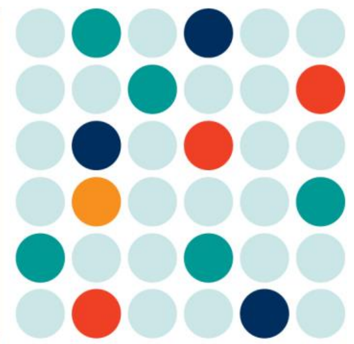
# LEGAL UPDATE

June 2015 By: Richard Levy, Jr.



## SUPREME COURT DECLINES TO REVIEW SECOND CIRCUIT DECISION IN MADOFF CASE SIGNIFICANTLY LIMITING TRUSTEE'S POWER TO AVOID SECURITIES-RELATED PAYMENTS AS FRAUDULENT TRANSFERS

On June 22, 2015, the Supreme Court summarily declined to review the unanimous decision of a panel of the U.S. Court of Appeals for the Second Circuit in the Madoff Securities liquidation proceeding, issued in December 2014, which significantly limited the scope of a trustee's clawback remedies. *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), *cert. denied,* Nos. 14-1128 *and* 14-1129, 2015 U.S. LEXIS 4229, 2015 U.S. LEXIS 4232 (U.S. June 22, 2015). (The author of this Legal Update argued in the Second Circuit on behalf of former customers of Madoff Securities, and was counsel of record for the customers in the Supreme Court proceeding.)

In its *Fishman* decision, the Second Circuit affirmed an earlier decision by the U.S. District Court for the Southern District of New York, holding that the trustee in a brokerage firm liquidation case may not avoid fraudulent transfers and preferences involving certain securities-related transactions. Applying a safe harbor under Section 546(e) of the Bankruptcy Code, the Circuit Court held that Irving Picard, 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. Denying the petitions for review filed by the Trustee and the Securities Investor Protection Corporation (SIPC), the Supreme Court let the Second Circuit's decision on the application of the Section 546(e) safe harbor stand in all respects. 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 to those customers and their subsequent transferees.

Picard and SIPC had asked the Supreme Court to review the Second Circuit's ruling that the Trustee could not recover transfers made to Madoff customers more than 2 years before the collapse of Madoff, and could only reach made within that 2-year period that qualified as fraudulent transfers made with an actual intent to defraud creditors. The Second Circuit concluded in *Fishman* that the transfers made more than 2-years before the start of the bankruptcy case were covered by the safe harbor in Section 546(e) of the Bankruptcy Code, which protects payments that either were made by a stockbroker "in connection with securities contracts" or were securities "settlement payments." Although Picard and SIPC argued that the statute should not apply to an alleged "Ponzi scheme" in which no actual securities trades occurred, the Second Circuit held that the plain language of the statute applied 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.

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 *Fishman* 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 Second Circuit'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). Left wholly intact by the Supreme Court, the *Fishman* 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 bankruptcy settings where challenged transfers fall within the safe harbor under Section 546(e).

The Second Circuit, in *Fishman,* 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." But it is the first federal circuit court to hold that the safe harbor applies even where the stockbroker is alleged to not to have made any real securities trades for its customers' accounts. Notwithstanding the Trustee's allegations of the existence of a Ponzi scheme perpetrated by Madoff and the lack of securities trading, the Second Circuit held in *Fishman* 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 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 broker's transfers to the customers were protected as securities "settlement payments." Again, despite the alleged absence of underlying securities trades, the Second 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, therefore, settled 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.

Now that the Supreme Court has declined to review the *Fishman* decision, the Second Circuit's ruling 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 a strong precedent because the Second Circuit is viewed as a particularly influential federal tribunal based on its heavy concentration of corporate and commercial disputes.

Despite the breadth of its holding, the *Fishman* decision does not eliminate all of the Madoff Trustee's all clawback remedies. The Second Circuit's ruling does not affect a bankruptcy or SIPA trustee's ability to seek avoidance of transfers made by stockbroker during the two years immediately preceding the commencement of the bankruptcy case where the transfers were made by the broker with an actual intent to hinder, delay or defraud creditors. (Those claims remain in play against the customer-defendants covered by the *Fishman* decision.) In addition, *Fishman* provides no immediate protection to clawback targets alleged by a trustee to have known of the debtor's fraud or

to have willfully blinded themselves to it. (In the Madoff Securities context, those targets generally include feeder funds and financial institutions, and 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 customer-defendants covered by the Second Circuit ruling) likely will be unable to obtain dismissal of those claims at the pleading stage of claims for avoidance of transfers made more two years before the bankruptcy case, 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 may have to litigate the claims through to summary judgment motion practice or trial in order to defeat such claims alleged by a trustee.

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*For more information concerning proceedings and issues in the Madoff Securities case, please contact: Richard Levy, Jr. at (212) 326-0886 or rlevy@pryorcashman.com.*

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Richard Levy, Jr. is co-chair of Pryor Cashman's Bankruptcy, Reorganization & Creditors' Rights Group, and also a member of the firm's Litigation, Banking and Finance and Investment Management Groups. He is experienced in all phases of Chapter 11 and Chapter 7 bankruptcy cases, related litigation and dissolutions under state law. Rich counsels and represents business and individual clients in reorganization and liquidation matters. His work regularly involves bankruptcy- and insolvency-related counseling, corporate, commercial and real estate transactions and intellectual property licensing.

Rich appears in federal and state courts representing clients in commercial, business and insolvency-related litigation, including the defense of fraudulent transfer and preference avoidance actions. He is also a certified mediator in the U.S. Bankruptcy Court for the Southern District of New York.