PRYOR CASHMAN LLP

LEGAL UPDATE

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SECOND CIRCUIT DECISION IN MADOFF CASE LIMITS AVOIDANCE OF SECURITIES-RELATED TRANSFERS AS FRAUDULENT TRANSFERS

On December 8, 2014, the U.S. Court of Appeals for the Second Circuit issued its long-awaited ruling on the scope of clawback remedies in the Madoff Securities liquidation proceeding. Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Secs. LLP), No. 12-2557, 2014 U.S. App. Lexis 23032 (2d Cir. Dec. 8, 2014). The Court affirmed an earlier decision of the U.S. District Court for the Southern District of New York which significantly limited the ability of the trustee in a brokerage firm liquidation case to avoid fraudulent transfers and preferences involving certain securities-related transactions. Applying a safe harbor in Section 546(e) of the Bankruptcy Code, the Circuit Court held that the Trustee appointed to collect and liquidate Madoff Securities' assets under the Securities Investor Protection Act (SIPA) may avoid the pertinent payments only as actual fraudulent transfers if they were made within the 2 years preceding the start of the liquidation case. The decision means that the Trustee may not avoid the payments as preferences made within 90 days before the case (or within one year before the case, if made to insiders of the transferor) or as fraudulent transfers made more than 2 years before the case. (The author argued the appeal on behalf of defendant-customers sued by the Madoff Securities Trustee.)

Section 546(e) precludes a bankruptcy trustee from avoiding transfers that are either "made in connection with securities contracts" or that constitute "settlement payments" relating to securities. Under the Circuit Court's decision, where alleged avoidable transfers fall within the protected categories, a trustee's avoidance powers will only reach transfers that occurred within the 2 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 such transfers made outside of the 2-year period are protected from challenge by the statute. (Thus, both the text of Section 546(e) and the Circuit Court's decision permit a trustee to continue to prosecute the 2-year actual fraudulent transfers, but bar all other avoidance claims under other state or federal law if the transfers fall within the safe harbor).

By limiting the Trustee's avoidance powers to the 2-year remedy for actual fraudulent transactions, the Court's ruling has the direct effect of prohibiting the Trustee 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's 6-year fraudulent transfer statutes). Directly benefitting hundreds of former Madoff Securities customers named as defendants in more than 600 lawsuits, the decision places beyond the Trustee's reach an aggregate of more than $1.8 billion in challenged transfers to the former customers and their subsequent transferees. The decision will significantly impact trustees and transferees in other securities-and brokerage-related bankruptcy settings where challenged transfers may fall within the safe harbor under Section 546(e).

Notwithstanding the Trustee's allegations of the existence of a Ponzi scheme perpetrated by Madoff, the Second Circuit held that a 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 and, therefore, were protected against avoidance even where the broker failed to perform its obligations, such as failing to trade for the customers' accounts or misappropriating the customers' funds or securities. The Court also held that the transfers to the customers were protected as "settlement payments." Despite the alleged absence of underlying securities trades, the Circuit Court concluded that each payment was made in response to a customer's request for a withdrawal from its account, i.e., as a request to dispose of securities from the customer's account. The payments, therefore, completed a securities transaction between the broker and customer, even though the stockbroker did not actually execute a trade and, instead, stole money from other clients to fund the payment.

The Madoff Securities decision is likely to have far-reaching implications. In the first instance, the decision shrinks the scope of a SIPA trustee's power to pursue avoidance claims in SIPA liquidation cases. But the decision also will prevent trustees in ordinary bankruptcy cases from avoiding transfers that satisfy the safe-harbor categories of Section 546(e), even where there may have been no underlying securities transactions but the parties otherwise were engaged in relationships that involved securities contracts or settlement payments. Although the decision only directly binds the lower federal courts within the Second Circuit (New York, Connecticut and Vermont), the decision is likely to be cited as strong precedent by other courts because the Second Circuit historically is viewed as an influential federal tribunal from its heavy concentration of corporate and commercial disputes.

The Second Circuit decision does not provide immediate protection to clawback targets that a trustee alleges to have known of, or willfully blinded themselves to, the Madoff scheme. (In the Madoff Securities context, those parties generally include feeder funds and financial institutions, as well as individuals who had close relationships with Madoff over long periods of time). Under other District Court decisions (not involved in this appeal), those defendants remain subject to the Trustee's continued prosecution of avoidance claims involving fraudulent transfers made within the 2-year period, preferences under the Bankruptcy Code, and fraudulent transfers older than 2 years where reached by longer state law avoidance periods.

For more information concerning proceedings and issues in the Madoff Securities case, please contact:

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ABOUT THE AUTHOR

Richard Levy, Jr. is Co-Chair of the Bankruptcy, Reorganization and Creditors' Rights Group practice at Pryor Cashman. His experience includes all phases of cases under Chapter 11 and Chapter 7 of the Bankruptcy Code, bankruptcy litigation, civil litigation in federal and state courts, related counseling, arbitration and mediation. Rich has represented creditors, debtors, official and unofficial committees (including committees of creditors, equity holders or retired employees), landlords, indenture trustees, labor unions, pension funds, and asset purchasers. He also has represented parties in state court insolvency and corporate dissolution proceedings.

Rich leads the representation of the firm's clients in connection with the liquidation of Bernard L. Madoff Investment Securities. Rich has counseled firm clients relating to the filing and defense of customer net equity claims, and he currently represents clients against claims brought by the SIPA Trustee to recover preferences and fraudulent conveyances under federal and state law.

He represented the indenture trustees of publicly-traded bonds in the Kmart, Cooper Standard, Global Crossing, Hayes Lemmerz, Owens Corning, and Quality Stores cases, among others. His experience also includes bankruptcy litigation on behalf of indenture trustees with respect to their contractual rights and obligations under their indentures including, for example, the charging lien litigation commenced by the official creditors committee against the indenture trustee in the Global Crossing case.

Rich regularly assists other practice areas of the firm by providing bankruptcy support and counsel in the structuring of business and commercial transactions, including, for example, financings, mergers and acquisitions, securitization transactions requiring non-consolidation or true sale opinions, intellectual property licenses, real estate leases and other executory contracts. For example, Rich recently assisted a major motion picture studio in its attempt to acquire significant intellectual property assets from the bankruptcy estate of an insolvent film production company. He is also called upon to provide advice and representation with respect to the enforcement of judgments and debtor/creditor remedies under state law.

Rich has held special appointments in a number of bankruptcy cases. He served as counsel to the Chapter 11 Trustee appointed by the U.S. Bankruptcy Court for the District of Delaware in the asbestos-related bankruptcy case of United States Mineral Products Company, a leading manufacturer of spray-applied fire resistive materials for steel framed buildings and other structures. The case was one of the first to involve a successful restructuring of both asbestos-related personal injury claims and property damage claims under Section 524(g) of the U.S. Bankruptcy Code, and also is believed to be the first asbestos bankruptcy case to result in a successful reorganization under the auspices of a court-appointed bankruptcy trustee.

Rich has also served as the court-appointed official legal representative of future claimants in two other asbestos bankruptcy cases. He was the court-designated lead counsel in consolidated insolvency litigation proceedings arising from the Chapter 11 bankruptcy of a major airline. He also served as court-appointed examiner and, subsequently, as the post-confirmation creditor trustee in the Chapter 11 case of a well-known entertainer. Rich represented the official representative of retired employees appointed in the bankruptcy case of a metal products manufacturer, and the unofficial retiree committee in the reorganization case of a major meat-packing company. Rich served as a member of the Trust Advisory Board for the HLI Creditor Trust established in connection with the confirmed Chapter 11 bankruptcy plan for Hayes Lemmerz, Inc.

Rich graduated magna cum laude from Syracuse University College of Law in 1977, where he was elected to the Order of the Coif and served as Notes & Comments Editor of the Syracuse Law Review (1976-77).

A 1974 graduate of Williams College (cum laude, with honors in Political Economy), Rich served as President

of the Society of Alumni of Williams College – the oldest continuously-existing college or university alumni association in the world – from June 2006 to June 2008. During his term, Rich also chaired the Executive Committee of the Society of Alumni and attended meetings of the Board of Trustees of Williams College at the invitation of the Board.

Rich is AV Peer Review Rated, Martindale Hubbell's highest peer recognition for ethical standards and legal ability.