How Long and Strong is Trustee Piccard's Claw?

On December 10, 2008, Bernard Madoff confessed to his two sons that he had been running what amounted to a massive Ponzi scheme on the scale of approximately $50 billion and that he could no longer sustain it due to, among other things, substantial redemption requests. That night, his sons alerted authorities.

The following day, the Securities and Exchange Commission (SEC) filed a lawsuit in the United States District Court for the Southern District of New York against Madoff and Bernard L. Madoff Investment Securities LLC (Madoff Securities), the registered investment adviser and broker/dealer that fronted Madoff's activities (the "New York Suit"). The New York Suit requested various types of preliminary relief, including a freeze on the assets of Madoff Securities. The same day, the Office of the United States' Attorney in the Southern District of New York filed a criminal complaint against Madoff, alleging securities fraud and other criminal wrongdoing.

Madoff Securities is Being Liquidated Pursuant to the Provisions of the Securities Investor Protection Act of 1970

On December 15, 2008, the Securities Investor Protection Corporation (SIPC), asked the federal court presiding over the New York Suit to enter a finding that customers of Madoff Securities needed the protections afforded under the Securities Investor Protection Act of 1970, as amended, 15 U.S.C. §§ 78aaa et seq. (SIPA). The SIPA is a federal statute that regulates broker/dealers and is designed to protect their customers. The SIPA also has detailed procedures for liquidating its members and it also authorizes the creation of an insurance program that is funded, in part, by assessments against SIPC member firms. The fund is designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of financial failure of the member. If the assets in the fund are not adequate to deal with allowable claims against a failed broker/dealer, the SIPA authorizes borrowing from the U.S. Treasury.

The federal court promptly granted the SIPC request, appointed Irving Piccard as the trustee for the SIPA proceeding and transferred to the Bankruptcy Court in New York the legal proceeding to liquidate Madoff Securities. Although the proceedings are being handled in the New York Bankruptcy Court, Madoff Securities is not, technically speaking, in a bankruptcy proceeding. Instead, Madoff Securities is being liquidated pursuant to the provisions of the SIPA. Bankruptcy Judge Burton R. Lifland is presiding over the case. Judge Lifland also presided over the liquidation of another complex and large-scale Ponzi scheme (i.e., paying old investors with money from new investors, instead of profits) known as the Manhattan Investment Fund, Ltd. (the" Manhattan Investment Case") and has published opinions that disclose some of his views on relevant issues. In that case, a bankruptcy trustee for a fund with approximately $400 million under management that had been operated as a Ponzi scheme sued Bear Stearns in its capacity as a broker to the fund to recover various payments, including margin calls.

Bankruptcy Code Provisions Applicable in a SIPA Liquidation

In many respects, the powers of the SIPC trustee overseeing a SIPA proceeding mirror the powers of a Chapter 7 trustee overseeing a bankruptcy liquidation. Accordingly, Trustee Piccard wields many of the same powers that a Chapter 7 bankruptcy trustee would exercise if Madoff Securities were a debtor in a liquidation case under the Bankruptcy Code. In fact, the SIPA expressly provides that the trustee shall be vested with the same powers and title with respect to the broker/dealer and its property, including the same rights to avoid preferences, as a bankruptcy trustee. Furthermore, the SIPA expressly provides that, to the extent possible, the SIPA liquidation is to be conducted in accordance with Chapters 1, 3, and 5 and Subchapters I and II of Chapter 7 of the Bankruptcy Code. Trustee Piccard already has utilized Section 365 of the Bankruptcy Code to obtain an order authorizing him to reject certain expensive automobile leases that Madoff Securities had executed before his appointment.

Chapter 5 of the Bankruptcy Code delineates a trustee's powers to avoid (or recapture) certain transfers of property made prior to the commencement of the SIPA proceeding. These powers are colloquially referred to as the trustee's "clawback" authority. Specifically, Section 548 of the Bankruptcy Code authorizes the SIPC trustee to reach back 2 years to recover fraudulent conveyances. There are two general types of fraudulent conveyances: (a) a transfer made with actual intent to hinder, delay or defraud creditors (i.e., an actual fraudulent transfer) and (b) a transfer made for less than reasonably equivalent value or fair consideration by an entity that is insolvent or undercapitalized (i.e., a constructive fraudulent transfer). Similarly, Section 544 of the Bankruptcy Code authorizes a trustee to sue under applicable nonbankruptcy law to recover fraudulent conveyances (both actual and constructive) and thereby take advantage of even longer reachback periods under nonbankruptcy law.

In addition to the power to recover transfers made prior to the SIPA proceeding, the SIPA trustee also is responsible for investigating the acts, conduct and condition of the broker/dealer.

The Teachings from the Bayou Case

In the summer of 2005, a group of hedge funds with a reported $450 million in assets under management that Samuel Israel and Daniel Marino had organized under the "Bayou" name abruptly collapsed. Not unlike the allegations that have surfaced regarding Madoff Securities, the Bayou funds generated false performance summaries and false financial statements designed to mislead investors, under cover of purported "audits" by an accounting firm.

Ultimately, Israel and Marino pled guilty to multiple counts of wire fraud, investment adviser fraud, mail fraud and conspiracy arising from their operation of a massive Ponzi scheme. They currently are serving long prison sentences.

Unlike Madoff Securities, however, the Bayou funds were not subject to oversight by the SIPC because they were not broker/dealers. Instead, a federal court lawsuit was filed against the Bayou entities (the "Bayou case") and shortly thereafter a receiver was appointed to conduct the liquidation of the Bayou Onshore Funds. The receiver then elected to place the Bayou Onshore Funds into a Chapter 11 bankruptcy proceeding in the United States Bankruptcy Court for the Southern District of New York.

The Bayou bankruptcy estate filed numerous suits in the New York Bankruptcy Court against those investors who had redeemed their investments prior to the public collapse of the fund in August 2005. The suits were brought under Section

548(a) of the Bankruptcy Code, and Sections 273 through 276 of the New York Debtor and Creditor Law, to recover, as fraudulent conveyances, the amounts paid to redeeming investors, including both the principal invested and "fictitious profits" fraudulently reported by the Bayou hedge funds' prior management.

Those who were fortunate enough to have redeemed some or all of their funds prior to the Bayou funds' collapse argued in their defense that they should not have to return any distributions because they had obtained repayment of amounts owed to them on account of their initial investments into the Bayou funds. The court agreed with the redeeming investors, but only to a limited extent and in a way that did not provide them with very much protection. It determined that the "defendants gave reasonably equivalent value for their redemptions to the extent of their original investments." That determination, however, only protected the redeeming investors from a constructive fraudulent conveyance claim. It did not protect the redeeming investors from the allegation, also made against them in the litigation, that the Bayou funds had acted with the actual intent to hinder, delay and defraud investors.

In light of the undisputed evidence (including Israel's and Marino's guilty pleas in the criminal proceeding) that the Bayou funds were run as a Ponzi scheme, the court also had no trouble concluding that any redemption payments made by the Bayou funds, including repayments of principal and fictitious profits, were in fact made with actual intent to hinder, delay or defraud creditors. Once a court determines that an entity has been operating as a Ponzi scheme, the court then presumes that all transfers made by the entity to further the scheme were made with actual fraudulent intent. This is known as the "Ponzi scheme presumption."

Based upon the finding that the Bayou funds had acted with actual fraudulent intent, Judge Hardin further concluded the payments made to redeeming investors were fraudulent conveyances, even though the recipients of those payments were not guilty of any wrongdoing whatsoever. In that regard, Judge Hardin reasoned that the relevant provisions under New York law and the Bankruptcy Code rendered the intent of the transferee (e.g., the redeeming investor) irrelevant when determining whether the redemption was made with actual fraudulent intent. Significantly for the SIPA proceeding in the Madoff Securities case, other judges sitting in the United States Bankruptcy Court for the Southern District of New York (including Judge Lifland, who is presiding over the Madoff case) have held otherwise and have concluded that an actual fraudulent conveyance under New York law does require a showing that the transferee (e.g., the redeeming investor) participated or acquiesced in the fraudulent act. Judge Lifland expressly noted in a 2002 opinion from the Manhattan Investment case that under Section 276 of the New York Debtor and Creditor Law, "a cause of action must allege fraudulent intent on the part of the transferor as well as the transferee."

In all likelihood, Judge Hardin's rulings in the Bayou bankruptcy case will be appealed to a higher court, unless the remaining defendants and plaintiffs settle their disputes before then. Nonetheless, those rulings remain "good law" in the New York Bankruptcy Court, although they are not binding on other New York bankruptcy judges, including Judge Lifland, as he presides over the liquidation of Madoff Securities.

The Good Faith Defense to the Recovery of Principal Payments

Although Judge Hardin concluded that all of the redemptions made to Bayou investors within a year of the bankruptcy filing were made with actual fraudulent intent, he also concluded that redeeming investors could retain repayments of principal, to the extent that they could establish what is termed the "good faith defense." The good faith defense is available to shield from recovery a transfer that is otherwise made in fraud of creditors. Judge Lifland also recognized the availability of the

good faith defense in the Manhattan Investment case.

As a threshold matter, the good faith defense only shields transfers made for "fair consideration" or "reasonably equivalent value." Therefore, the defense did not apply in the Bayou case to the fictitious profits that some investors received along with the repayment of their principal when they obtained redemptions from the Bayou funds. Many courts have recognized that fictitious profits, or interest payments, transferred to Ponzi scheme investors are subject to recovery and are not eligible for the good faith defense.

Additionally, to invoke the good faith defense, the redeeming investors in the Bayou case had to show that they did not know, and they did not have a reason to know, that Israel and Marino operated the Bayou funds as a Ponzi scheme. Investors thus had to establish that they lacked actual notice of the fraud and, more importantly, that they were not on "inquiry notice" (i.e., that there were no red flags) of the fraud.

In the Bayou case, the court considered a redeeming investor to be on "inquiry notice" if it knew or should have known of information placing it objectively "on alert that there was a potential problem" with the Bayou hedge funds so that the redeeming investor "should have attempted to learn more." In the Manhattan Investment case, Judge Lifland expanded upon this objective test, observing that the determination of whether an entity had inquiry notice requires an assessment of what the transferee objectively knew or should have known, "rather than examining what the transferee actually knew from a subjective standpoint."

Based upon this test, Judge Lifland also determined that Bear Stearns was on inquiry notice when one of its senior managing directors had a "conversation [in December of 1998] regarding the Manhattan Investment Fund at a party," and was "told by an individual who … had clients that invested in the Fund, that the Fund was reporting a 20% profit for the year." Because that information substantially conflicted with the employee's own "impression that the Fund was losing money based on his participation in risk-related conference calls in which the Fund had been mentioned," Judge Lifland concluded that Bear Stearns was on inquiry notice of the Fund's fraud from a year before the Fund actually failed in December 1999.

The Bayou and Manhattan Investment cases also explain that an entity having inquiry notice of a potential fraud can still be protected by the good faith defense as long as it establishes that it conducted a diligent investigation and did not merely put its head in the sand and collect distributions.

The good faith defense may well provide a measure of protection to entities that successfully obtained redemptions from Madoff Securities, particularly where some very sophisticated institutional investors, as well as the SEC, did not detect Madoff's alleged fraud. Whether those entities should have, or even could have, detected the fraud is another issue that is likely to spawn considerable litigation.

Secondary Liability for a Fraudulent Conveyance

Judge Hardin's opinion in the Bayou case addressed the liability of those who received payments directly from the Bayou funds. However, a fraudulent conveyance also can be recovered from a downstream party who secondarily receives the transfer (known as a "subsequent transferee"). A party "for whose benefit" a fraudulent transfer was made also can be held liable for its return under certain statutes. Thus, entities can be secondarily or derivatively liable for a fraudulent conveyance.

The potential for secondary liability raises some thorny questions for entities that obtained transfers from Madoff Securities and certain downstream parties. For example, if a feeder fund that invested with Madoff Securities obtained a redemption request from its own investor, and then obtained a corresponding redemption from Madoff Securities to honor its investor's request, questions undoubtedly will arise as to whether Trustee Piccard can bring a fraudulent conveyance suit against the investor in the feeder fund (as well as the feeder fund itself) on the grounds that the investor either was a subsequent transferee of the fraudulent conveyance, or was the entity for whose benefit the transfer out of Madoff Securities was made.

It remains to be seen whether Trustee Piccard will try to recover from indirect investors in Madoff Securities who obtained redemptions from a feeder fund[1].

Lengthy Reachback Period for Fraudulent Conveyances

There has been discussion in the media about how far back Trustee Piccard can reach to capture amounts that Madoff Securities distributed to investors. The answer will be influenced, in substantial part, by the laws that are likely to apply, including applicable nonbankruptcy laws.

First, Section 548 of the Bankruptcy Code authorizes Trustee Piccard to reachback 2 years to recover distributions to investors[2]. When a suit is filed under Section 548 in a bankruptcy case, the 2 years commences on the date the bankruptcy is filed. Less clear is when the 2 year period begins in a SIPA liquidation proceeding.

Additionally, Section 544 of the Bankruptcy Code enables Trustee Piccard to utilize the reachback period that is available to any Madoff Securities unsecured creditor who would have the right, absent the SIPC proceeding, to avoid a transfer made by Madoff Securities under applicable nonbankruptcy law. For obvious reasons, trustees often invoke Section 544 in an effort to apply the longest reachback period possible under applicable nonbankruptcy law.

Nearly every state has one or more statutes that permit creditors to sue to recover fraudulent conveyances. Such laws also exist at the federal level and can be used when the federal government is the creditor. Although uniform state laws do exist (e.g., the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act), not all states have adopted them. Further, even if a state has adopted a uniform fraudulent conveyance law, the applicable reachback period may not be a part of the uniform law and may depend upon the particular state's statute of limitations. Statutes of limitations do vary to a considerable extent.

For example, under New York law, a creditor can seek to recover a fraudulent transfer made within 6 years. In Florida, the reachback period is 4 years. Under the Internal Revenue Code, a federal statute, the IRS can go back 10 years to recover fraudulent transfers. The court hearing the matter would decide disputes about which law and which reachback period or statute of limitations should apply[3].

[1] In the Enron bankruptcy case pending in the United States Bankruptcy Court for the Southern District of New York before Judge Gonzalez, a suit to recover preferential payments was asserted against certain holders of Enron commercial paper who received payment within 90 days of the bankruptcy filing. In some instances, Enron sued not only the direct recipients of the payments, but also the customers of those entities on the theory that the customers ultimately received the proceeds of the transfers. Many of those claims have been settled.

[2] Section 548 was amended effective October 2005 to extend the reachback period from 1 year to 2 years.

[3] The factors that courts consider in deciding which law to apply include: the state in which the lawsuit is brought, the state with the most substantial connection to the matter, and whether the applicable law involves the assertion of a substantive right and remedy, or relates mainly to the implementation of a procedural rule.

Conclusion

Trustee Piccard's ability to clawback redemption payments is not unbridled. There are powerful defenses that can and will be advanced, including the good faith defense that protected many redeeming investors in the Bayou case. Additional defenses also are likely to be developed as the facts surrounding what Madoff did come into sharper focus. Entities and individuals that are in any way concerned about potential clawback liability should consider consulting with a lawyer before Trustee Piccard exercises his claw.

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