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ALERT MEMORANDUM

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Second Circuit Holds that Madoff Trustee Lacks Standing to Assert Common Law Claims on Behalf of Customers

A recent decision of the United States Court of Appeals for the Second Circuit affirmed decisions of the district court holding that the trustee appointed under the Securities Investor Protection Act ("SIPA") to oversee the liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS") lacks standing to assert common law claims on behalf of Madoff's customers against financial institutions that the trustee alleges aided and abetted Madoff's fraud. The decision resolved a split among lower courts by confirming that a 1978 decision, *Redington v. Touche Ross & Co.*, 592 F.2d 617 (2d Cir. 1978), which had addressed the standing of a SIPA trustee but was reversed by the Supreme Court on other grounds and then vacated on remand, does not have precedential effect.

In addition, the Second Circuit held that the doctrine of *in pari delicto* barred the BLMIS trustee from asserting the common law claims on behalf of the BLMIS estate and that there is no right to seek contribution from third parties for net equity payments that the BLMIS trustee has distributed to Madoff customers under SIPA.

The decision will have significant impact not only on the BLMIS liquidation but also on future SIPA liquidations of insolvent broker-dealers because it confirms that a trustee appointed under SIPA is subject to the same *in pari delicto* and standing restrictions that have long been recognized to apply to trustees appointed in ordinary bankruptcy cases and it also clarifies the limited scope of SIPC's subrogation rights.

Background

SIPA was enacted in 1970 to expedite the distribution of cash and securities back to brokerage customers following a broker-dealer's insolvency. The statute grants customers priority claims to a fund of customer property that is held separately from the general estate, with each customer sharing ratably in the fund according to his or her "net equity." In addition, the statute established the Securities Investor Protection Corporation, ("SIPC"), a nonprofit corporation consisting of registered broker-dealers and members of national securities exchanges, which is required under the statute to advance to the trustee up to $500,000 per securities customer in the event that the fund of customer property is not sufficient to satisfy all net equity claims.

The statute provides that a liquidation under SIPA shall be conducted as though it were being conducted under the Bankruptcy Code, subject to the special features and provisions of SIPA, *see* 15 U.S. § 78fff(b), and vests a trustee appointed under SIPA with "the same powers" and title with respect to the debtor and the property of the debtor as a trustee in a case under the Bankruptcy Code. 15 U.S.C. § 78fff-1(a).

It was long ago established by the Supreme Court in *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416 (1972), that a trustee in a case under the Bankruptcy Code has no standing to assert claims on behalf of creditors of the estate, but instead is restricted to asserting claims owned by the estate. In addition, a line of Second Circuit case law stemming from *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991), have applied the doctrine of *in pari delicto* under New York law to hold that claims against third parties for assisting a fraud committed by a corporation's management belong to creditors, not to the corporation's estate in bankruptcy, and therefore may not be brought by the trustee.

The Second Circuit issued its decision in *Redington* in 1978. In *Redington*, a SIPA trustee sought to assert an implied private right of action under Section 17(a) of the Securities Exchange Act of 1934 against the insolvent broker-dealer's accounting firm. A divided panel of the Second Circuit held, over a vigorous dissent by Judge Mulligan, that (1) Section 17(a) created such an implied private right of action, reversing the district court's decision on this question, and (2) a SIPA trustee had standing, under common law principles of bailment and subrogation, to assert the implied Section 17(a) claim on behalf of customers and on behalf of SIPC to the extent it had advanced funds to satisfy customer net equity claims.

On appeal, the Supreme Court reversed *Redington*'s determination that Section 17(a) created an implied right of action, thus finding it "unnecessary to reach" the standing question, and remanded the case for a determination whether there was any basis of federal jurisdiction over remaining state law claims. The Second Circuit issued an order on remand vacating its previous decision and subsequently found that there was no remaining basis for jurisdiction.

Following *Redington*, district and bankruptcy courts in the Southern District of New York disagreed and expressed doubt about whether *Redington*'s holding on the standing issue survived the Supreme Court's reversal on the threshold section 17(a) issue.

The BLMIS Trustee's Claims

The BLMIS trustee has brought over one thousand adversary proceedings asserting claims under the Bankruptcy Code on behalf of the Madoff estate to avoid transfers made prior to the bankruptcy and to recover them from Madoff's customers, which include a number of "feeder funds," as well as from other immediate or mediate transferees, including financial institutions that provided services to feeder funds. In a number of the actions, the BLMIS trustee also has alleged that the defendants aided and abetted Madoff's fraud. In these actions, the trustee has asserted common law claims seeking to recover billions of dollars on behalf of Madoff's customers, as well as claims seeking contribution for payments the trustee has made to satisfy customer net equity claims. All of the actions have been automatically referred to the bankruptcy court pursuant to 28 U.S.C. § 157(a) and the Southern District of New York's standing order of reference.

On February 3, 2011, HSBC Bank plc and several of its affiliates, represented by Cleary Gottlieb, filed a motion pursuant to 28 U.S.C. § 158(d) requesting that the district court withdraw the reference of the adversary proceeding to the bankruptcy court so that the district court could decide, among other issues, whether the BLMIS trustee had standing to assert the common law claims and whether SIPA creates a right of contribution. Other co-defendants in the case,

including UniCredit S.p.A., filed similar motions. The motions to withdraw were assigned to and granted by Judge Jed S. Rakoff.

Defendants in other actions, including JPMorgan Chase and UBS, subsequently filed motions to withdraw the reference raising similar arguments, which were assigned to and granted by Judge Colleen McMahon.

The District Court's Decisions

On July 28 2011, Judge Rakoff issued a decision granting the motions to dismiss filed by HSBC and several co-defendants and dismissing the common law and contribution claims. The district court held that the BLMIS trustee was *in pari delicto* with the defendants and therefore could not assert the common law claims on behalf of the BLMIS estate, lacked standing to assert the claims on behalf of customers notwithstanding *Redington*, which Judge Rakoff found was no longer good law and, in any event, was distinguishable, and could not demonstrate a right of contribution.

In November 2011, Judge McMahon likewise concluded that the Trustee lacked standing to sue on behalf of customers and had no valid claim for contribution, and dismissed the claims against JPMorgan and UBS. The trustee appealed both decisions, and the appeals were consolidated and heard in tandem by the Second Circuit.

The Circuit Court's Decision

On June 20, 2013, the Second Circuit affirmed the decisions of the district court. The Court first held that the BLMIS trustee, "who stands in Madoff's shoes," was barred from asserting claims directly against the defendants on behalf of the Madoff estate for the fraud that Madoff orchestrated. The Court cited the holding from its *Wagoner* line of cases, based on the doctrine of *in pari delicto* under New York law, that a "claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporations." Accordingly, the BLMIS trustee could not assert common law claims on behalf of the BLMIS estate against third parties for allegedly assisting Madoff in the fraud.

The Court then turned to whether the BLMIS trustee could assert on behalf of the estate claims for contribution, which are not barred by *in pari delicto*, for payments the estate has made to satisfy customer net equity claims pursuant to SIPA. In holding that the BLMIS trustee could not assert such a contribution claim, the Court found dispositive the fact that SIPA does not expressly provide for any right of contribution. Nor could the BLMIS trustee rely on the right of contribution created under a New York state statute because the payment obligation for which the trustee sought contribution was imposed by SIPA, a federal statute, and not state law. Therefore, the Court affirmed the dismissal of the Trustee's contribution claims.

Finally, the Court considered whether the BLMIS trustee could assert common law claims on behalf of BLMIS's customers. The Court first reviewed the principles established in the Supreme Court's 1972 decision in *Caplin* that federal bankruptcy law does not empower a trustee to sue on behalf of creditors. The Court then rejected the BLMIS trustee's reliance on *Redington* and concluded that the Supreme Court's reversal on the threshold issue of whether

Section 17(a) created a cause of action "drained" the Second Circuit's opinion of any force on the standing question, and that the Second Circuit's vacatur of its original decision on remand further "dissipate[d] [its] precedential force." The Court acknowledged that *Redington* nevertheless "enjoyed something of a half-life," despite being questioned or rejected by several district court judges, and announced that *Redington* "should be put to rest; it has no precedential effect." The Court further found that the claim at issue in *Redington* was in any event distinguishable from those being asserted by the BLMIS trustee.

In addition, the Second Circuit was not persuaded by the Trustee's proposed broad reading of a case called *St. Paul Fire & Marine Insurance Co. v. Pepsico, Inc.*, 884 F.2d 688 (2d Cir. 1989), to argue that his claims were "generalized in nature" and therefore belonged to the BLMIS estate rather than its customers. The Court held that *St. Paul* simply stands for the principle that a trustee has exclusive standing to bring claims that belong to the corporation and it does not give him authority to bring claims belonging to creditors. The Court clarified that a claim is "general" only if "it seeks to augment the fund of customer property and thus affects all creditors in the same way," whereas the BLMIS trustee had "assert[ed] claims on behalf of thousands of customers against third-party financial institutions for their handling of individual investments made on various dates in varying amounts."

The Court also rejected the BLMIS trustee's argument that a SIPA liquidation is "unique" and therefore not controlled by *Caplin* and its progeny because a SIPA trustee is a "bailee" of customer property and has standing to sue in that capacity. The Court first pointed out that SIPA is not "cast in terms of bailment" and expressly confers a SIPA trustee with the "same powers" as a trustee in an ordinary bankruptcy case. The Court also labeled as dubious the trustee's attempt to overlay common law bailment principles onto a statutory framework and, in any event, found the bailment analogy "flawed from start to finish."

Finally, the Second Circuit rejected the BLMIS trustee's argument that, to the extent SIPC has advanced money to pay customer net equity claims, SIPC becomes equitably subrogated to any claims that such customers may have against third parties who allegedly contributed to the loss. The Court found that neither the plain language of SIPA, which expressly grants SIPC only a narrow right of subrogation to the "claims of customers" against the estate, nor a technical amendment in 1978 that added a reference to SIPC retaining "all other rights it may have at law or in equity," evinced any Congressional intent to confer SIPC with broad subrogation rights against third parties. The Court also rejected the trustee's attempt to import insurance law principles of equitable subrogation into the SIPA statutory scheme and quoted a 1992 Supreme Court precedent stating in dicta that a similar argument that had been advanced at that time by SIPC was "fraught with unanswered questions."

In closing, the Court found that allowing a SIPA trustee to assert claims on behalf of customers would create the same difficult questions and practical concerns that the Supreme Court in *Caplin* cited as reasons for denying such powers to trustees in an ordinary bankruptcy context, because the trustee and individual customers might both sue for the same loss. The Court agreed with *Caplin* that "it is better to leave these intractable policy judgments to Congress."

In summary, this decision resolves uncertainty about the scope of a SIPA trustee's standing by restricting it to well-established rules that have long applied to ordinary bankruptcy trustees and allocates standing to the insolvent broker-dealer's customers to bring claims on their own behalf.

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The Cleary Gottlieb team was led by partners Thomas Moloney, who argued the appeal on behalf of HSBC, and David Brodsky, and also included senior counsel Evan Davis and associates Marla Decker, Charles Keeley and Justin Ormand.

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