Westlaw Journal
WHITE-COLLAR CRIME
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 29, ISSUE 12 / SEPTEMBER 2015

EXPERT ANALYSIS

Supreme Court Preserves Decision Limiting BankruptcyTrustees' Powers To Avoid Securities-Related Transfers

By Richard Levy Jr., Esq.
Pryor Cashman

On June 22, the U.S. Supreme Court summarily denied two petitions for *certiorari*[1] that sought review of the unanimous decision of a panel of the 2nd U.S. Circuit Court of Appeals in the Bernard L. Madoff Investment Securities liquidation proceeding. The panel decision in *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Investment Securities LLC)* significantly limited the scope of a trustee's clawback remedies.[2]

By applying the text of Section 546(e) of the Bankruptcy Code[3] to the facts alleged in hundreds of avoidance complaints filed by the federally appointed trustee in the broker's liquidation case, the 2nd Circuit's ruling — now beyond review — significantly limited the avoidance remedies of a trustee in a Securities Investor Protection Act liquidation proceeding. By extension, this ruling now limits the avoidance remedies of a bankruptcy trustee in any case involving transfers made by or to a stockbroker and other market participant covered by the statute.

BACKGROUND

In 2008, Irving H. Picard was appointed as the trustee under the SIPA to oversee the liquidation of Bernard L. Madoff Investment Securities LLP. In late 2010, the SIPA trustee invoked his avoidance powers — borrowed from the Bankruptcy Code[4] — to commence more than 1,000 adversary proceedings seeking avoidance of transfers by Madoff Securities (as actual fraudulent transfers under federal and state law, constructive fraudulent transfers under federal and state law, and preferences under bankruptcy law).

More that 600 of those suits targeted the broker's former customers (so-called innocent customers), none of whom were asserted by the SIPA trustee to have any knowledge or involvement in the alleged Ponzi scheme perpetrated by Madoff Securities.

In its *Fishman* decision in 2014, the 2nd Circuit affirmed an earlier decision of the U.S. District Court for the Southern District of New York that held the trustee in a SIPA stockbroker liquidation case may not avoid as fraudulent transfers or preferences certain securities-related transfers.[5] Applying the safe harbor under Section 546(e) of the Bankruptcy Code, the 2nd Circuit agreed that the SIPA trustee may avoid payments made during the two years immediately preceding the start of the liquidation case, but only as actual fraudulent transfers if they were made with the requisite intent.

Denying the petitions for review filed by the trustee and the Securities Investor Protection Corp., the Supreme Court let stand in all respects the 2nd Circuit's decision on the application of the Section 546(e) safe harbor. The denial left the trustee only with his claims for avoidance of actual fraudulent transfers under the Bankruptcy Code.

This brings to a close the litigation of that issue as it affected more than 1,600 customers named as defendants in more than 600 clawback actions commenced by the trustee in 2010. Moreover, it

protects from avoidance more than $1.8 billion in transfers made to those customers and their subsequent transferees.[6]

MADOFF SECURITIES' TRANSFERS ARE PROTECTED AS PAYMENTS

Picard and the SIPC had asked the Supreme Court to review the 2nd Circuit's ruling that the trustee could not avoid and recover any transfers made to Madoff customers more than two years before Madoff's collapse. It further sought review of the ruling that the trustee could only reach transfers made within the two-year period if they were fraudulent — that is, made with the intent to defraud creditors.

The 2nd Circuit concluded that transfers made more than two years before the start of the bankruptcy case were covered by the safe harbor in Section 546(e) of the Bankruptcy Code. That section payments that either were made by a stockbroker "in connection with securities contracts" or were securities "settlement payments."

Although Picard and the SIPC argued that the statute should not apply to an alleged "Ponzi scheme" in which no actual securities trades occurred, the 2nd Circuit (building upon its broad ruling four years earlier in *Enron*[7]) held that the plain language of the statute governed the case and thus limited the trustee's clawback remedies.

The Supreme Court's denial of review means that former Madoff Securities customers named as defendants by Picard, who dealt with the broker under standard brokerage contracts and who knew nothing of their broker›s conduct, are protected from having to give back any account withdrawals made more than two years before the collapse of Madoff's firm.

The 2nd Circuit ruling limits the avoidance remedies of a bankruptcy trustee in any case involving transfers made by or to a stockbroker.

Section 546(e) precludes bankruptcy trustees from avoiding transfers that are "made in connection with securities contracts" *or* that constitute "settlement payments" relating to securities. Any transfer that is made more than two years before the bankruptcy case and that satisfies *either* category qualifies for the statutory protection. Thus, under *Fishman*, where alleged avoidable transfers fall within either of the protected categories, a trustee's avoidance powers will reach only transfers that occurred within the two years preceding the filing of the bankruptcy case *and* that were made by the transferor with an actual intent to hinder, delay or defraud creditors — even if they are securities-related transfers.

But qualifying transfers made outside of the two-year period will be protected from challenge by the statute. Thus, both the text of Section 546(e) and the 2nd Circuit's decision permit a trustee to continue to prosecute the two-year actual fraudulent transfers but bar all other avoidance claims under state or federal laws if the transfers fall within the safe harbor.

THE EFFECT OF THE DECISION

When applied to the requisite securities-related transfers, Section 546(e) by its terms will bar all of a SIPA trustee's clawback claims except for the two-year actual fraudulent transfer claims under Section 548(a)(1)(A). By limiting the trustee's avoidance powers to the two-year remedy for actual fraudu-lent transactions, the court's ruling has the direct effect of prohibiting the SIPA trustee for Madoff Securities from utilizing the typically longer reach-back remedies under state fraudulent transfer laws otherwise available for non-securities-related transfers. In the Madoff Securities case, for example, New York has six-year fraudulent-transfer statutes.

Left wholly intact by the Supreme Court, the *Fishman* decision places beyond the SIPA trustee's reach an aggregate of more than $1.8 billion in challenged transfers by Madoff Securities to former customers and subsequent transferees.

The *Fishman* decision will significantly impact trustees and transferees in other bankruptcy settings where challenged transfers fall within the safe harbor under Section 546(e). In *Fishman*, the 2nd Circuit became the latest of several federal appeals courts to hold that, by its plain terms, Section 546(e) applies to qualifying transfers even in the context of massive frauds characterized as a "Ponzi schemes."[8] However, it is the first federal circuit court to hold that the safe harbor applies even if the stockbroker allegedly did not make any real securities trades for its customers.

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Notwithstanding the trustee's allegations of the existence of a Ponzi scheme perpetrated by Madoff and the lack of securities trading, *Fishman* held that a sufficient contractual relationship existed between the broker and the customers based on their account documents and the broker's promises to the customers. Accordingly, the payments were made "in connection with" those contracts. Therefore, they were protected against avoidance even where the broker failed to perform its obligations, such as by failing to trade for the customers' accounts or misappropriating the customers' funds or securities.

The court also held that the broker's transfers to the customers were protected as securities "settlement payments." Again, despite the alleged absence of underlying securities trades, the 2nd Circuit concluded that each payment was made in response to a customer's request for a withdrawal from its account, i.e., a request to dispose of securities from the customer's account. The payments thus settled a securities transaction between the broker and customer, even though the stockbroker did not actually execute a trade but instead stole money from other clients to fund the payment.

Now that the Supreme Court has declined to review the *Fishman* decision, the 2nd Circuit's ruling is likely to have far-reaching implications. Importantly, the decision shrinks the scope of a SIPA trustee's power to pursue avoidance claims in SIPA liquidation cases. But the decision will also prevent trustees in ordinary bankruptcy cases from avoiding transfers that satisfy the safe-harbor categories of Section 546(e) —even if there was no underlying securities transactions but the parties otherwise were engaged in relationships that involved securities contracts or settlement payments.

More that 600 lawsuits targeted the broker's former customers (so-called innocent customers) who did not have any knowledge of the alleged Ponzi scheme perpetrated by Madoff Securities.

Although the decision directly binds only the lower federal courts within the 2nd Circuit (New York, Connecticut and Vermont), it is likely to be cited as a strong precedent. This is because the 2nd Circuit is viewed as a particularly influential federal tribunal based on its heavy concentration of corporate and commercial disputes.

Despite its breadth, the holding in *Fishman* does not eliminate all of the Madoff trustee's clawback remedies. Nor does it extinguish all avoidance remedies of other bankruptcy trustees. The 2nd Circuit's ruling does not affect a bankruptcy or SIPA trustee's ability to seek avoidance of transfers made by stockbrokers in the two years immediately preceding the commencement of the bankruptcy case, if the broker made the transfers with an actual intent to hinder, delay or defraud creditors. Those claims remain in play against the customer-defendants covered by the *Fishman* decision.

Moreover, *Fishman* provides no immediate protection to any clawback targets alleged by a trustee to have known of the debtor's fraud or to have blinded themselves to it.[9] In the Madoff Securities context, those targets generally include feeder funds and financial institutions as well as individuals who had close relationships with Madoff over long periods of time.

Under pertinent case law not involved in the *Fishman* ruling, such targets (unlike the "innocent" customers covered by the 2nd Circuit ruling) likely will be unable to obtain dismissal at the pleading stage of claims for avoidance of transfers made more than two years before the bankruptcy case. This is because of the fact-intensive nature of issues regarding actual knowledge of or willful blindness to a debtor's fraud. A defendant faced with such allegations by a trustee may have to litigate the action through to summary judgment motion practice or even trial to defeat the claims.

NOTES

[1] *Sec. Inv'r Prot. Corp. v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC),* 135 S. Ct. 2858 (2015); *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Secs. LLC),* 135 S. Ct. 2859 (2015).

[2] *Picard v. Ida Fishman Revocable Trust et al*. (In re Bernard L. Madoff Inv. Sec. LLC), 773 F.3d 411 (2d Cir. 2014).

[3] Section 546(e) provides, in relevant part, "The trustee may not avoid a transfer that is a … settlement payment, as defined in section 101 or 741 of this title, made by … a … stockbroker … or that is a transfer made by … a … stockbroker … in connection with a securities contract, as defined in section 741(7) [the

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Bankruptcy Code] … that is made before the commencement of the case, except under section 548(a)(1)(A) of [the Bankruptcy Code]." 11 U.S.C. § 546(e).

[4] See SIPA § 8(c)(3), 15 U.S.C. § 78fff-2(c)(3).

[5] *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC,* 476 B.R. 715, 722, 730 (S.D.N.Y. 2012) (Rakoff, J.). Accord, Picard v. Katz (In re Bernard L. Madoff Inv. Sec. LLC), 462 B.R. 447 (S.D.N.Y. 2011) (Rakoff, J.), certification for interlocutory appeal denied, 466 B.R. 208 (S.D.N.Y. 2012), settlement approved and action dismissed, No. 11-cv-3605 (S.D.N.Y. June 1, 2012) (ECF Nos. 192-93). The District Court approved the limited consolidation of all pending actions by the trustee against "innocent customer" defendants for purposes of facilitating an appeal of the Section 546(e) issue, and it certified its dismissal of the affected claims as final judgments under Federal Rule of Civil Procedure 54(b) from which the trustee and SIPC appealed to the 2nd Circuit.

[6] See Trustee's Ninth Interim Report, *In re Bernard L. Madoff Inv. Sec. LLP,* 44 n.7 (Bankr. SD.N.Y. Apr. 30, 2013) (ECF No. 5351) ("[I]f [the District Court's] interpretation of Section 546(e) is upheld, the trustee will be prohibited from pursuing preference and state law fraudulent conveyance claims totaling approximately $1.8 billion, but will remain able to pursue avoidance actions seeking the return of approximately $1.5 billion in fraudulent conveyances occurring within the two years prior to the BLMIS bankruptcy filing."). In his Supreme Court petition, the trustee asserted that allowing the 2nd Circuit decision to stand could affect his ability to recover up to $4 billion in claims but did not explain the basis of that figure.

[7] *Enron Creditors Recovery Corp. v. Alfa S.A.B. de C.V.,* 651 F.3d 329, 334 (2d Cir. 2011).

[8] *See, e.g., Grede v. FCStone, LLC,* 746 F.3d 244, 251-54 (7th Cir. 2014) (applying Section 546(e)'s "deliberately broad" text to shield from clawback "settlement payments" made "in connection with a securities contract"); *Grayson Consulting Inc. v. Wachovia Sec. (In re Derivium Capital LLC),* 716 F.3d 355, 366 (4th Cir. 2013) (rejecting argument that there should be an "exception" to Section 546(e) for Ponzi schemes). *See also Wyle v. Howard, Weil, Labouisse, Freidrichs Inc. (In re Hamilton Taft & Co.),* 114 F.3d 991, 997 (9th Cir. 1997) ("[The ethical nature of the transaction is irrelevant to our determination of the legal issues involved. … [The prior version of] Section 546(e) [then in force] explicitly excepts fraudulent transfers that are completed within one year of the filing of the bankruptcy petition. Because the reverse repo transaction at issue here was completed over two years before the filing of [the debtor's] bankruptcy petition, the trustee cannot invoke the fraud exception to Section 546(e).").

[9] *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLP, No.* 12 MC 115, *2013 WL 1609154, at *4* (S.D.N.Y. Apr. 15, 2013) (Rakoff, J.) ("If the allegations adequately allege that a defendant had actual knowledge of Madoff's scheme, such a transferee stands in a different posture from an innocent transferee, even as concerns the application of Section 546(e). … [T]he burden is on the trustee to prove that a transferee does not meet what the language and purpose of Section 546(e) require. … [T]o do this, the trustee must show, at a minimum, that the transferee had acquittal knowledge that there were no actual securities transactions being conducted"); *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec. LLC)*, 515 B.R. 117, 138 (Bankr. S.D.N.Y. 2014) (Bernstein, J.) ("If, however, an initial (or subsequent) transferee had actual knowledge of Madoff's Ponzi scheme, he cannot avail himself of the Section 546(e) safe harbor, and the trustee can avoid and recover preferences and actual and constructive fraudulent transfers to the full extent permitted by state and federal bankruptcy law."). But the standard of proof for a trustee to escape the application of Section 546(e) is high: "'[A]ctual knowledge' implies a high level of certainty and absence of any substantial doubt regarding the existence of a fact." *Picard v. Merkin,* 515 B.R. at 139.

Richard Levy Jr. is a partner of **Pryor Cashman** in New York, where he is co-chair of the firm's bankruptcy and creditors' rights practice group. He argued the appeal discussed in this commentary in the 2nd U.S. Circuit Court of Appeals on behalf of the former customers of Madoff Securities, and he was counsel of record for the customers in related U.S. Supreme Court proceedings. Levy and Pryor Cashman continue to represent numerous Madoff Securities customers in pending litigation with Irving H. Picard, the Securities Investor Protection Act trustee appointed for the liquidation of Madoff Securities.

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