mem. at 17).

Information of this sort is properly obtained through discovery, and not by a motion for a more definite statement. In light of the Federal Rules' underlying policy of notice pleading, the Rule 12(e) motion is a disfavored one, which is appropriately granted only in those extreme

cases where the complaint is so ambiguous that the defendant cannot determine what, if anything, he is accused of. *See Kelly v. L.L. Cool J.,* 145 F.R.D. 32, 35 (S.D.N.Y. 1992); *B-H Transportation Co. v. Great Atlantic & Pacific Tea Company*, 44 F.R.D. 436, 439 (N.D.N.Y. 1968). Where the complaint merely lacks detail, but is not unintelligible, a more definite statement is not required. *See Hassett v. Ganz (In re O.P.M. Leasing Services, Inc.)*, 21 B.R. 986, 992 (Bankr. S.D.N.Y. 1982). As noted above, the Trustee's complaint has given Defendants a precise description of the alleged basis for the avoidance actions; moreover, the Trustee's apparent assertion that all payments made within 90 days of the petition date may be avoided removes any ambiguity with respect to individual transfers. While the Defendants would undoubtedly like a full catalogue of specific details regarding each individual transfer, the Federal Rules simply do not require the Trustee to provide such detail at this early stage of the litigation. Accordingly, Defendants' Fed.R.Civ.P. 12(e) motion must also fail.

ORDER

Based on the foregoing, Defendants' motion seeking dismissal of the Trustee's avoidance actions, or in the alternative a more definite statement, is hereby DENIED in its entirety.

Dated at Utica, New York

this 24th day of November 1998

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge