

Pivotal Decision Will Impact Madoff SIPC Proceedings and Fraudulent Transfer Cases

In a decision that will have a significant impact in the Bernard Madoff Securities Investor Protection Corporation (SIPC) proceedings and beyond, Judge Rakoff of the District Court for the Southern District of New York (the court) recently dismissed almost every count in a complaint filed by the trustee for the Madoff proceedings, Irving H. Picard (the trustee), against a number of defendants, including the owners of the New York Mets (the defendants), who had received distributions from Bernie Madoff and his company, Bernard L. Madoff Investment Securities LLC (BLMIS). Notably, the court rejected the trustee's argument that investors have an affirmative duty to investigate a broker's activities. The court held that an investor simply failing to mount an investigation as a result of perceived suspicious circumstances involving a broker's internal practices cannot be equated with a lack of good faith that would preclude application of a safe harbor for avoidance of constructive fraudulent transfers.

As has now become common knowledge, for more than 30 years, investors deposited billions of dollars with BLMIS and billions of dollars were paid out by BLMIS. Unfortunately, BLMIS never invested those customer funds. Instead, it generated fictitious paper accounts and trading statements, all of which consistently showed profitable trades and continuing gains. In the classic Ponzi tradition, the scheme collapsed when new investments were insufficient to support the payments required on the earlier allegedly invested funds. The final customer statements issued by BLMIS falsely recorded nearly US\$64.8 billion of net investments and related fictitious gains. Once the fraud was discovered, the Securities and Exchange Commission commenced a suit against BLMIS in the District Court for the Southern District of New York under the Securities Investor Protection Act (SIPA). That suit was subsequently referred to the Bankruptcy Court for the Southern District of New York, and the trustee was appointed to oversee the liquidation of BLMIS. Nevertheless, the court withdrew the reference with respect to this adversary proceeding, which is now before the district court.

The trustee's complaint alleged that transfers from BLMIS to the defendants constituted both actual and constructive fraudulent transfers under Bankruptcy Code section 548 and New York state law, made applicable under Bankruptcy Code section 544. Constructive fraud requires that the trustee prove the payments made by BLMIS to the defendants were made for less than reasonably equivalent value and that BLMIS was insolvent at the time or rendered insolvent by the payments. Actual fraud requires that the trustee prove that the payments were made to the defendants with actual intent to hinder, delay or defraud creditors; insolvency and reasonably equivalent value are irrelevant.

The defendants argued and the court agreed that the alleged constructive fraudulent transfers at issue were precluded from avoidance under the Bankruptcy Code and New York law by Bankruptcy Code section 546(e), the “safe harbor” provision, which excepts from avoidance certain securities transactions. Bankruptcy Code section 546(e), however, does not protect transfers done with actual intent. Given the extent of Madoff’s Ponzi scheme, the court found that all of the transfers done by BLMIS during the two-year period before the filing were done with actual intent. Nevertheless, the court pointed out that Bankruptcy Code section 548 provides a defense for the transferee of a transfer made with actual intent who takes for value and in good faith to retain the transferred property to the extent of the value given to the debtor by the transferee. The court found that the principal invested by the defendants (i.e., the actual amount paid in to BLMIS) constituted “value,” and thus could not be recovered by the trustee absent bad faith. With respect to any “profits” earned that were, by definition, in excess of the “extent of the value” given by the defendants, these could be recovered by the trustee regardless of the defendants’ lack of good faith.

The court was therefore left to determine what constituted a lack of “good faith” for purposes of this adversary proceeding. Both sides agreed that the defendants did not have actual knowledge that they were investing in a Ponzi scheme. The parties also agreed, however, that if the defendants “willfully blinded” themselves to the scheme, it might constitute a lack of good faith. The trustee argued that the defendants’ own investment strategy indicated that they knew they were getting something the market didn’t offer: substantial short-term profits while protecting themselves against long-term risk. Although the defendants denied these accusations, the court found there was enough evidence to at least survive a motion to dismiss.

The trustee also argued that the defendants were on “inquiry notice” of the fraud but failed to diligently investigate and that this also constitutes a lack of good faith. The court rejected this argument, finding that an investor is under no duty to investigate his or her broker’s activities. While an investor who chooses to “willfully blind” him- or herself to “red flags” that suggest fraud may show a lack of good faith, simply failing to mount an investigation as a result of perceived suspicious circumstances involving a broker’s internal practices cannot be equated with a lack of good faith.

As a result, the court held that as to the claim of actual fraud, the defendants can defeat the trustee’s claim with respect to the recovery of the defendants’ principal simply by proving their good faith. As to payments received by the defendants in excess of their principal, the defendants can defeat the trustee’s claim of actual fraud only by showing not only that they were proceeding in good faith but also that they took for value.

The confluence of the Bankruptcy Code and SIPA and the enormous amounts of money at stake in the Madoff case have inspired the most esoteric arguments in favor of and against various points of view. Although most of the complaints appear straightforward, arguments raised by the trustee and defenses

raised by various defendants have shown that even the most experienced of investors, whether individual or institutional, are at a loss as to how to protect themselves against the trustee's strenuous recovery efforts. Further, Madoff is but one Ponzi schemer. Even now, there are others. Investors need to be able to identify the signs of fraud at least to the extent to defend themselves against a charge of "willful blindness."

Squire, Sanders & Dempsey (US) LLP's restructuring and insolvency lawyers have significant experience representing fraudulent transfer defendants. If you have any questions, please feel free to contact your Squire Sanders lawyer or any of the lawyers identified in this Alert.

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