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Alert Memo

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Southern District of New York Decision Finds That Bankruptcy Code Section 546(e) Safe Harbor Applies To Protect Transfers Made To Madoff Customers

On September 27, 2011, in *Picard v. Katz*, No. 11-03605 (JSR) (SDNY Sept. 27, 2011) (Docket No. 40), Judge Rakoff granted, in part, the defendants' motion to dismiss the Madoff Trustee's amended complaint. In dismissing all but two of the Trustee's claims, the Court ruled that (1) the safe harbor provision in Section 546(e) of the Bankruptcy Code is applicable to transfers made by Bernard L. Madoff Investment Securities ("BLMIS") to BLMIS customers and thus the only avoidance claims the Trustee may assert are the Section 548(a)(1)(A) intentional fraud claims with a two-year look-back period, (2) disallowance of BLMIS customers' creditor claims against the BLMIS estate is inconsistent with SIPA, (3) equitable subordination of creditor claims is appropriate only where a creditor acts in bad faith, and (4) bad faith in SIPA proceedings is measured by a "willful blindness" standard.

Statutory Framework

By way of background, there are primarily four Bankruptcy Code provisions discussed in Judge Rakoff's decision.

Section 547 of the Bankruptcy Code permits a trustee to "avoid" (i.e., unwind) "preference payments", defined as payments made by a debtor in preference to one creditor over another. A preference payment may be avoided regardless of the intent of the parties or the validity of the transfer if the transfer occurred within 90 days of the debtor filing for bankruptcy. 11 U.S.C. § 547(b).

Section 548 of the Bankruptcy Code permits a trustee to avoid "fraudulent transfers" under two theories. A trustee may avoid an actually fraudulent transfer under Section 548(a)(1)(A) of the Bankruptcy Code where the transfer is made by an insolvent debtor "with actual intent to hinder, delay or defraud" its creditors. 11 U.S.C. § 548(a)(1)(A). Section 548(a)(1)(B) permits a trustee to recover a constructively fraudulent transfer where the debtor makes a transfer to a creditor for "less than a reasonably equivalent value." 11 U.S.C. § 548(a)(1)(B). Further, under Section 548(a)(1) a trustee can only avoid transfers that occurred within two years of the date the debtor filed for bankruptcy (i.e., the "two year look-back period").

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Section 544 of the Bankruptcy Code permits a trustee to invoke any available state law avoidance powers at his disposal, and recognizes such powers under the Bankruptcy Code. In New York, Sections 273 through 279 of the New York Debtor and Creditor Law enable a trustee to avoid fraudulent transfers under theories that are similar in substance to Section 548(a)(1) of the Bankruptcy Code. One important difference between the bodies of law is that the New York Debtor and Creditor Law authorizes a trustee to avoid fraudulent transfers that occurred up to six years prior to the filing of the bankruptcy petition, not the two year period under Section 548.

Section 546(e) of the Bankruptcy Code limits the Trustee's powers to invoke certain of the Bankruptcy Code's avoidance provisions (e.g., Sections 544, 547(c) and 548(a)(1)), known as the "safe harbors." This provision precludes a trustee from avoiding any transfer that falls within these safe harbors, except in the case of actually fraudulent transfers. Of relevance here, the safe harbors apply to transfers made as "settlement payments" and to transfers that are "in connection with" a "securities contract." 11 U.S.C. § 546(e).

The Decision

Judge Rakoff, hearing the motion to dismiss after withdrawing the case from the bankruptcy court, dismissed the Trustee's claims, on the basis of Section 546(e) of the Bankruptcy Code, to avoid payments to BLMIS customers as preference payments, constructive fraudulent conveyances, and both actual and constructive fraudulent conveyances under New York state law. Additionally, the Court ruled that the Trustee could not disallow claims made by the defendants against the Madoff estate. The Court denied the motion to dismiss with respect to the Trustee's claims for avoidance of transfers made with actual fraudulent intent, and equitable subordination of the defendants' claims. The significant holdings of the decision include:

- The "settlement payment" and "securities contract" safe harbor provisions in Section 546(e) of the Bankruptcy Code preclude the Trustee from "bringing any action to recover from any of Madoff's customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud." Thus, the Trustee may only bring avoidance claims for transfers made with actual fraudulent intent under Section 548(a)(1)(A) of the Bankruptcy Code. Accordingly, Judge Rakoff dismissed all of the avoidance claims the Trustee purported to bring under the Section 547 preference and Section 548(a)(1)(B) constructive fraud avoidance provisions as well as the New York state law claims brought pursuant to Section 544 of the Bankruptcy Code with their six year (or potentially longer under New York State's "discovery rule") look-back periods.

- Section 502(d) of the Bankruptcy Code, which allows the Trustee to disallow claims until avoidable transfers are returned to the Debtor's estate, is inconsistent with, and "overridden" by, SIPA; thus the Trustee is precluded from disallowing claims made

against the BLMIS estate by customers on the basis that they received and had not returned an avoidable transfer.

- Although the customers' claims may not be disallowed, they may be equitably subordinated, pursuant to Section 510(c) of the Bankruptcy Code, upon a showing that the customer-claimant "did not receive the fraudulent transfers in good faith."

- In SIPA proceedings, where bankruptcy law is informed by federal securities laws, good faith is determined under a subjective standard of "willful blindness" on behalf of the transferee, not under an objective standard of the transferee being on "inquiry notice" of possible fraud followed by a failure to diligently investigate. The Court defined "willful blindness" as a party "intentionally choos[ing] to blind himself to the 'red flags' that suggest a high probability of fraud." Further, the Court rejected the argument that an investor has a duty to investigate the activities of his stockbroker "simply [because it is] confronted with suspicious circumstances" and held that "lack of due diligence cannot be equated with a lack of good faith" for purposes of Section 548(c).

- Although Judge Rakoff's opinion makes clear that the Trustee's avoidance powers are limited to transfers which occurred within Section 548(a)(1)'s two-year look-back period, one issue left open by the decision is whether certain payments received by the defendants during that period should be characterized as a return of principal or as a return of net profits on their investments. This determination could turn on whether the test of profitability is limited to the two-year avoidance period or whether profitability is measured by investment performance over the entire term of the investment. This distinction is relevant because Judge Rakoff found that any net profits received by "winning" investors in a Ponzi scheme within Section 548(a)(1)'s two-year look-back are presumptively avoidable transfers. By contrast, transfers which simply represent a return of all or a portion of an investment are presumptively for "value" and are therefore only avoidable if as a result of the investor's knowledge of the fraud or willful blindness the investor did not receive the transfers in "good faith". In an order issued on September 28, 2011, Judge Rakoff directed the parties to set a briefing schedule to resolve this open question.

Discussion:

In ruling on the applicability of the safe harbor provision in Section 546(e) of the Bankruptcy Code, the Court made several important threshold rulings inconsistent with prior decisions by Judge Lifland in the Bankruptcy Court: first, that BLMIS, which was a registered brokerage firm, was a "stockbroker"; second, that "the kind of contract[s] Madoff Securities ha[d] with its customers," which established brokerage discretionary accounts, were by definition "securities contracts"; and third, that all payments BLMIS made to its customers were "clearly" settlement payments.

Judge Rakoff's analysis was based on the application of the plain meaning of the statutory text, rejecting arguments to consider policy-based considerations gleaned from legislative history. Importantly, Judge Rakoff indicated this is the mode of analysis of Section 546(e) required by the Second Circuit's decision in *In re Enron Creditors Recovery Corp.*, 2011 WL 2536101 (2d Cir. 2011).[1]

Moreover, even were it relevant to consider matters outside the language of the statute, the Court, citing the Trustee's own language in the amended complaint describing the size of the BLMIS fraud, rejected the Trustee's argument that unwinding BLMIS's transfers to its customers does not have the potential to cause upheaval in the securities markets, placing such transfers outside the legislative intent of the safe harbor provision.

Judge Rakoff's opinion stands in sharp contrast with *Picard v. Merkin*, where Judge Lifland held it was premature to decide the issue of whether Section 546(e) applied on a motion to dismiss. Judge Lifland also expressed doubt as to the applicability of the safe harbor provisions to BLMIS customer transfers because of (1) questions as to whether BLMIS was a stockbroker due to the fact that BLMIS did not perform actual securities transactions, (2) questions as to whether BLMIS customer contracts constituted securities contracts, and (3) claimed inconsistencies between the safe harbors and the purposes of SIPA. *See Picard v. Merkin*, 440 B.R. 243, 266-69 (Bankr. S.D.N.Y. 2010) ("*Merkin*").

District Judge Wood dismissed an attempted interlocutory appeal of the Merkin decision on the grounds that defendants had not met the standard for obtaining such an appeal. She therefore declined to reach the merits of whether the safe harbor provision applied to the BLMIS customer transfers. *See generally, Picard v. Merkin*, 2011 WL 3897970 (S.D.N.Y. 2011). On all of the issues on which defendants sought appeal, Judge Wood found that the defendants had failed to demonstrate either a substantial ground for a difference of opinion on a controlling question of law (i.e., the defendants did not present contradictory authority to Judge Lifland's rulings), or that granting an appeal would materially advance the litigation – two required elements for an interlocutory appeal. Clearly the landscape has changed in light of Judge Rakoff's decision.

The bottom line of Judge Rakoff's opinion is that, with respect to a SIPA Trustee's avoidance powers, the SIPA Trustee will not be able to take advantage of the Bankruptcy Code's avoidance provisions without also being subject to the same defenses Congress determined should be applicable to those claims in a Title 11 case. The Trustee announced he intends to appeal the decision.

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[1] For further discussion of *In re Enron Creditors Recovery Corp.*, please see CGSH Alert Memo: Second Circuit Upholds Determination That Safe Harbor In Section 546(e) Of The Bankruptcy Code Protects From Avoidance Payments Made By A Debtor To Redeem Its Commercial Paper Prior To Maturity (dated June 30, 2011).

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If you have any questions about this case, this alert memorandum or the implications of this case more generally, please contact any of your regular litigation or bankruptcy contacts, or any of our partners and counsel listed under "Bankruptcy and Restructuring" or "Litigation" in the "Practices" section of our website at http://www.clearygottlieb.com.[2]

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[2] The firm represents a number of major institutional defendants in actions brought by the Trustee and other foreign liquidators and represented the prevailing party in: *Picard v. HSBC Bank PLC*, 450 B.R. 406 (S.D.N.Y. 2011) (granting defendants' motion to withdraw the reference of the Trustee's common law claims so that the District Court could resolve issues of standing and preemption under the federal securities laws); *Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y 2011) (holding that the Trustee lacks standing to assert those claims and granting defendants' motion to dismiss); *Inversiones Mar Octava Limitada v. Banco Santander S.A.*, 2011 WL 38232284 (11th Cir. 2011) (affirming district court's dismissal of class action brought on behalf of investors in the Optimal funds on grounds of forum non conveniens and lack of personal jurisdiction); *In re Fairfield Sentry Ltd. Litig.*, 2011 WL 4359937 (S.D.N.Y. 2011) (reversing bankruptcy court's denial of defendants' motions for remand and abstention in actions brought by liquidators of the Fairfield Sentry fund); and *In re Kingate Mgmt. Ltd. Litig.*, 2011 WL 1362106 (S.D.N.Y. 2011) (applying SLUSA and Martin Act preemption to dismiss purported class action complaint and deny leave to replead as futile).

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