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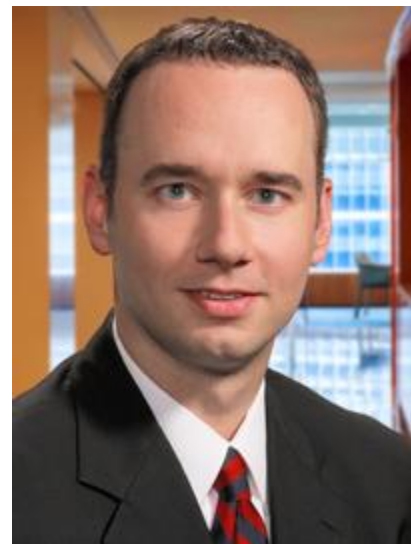
A Significant Expansion Of Section 546 In Madoff Ruling

Law360, New York (January 14, 2015, 1:38 PM ET) --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In a highly anticipated decision, the U.S. Court of Appeals for the Second Circuit ruled in Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Investment Securities LLC)[1] that Securities Investor Protection Act trustee Irving H. Picard could not recover certain prepetition withdrawal payments made to Madoff's customers. Relying on the broad language of the Bankruptcy Code, the Second Circuit held that Section 546(e) shields these payments from recovery even though no securities were actually purchased or sold.

The decision represents a significant expansion of the scope of Section 546's reach and provides further guidance to market participants on the interpretation of the terms "securities contract," "in connection with" and "settlement payment" as used in Sections 546 and 741. Moreover, in the Second Circuit and other jurisdictions that follow its reasoning, the decision adversely impacts a trustee's ability to recover prepetition payments made to customers who unknowingly profit from a debtor's fraud to the detriment of the debtor's other customers.

Background

Although many of the facts of Madoff's massive Ponzi scheme are well-known, several details are particularly relevant to the Second Circuit decision.

Before potential customers could invest with the investment advisory unit of Bernard L. Madoff Investment Securities LLC (BLMIS), they were required to execute several documents, including a customer agreement, a trading authorization and an option agreement (the "account documents"). Collectively, these documents authorized BLMIS to open and maintain the accounts and to buy, sell and trade securities and options for the customer's account. They also generally identified the investment strategy BLMIS would purportedly employ, which involved timed purchases of S&P 100 stocks and option hedges.

In reality, BLMIS conducted no securities or options trading on its customers' behalf. Instead, BLMIS fabricated account statements showing fictitious securities trading activity and profits, and made all customer deposits and withdrawals from a single commingled checking account.

In December 2008, Madoff's scheme was exposed, and trustee Picard was appointed for BLMIS pursuant

to the Securities Investor Protection Act. The trustee commenced recovery actions against hundreds of BLMIS customers who had withdrawn funds from Madoff's scheme. Asserting both actual and fraudulent transfer claims as well as preference claims, the trustee sought to claw back these withdrawal payments so they could be distributed ratably for the benefit of all BLMIS customers.

After withdrawing the bankruptcy reference in over 80 clawback actions, U.S. District Judge Jed S. Rakoff concluded, in two separate decisions from September 2011 and April 2012, that the Section 546(e) safe harbor for securities contracts applied, and dismissed the clawback claims except for claims based on actual fraudulent transfers under Section 548(a)(1)(A), which are specifically excepted from Section 546(e). The trustee appealed.

Section 546(e) and the Trustee's Arguments

Section 546(e) of the Bankruptcy Code provides, in relevant part:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) ..., the trustee may not avoid a transfer that is a ... *settlement payment* ... made by or to (or for the benefit of) a ... stockbroker ... or that is a *transfer* made by or to (or for the benefit of) a ... stockbroker ... *in connection with a securities contract* ..., except under section 548(a)(1)(A). (emphasis added).

On appeal, the trustee principally argued that the customer payments could not qualify as a "settlement payment" or a "transfer in connection with a securities contract" because BLMIS never actually completed the securities transactions contemplated by its customer agreements.[2]

Account Documents Governing the Broker-Customer Relationship Qualify as a "Securities Contract"

The Second Circuit first addressed whether the account documents that BLMIS entered into with its customers qualified as a "securities contract" under Section 741(7) of the Bankruptcy Code. Section 741(7)(A) defines a "securities contract" in relevant part as:

(i) a *contract for the purchase, sale* or loan *of a security* ... or ... option to purchase or sell any such security ...;

(vii) any other agreement or transaction that is *similar to* an agreement or transaction referred to in this subparagraph ...;

(x) a *master agreement* that provides for an agreement or transaction referred to in clause (i) [or] ... (vii) ...; or

(xi) any security agreement or arrangement ... related to any agreement or transaction referred to in this subparagraph, including any guarantee or *reimbursement obligation* by or to a stockbroker[3] .... (emphasis added).

Relying on the "extraordinary breadth" of the definition, the Second Circuit found little difficulty in extending it to the account documents.

Although the trustee argued that the account documents merely established an "agency" relationship, and therefore were "no more contracts for the purchase and sale of a security than a real estate brokerage agreement is a contract for the purchase or sale of a house," the Second Circuit disagreed. In particular, the Second Circuit was persuaded that the account documents qualified as "a contract for the

purchase, sale or loan of a security" because the customers' deposits and withdrawals "originated with" and "could not have been possible but for" the relationship created by the account documents.

Furthermore, the Second Circuit found the account documents qualified as a "securities contract" because they reflected the parties' "mutual assent that BLMIS would conduct securities transactions on the customers' behalf pursuing a specific investment strategy." As such, they qualified as both a "master agreement" — which, in the securities industry, refers to "a contract establishing the mutual undertakings between two counterparties that anticipate executing future securities transactions with each other" — and an agreement or transaction that is "similar to" a contract for the purchase or sale of a security.

Moreover, the Second Circuit held it was sufficient that the account documents merely identified the type of public securities (S&P 100 stocks) to be traded, and did not require, as the trustee argued, that they specify the terms of any particular securities transactions (such as the securities, issuer, quantity or price).

The Second Circuit also rejected the trustee's argument that the account documents could not be a "securities contract" because BLMIS never actually undertook any securities transactions. The Second Circuit refused to read "a purchase and sale requirement" into the express language of Sections 741(7) and 546(e), in part because doing so would essentially allow a broker's breach of contract to nullify the nature of the agreement itself and the protections of the Bankruptcy Code, thereby undermining the customer's expectations.

Ultimately, the Second Circuit concluded, as a policy matter, that the securities market would benefit from protecting these payments from avoidance even though no actual securities transactions were involved, since allowing the trustee to claw back "millions, if not billions of dollars from BLMIS clients — many of whom are institutional investors and feeder funds" — would likely cause the very "displacement" that Section 546(e) was designed to avoid.

Customer Payments were Made "in Connection with" Securities Contracts

The Second Circuit next turned to the question of whether the customer withdrawals were made "in connection with" a securities contract. The Second Circuit stated that the "low bar" set by Section 546(e) for this requirement merely required that a transfer be "related to" or "associated with" a securities contract, even if the agreements were either irrelevant to the payments or the payments were unauthorized. In other words, a payment would be protected under the safe harbor even if it was not made "pursuant to," "in accordance with the terms of" or "as required by" the securities contract itself.

Thus, the Second Circuit held the customer withdrawals were made "in connection with" the account documents even though these payments were fraudulently made from the fictitious profits of a Ponzi scheme whose actions not only breached the account documents, but violated applicable law.

Customer Payments were "Settlement Payments"

As an alternative basis for applying Section 546(e), the Second Circuit concluded the customer withdrawals were protected from avoidance as "settlement payments,"[4] a term that has been construed broadly to apply to "the transfer of cash or securities made to complete [a] securities transaction." Although the trustee argued that the transfers never settled any actual securities trades,

the Second Circuit focused instead on the fact that the customers intended BLMIS to liquidate securities to meet their withdrawal request "even if the broker may have failed to execute the trade and sent ... cash stolen from another client."

Shielding Payments from Avoidance Did Not Give Legal Effect to Fraud

The Second Circuit also rejected the trustee's argument that "to allow customers to retain the fictitious profits Madoff arbitrarily bestowed on them amounts to giving legal effect to his fraud." The trustee argued that doing so would undermine the court's prior decision in In re BLMIS, 654 F.3d 229 (2d Cir. 2011). There, the Second Circuit rejected the argument that each BLMIS customer's "net equity" should be calculated using its fictitious account statements — i.e., as one judge quipped, that "the fund should pay out in respect of each investor whatever amount Madoff made up chewing on his pencil and looking at the ceiling"[5] — because it would effectively legitimize Madoff's underlying fraud.

Although "compelling," the Second Circuit ultimately found the trustee's argument unavailing since the court was obliged to respect the balance Congress struck in enacting Section 546(e) — namely, "for a very broad range of securities-related transfers, the interest in finality is sufficiently important that they cannot be avoided by a bankruptcy trustee at all, except as actual fraudulent transfers ...."

Observations

Continuing the trend established in the Second Circuit's recent Quebecor and Enron decisions,[6] the Second Circuit Madoff decision extends the "very broad" reach of Section 546's safe harbor protections. In addition, the Second Circuit's extension of the "securities contract" definition to agreements that establish and govern a customer relationship, as well as its discussion of the terms of such agreements (e.g., reimbursement obligations and terms identifying the types of securities and investment strategy to be employed), provide important guidance to market participants on the application of the safe harbors.

It should be noted, however, that the decision does not mean that the existence of actual fraud is wholly irrelevant to the safe harbor analysis. Importantly, because Section 546(e) contains an express exception for Section 548(a)(1)(A), trustees are not barred from recovering actual fraudulent transfer payments made "with actual intent to hinder, delay, or defraud" creditors.[7]

Nevertheless, Section 546(e) undoubtedly places an obstacle in front of a powerful tool the trustee previously had at his disposal, since it forecloses a trustee's ability to take advantage of preference and constructive fraudulent transfer actions under the Bankruptcy Code and avoidance actions under state law (which may contain longer statutes of limitations).[8]

Notably, multiple courts in prior decisions have expressed reluctance to extend the protections of the Bankruptcy Code's safe harbors to the Ponzi scheme context or where fraud or other illegitimate activities were implicated.[9] Thus, the Second Circuit's decision, together with recent decisions from the Seventh Circuit,[10] stand squarely in opposition to these earlier decisions. Given the circuit split, the decision will almost certainly be appealed to the U.S. Supreme Court, and thus the last judicial chapter on this issue may not have been written just yet.

Moreover, Congress could always choose to take action to amend the statute. Recently, a special commission of the American Bankruptcy Institute released a report recommending certain reforms to Chapter 11 of the Bankruptcy Code. Among other things, the ABI report recommends that Section 546(e) should be amended so that its protections would not extend to actual fraudulent transfers

whether brought under state law or Section 548(a)(1)(A), thus potentially increasing the look-back period beyond the two-year period proscribed under the Bankruptcy Code.

The ABI commission also considered — but ultimately rejected — narrowing Section 546(e) so that its protections would apply only to transfers received "in good faith." Although the ABI commission acknowledged that the good-faith standard "could align with the objectives of both the safe harbor and fraudulent transfer law," it concluded that administering and litigating such a standard would likely create undesired uncertainty in the markets. It remains to be seen whether, in the wake of the Second Circuit decision, the Supreme Court grants certiorari to hear an appeal of the decision, or Congress, acting on its own initiative or the ABI report's recommendations, amends the safe harbor statute. For the moment, however, the decision is a roadblock for the trustee, who has otherwise recovered over $10 billion on behalf of BLMIS customers.

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[1] No. 12-2557-bk(L) (2d Cir. Dec. 8, 2014).

[2] The parties did not dispute that BLMIS qualified as a "stockbroker."

[3] The Second Circuit found that the account documents qualified as a "security agreement or arrangement ... [including a] reimbursement obligation" because they obligated BLMIS to reimburse its customers upon a withdrawal request.

[4] Section 741(8) defines "settlement payment" as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

[5] Transcript of Oral Argument at 18, In re BLMIS, No. 10-2378 (2d Cir. Mar. 3, 2011).

[6] Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.), 719 F.3d 94 (2d Cir. 2013) (payments to noteholders in exchange for private placement notes were protected by Section 546(e)); Enron Creditors Recovery Corp. v. Alfa, S.A.B. De C.V., 651 F.3d 329 (2d Cir. 2011) (redemption payments were protected from avoidance as "settlement payments" under Section 546(e)).

[7] In addition, Judge Rakoff held in another Madoff decision that transferees who had "actual knowledge" of Madoff's fraud could not avail themselves of the Section 546(e) safe harbor because they could not have reasonably expected their agreements to be "securities contracts" or their payments to be "settlement payments." SIPC v. BLMIS (In re Madoff Secs.), 2013 WL 1609154, at *1-2 (S.D.N.Y. Apr. 15, 2013) ("Cohmad"); see also O'Connell v. Penson Fin. Servs Inc. (In re Arbco Capital Mgmt LLP), 498 B.R. 32 (Bankr. S.D.N.Y. 2013) (extending Cohmad's exception to transferees who were "willfully blind" to or exercised "conscious disregard" of Ponzi scheme).

[8] In Madoff, the dismissal of the state law claims means that the trustee will be limited to recovering transfers made within two years of the petition date under Section 548(a)(1), instead of the six-year clawback period under New York's fraudulent conveyance law.

[9] See, e.g., In re Slatkin, 525 F.3d 805 (9th Cir. 2008); Wider v. Wooton, 907 F.2d 570 (5th Cir. 1990) (Section 546(e) did not apply since Ponzi scheme operator was not a "stockbroker" and applying Section 546(e) would lend judicial support to Ponzi schemes by rewarding early investors at the expense of later victims); Kippermann v. Circle Trust FBO (In re Grafton Partners LP), 321 B.R. 327 (BAP 9th Cir. 2005); cf. Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406 (S.D.N.Y. 2001) (payments by stockbroker engaged in criminal conduct were not settlement payments because they were not "commonly used in the securities trade").

[10] See Peterson v. Somers Dublin Ltd., 729 F.3d 741, 749-50 (7th Cir. 2013) (Section 546(e) protected redemption payments to customers of hedge fund that ran Ponzi scheme; Section 546(e) was not limited to legitimate transactions and customers had "securities" notwithstanding the fraudulent activities); Grede v. FCStone LLC, 746 F.3d 244 (7th Cir. 2014) (payments made to customers by investment management firm that engaged in activities that were illegal and contravened its investment agreements were protected from avoidance under Section 546(e)).

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