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No. 14-_____

IN THE

Supreme Court of the United States

IRVING H. PICARD, TRUSTEE FOR THE LIQUIDATION OF BERNARD L. MADOFF INVESTMENT SECURITIES LLC,

Petitioner,

v.

IDA FISHMAN REVOCABLE TRUST ET AL.,

Respondents.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

This case arises from the infamous multi-billion-dollar Madoff Ponzi scheme. Under the Securities Investor Protection Act (SIPA), a trustee was appointed to collect and return funds to Madoff's victims, including by "clawing back" transfers Madoff made to third parties, principally some of his investors. 15 U.S.C. § 78fff-2(c)(3). Respondents are roughly 1700 Madoff investors who received fictitious "profits" from Madoff, which were in fact funds stolen from victims rather than gains from any securities transactions. The trustee attempted to exercise his SIPA clawback power to recover those profits for distribution to thousands of Madoff's victims. SIPA provides that the Bankruptcy Code governs in SIPA proceedings only to "the extent consistent with" SIPA itself. 15 U.S.C. § 78fff(b). But the Second Circuit construed the "stockbroker defense" in the Bankruptcy Code, 11 U.S.C. § 546(e), to bar the relevant clawback claims. That ruling directly precludes the trustee from recovering and distributing to the victims almost $2 billion and calls into question a further $2 billion.

The Questions Presented are:

1. Does the "stockbroker defense" in the Bankruptcy Code, 11 U.S.C. § 546(e), apply to payments that involve only fictitious securities transactions?

2. Is the application of the "stockbroker defense" in the Bankruptcy Code to payments that involve only fictitious securities transactions barred as inconsistent with the Securities Investor Protection Act, 15 U.S.C. § 78fff(b)?

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Irving H. Picard respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

STATUTORY PROVISIONS INVOLVED

The relevant provisions of SIPA are reproduced as Appendix D to the parallel Petition for Certiorari filed by the Securities Investor Protection Corporation. Pet. App. 71a-77a. The relevant provisions of the Bankruptcy Code are reproduced as Appendix E. *Id.* 78a-101a.

OPINIONS BELOW

The opinion of the Second Circuit (Pet. App. 1a-29a) is published at 773 F.3d 411. The district court's opinion (Pet. App. 30a-68a), is published at 476 B.R. 715. The district court's supplemental order modifying the list of affected cases (*id.* 69a-70a) is unpublished.

JURISDICTION

The Second Circuit issued its decision on December 8, 2014. On February 25, 2015, Justice Ginsburg granted petitioner's timely application for an extension of time to file this Petition on or before April 7, 2015. *See* App. No. 14A890. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

Petitioner is the trustee appointed by statute for the liquidation emanating from the Bernard L. Madoff Ponzi scheme. This Petition involves petitioner's effort to "claw back" nearly *$2 billion* in fictitious "profits" withdrawn by certain Madoff customers. In fact, there

were no actual profits; Madoff stole all that money from thousands of other customers. Petitioner seeks to recoup those funds to redistribute them to those who lost their principal in the Madoff scheme. The Second Circuit held, however, that petitioner's efforts were barred under the Bankruptcy Code.

I. Statutory Background

In response to a rash of broker-dealer liquidations, Congress enacted the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. § 78aaa *et seq.*, to protect investors in the event of a securities broker's insolvency. *See Sec. Investor Prot. Corp. v. Barbour*, 421 U.S. 412, 415 (1975). The statute creates a fund of "customer property," separate from any bankruptcy estate, to be distributed to the broker's customers. Each customer shares ratably in this fund of assets to the extent of his net equity.[1] 15 U.S.C. § 78fff-2 (c)(1)(B).

SIPA's protections are invoked by the Securities Investor Protection Corporation (SIPC), a private, not-for-profit entity whose members include most registered broker-dealers. *See Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 261 (1992); 15 U.S.C. § 78ccc(a)(2)(A). SIPC may seek a protective decree in federal court upon determining that a member "has failed or is in danger of failing to meet its obligations

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[1] "Net equity" is the amount the broker would have owed to the customer if the broker liquidated the customer's securities positions, plus the cash deposited by the customer to purchase securities. 15 U.S.C. § 78*lll*(11).

to customers," 15 U.S.C. § 78eee(a)(3)(A), and that the member is insolvent or out of compliance, *id.* § 78eee(b)(1). If the court issues the decree, SIPC selects a trustee to protect the member's customers. *Id.* § 78eee(b)(3). The appointment of the trustee by the court commences the member's liquidation. *Id.* § 78eee(b)(4).

In the liquidation proceeding, a SIPA trustee's duties resemble those of a bankruptcy trustee, but with a particular emphasis on protecting the brokerage's customers. The trustee thus marshals customer property and distributes it ratably to the member's customers. *See id.* § 78fff-2(b) and (c). With respect to insolvent brokers, the success of the liquidation frequently turns on the trustee's exercise of the statutory power to "claw back" funds distributed by the broker. SIPA thus empowers the trustee to recover "customer property" that was transferred by the debtor "to the extent that such transfer is voidable or void under the provisions of title 11 [the Bankruptcy Code]." *Id.* § 78fff-2(c)(3). SIPA incorporates the statutory power under the Bankruptcy Code to avoid preferences, actually fraudulent transfers, and constructively fraudulent transfers. *Id.* § 78fff-1(a); 11 U.S.C. §§ 544, 547, 548. But the provisions of the Bankruptcy Code control only "[t]o the extent consistent with the provisions of" SIPA itself. 15 U.S.C. § 78fff(b).

The Bankruptcy Code contains an exception to the trustee's power to claw back funds known as the "stockbroker defense," under which a

> 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.

11 U.S.C. § 546(e).[2] Congress enacted the defense to protect the securities markets from a scenario in which a court orders the unwinding of trades by an insolvent broker or other market participant, triggering a cascading series of insolvencies by counterparties to those trades. *See* H.R. Rep. No. 97-420, at 2 (1982).

Under the Bankruptcy Code, a "securities contract" includes a range of contracts that execute securities transactions, including "a contract for the purchase, sale, or loan of a security," options to purchase or sell securities, or foreign currency options traded on national exchanges, credit transactions relating to securities trades, and "any other agreement or transaction that is similar to an agreement or transaction referred to" elsewhere in the statutory definition. *See* 11 U.S.C. § 741(7). The definition of a "settlement payment" is largely circular: "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or

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[2] Even when the stockbroker defense would otherwise apply, the trustee may claw back actually fraudulent transfers. 11 U.S.C. § 548(a)(1)(A).

any other similar payment commonly used in the securities trade." *Id.* § 741(8).

II. Facts And Proceedings Below

1. Petitioner is the SIPA trustee appointed for Bernard L. Madoff Investment Securities LLC (BLMIS), which was the vehicle for Madoff's multi-billion-dollar Ponzi scheme. Pet. App. 7a. Petitioner's statutory duty is "to collect and set aside a fund of 'customer property' specifically earmarked to repay BLMIS customers ratably in proportion to each customer's 'net equity.'" *Id.* 10a (citing 15 U.S.C. §§ 78*lll*(4), 78fff-2(c)).

The facts of the scheme are infamous. Madoff took his customers' money and purported to trade stocks and options through BLMIS. Pet. App. 9a. But that was a lie. BLMIS did not engage in any securities trading on its customers' behalf. Rather, BLMIS kept the customers' funds in a commingled checking account, which Madoff used to fund his own lifestyle and make other payments. Those payments from customer funds included fictitious "profits" to customers that made withdrawals from their accounts. *See id.* 9a-10a.

Eventually, the scheme unraveled when investor withdrawals exceeded the funds available and BLMIS's insolvency was exposed. *Id.* 10a. Investors collectively lost approximately $19.5 billion. *See* The Madoff Recovery Initiative, Recoveries to Date, http://www.madofftrustee.com/recoveries-04.html (Feb. 6, 2015). Madoff was convicted and sentenced to 150 years in prison for committing the largest financial

fraud in U.S. history. *See United States v. Madoff*, No. 09 Cr. 0213 (S.D.N.Y. June 29, 2009).

Although the devastating losses caused by Madoff's fraud are infamous, less well known is that thousands of BLMIS customers actually reaped "profits" from the Ponzi scheme by withdrawing more than they put in. But those profits were fictitious; Madoff stole that money from his other customers. *See* Pet. App. 8a. Some of those "net winners" have returned those stolen funds to help make whole the many thousands who lost their principal to the scheme.

2. This case involves those who have not. Petitioner sued those "net winners," seeking to claw back the fictitious profits so that the funds would be available for distribution. *See id.* The district court granted the defendants' motion to dismiss the complaint under the stockbroker defense. The court held that BLMIS was a "stockbroker," the account documents executed by the defendant customers were "securities contracts," and the payments BLMIS made to those customers were transfers "in connection with" those contracts or, in the alternative, "settlement payments." *Id.* 36a-44a.[3]

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[3] The district court applied that ruling in eighty-four cases, *id.* 60a, 70a, and certified its rulings as final judgments under Federal Rule of Civil Procedure 54(b). *Id.* 14a. Hundreds of other similar cases were consolidated for the limited purpose of adjudicating the applicability of the stockbroker defense.

3. The Second Circuit affirmed. The court of appeals reasoned that the Bankruptcy Code defines the term "securities contract" broadly to include "contracts for the purchase or sale of securities, as well as any agreements that are similar or related to contracts for the purchase or sale of securities." *Id.* 15a-17a (citing 11 U.S.C. §§ 741(7)(A)(i), (vii), (x), (xi)). The court of appeals found that a "securities contract" was established by each respondent's customer agreements (referred to as "Account Documents"), which included one or more of an agreement to open an account, a trading authorization to sell securities for the customer's account, and an option agreement regarding options trading for the customers' accounts. Each, the Second Circuit reasoned, contemplated that Madoff would trade in securities. *See id.* 18a.

The Second Circuit conceded that "the record reflects no written contract for the purchase or sale of a specific security between BLMIS and its customers"; that "standing alone, the Account Documents would not effectuate the purchase or sale of any particular security"; and that the Account Documents merely "function by authorizing BLMIS to act as an agent for the customer in unspecified expected future securities transactions." *Id.* 23a-24a. It further acknowledged that, in fact, BLMIS never engaged in securities transactions on its customers' behalf. *Id.* 9a.

Nevertheless, the Second Circuit held that the documents qualified as securities contracts under Section 546(e) because the statute is not limited to cases in which trades actually occur, and because the Account Documents are "sufficiently 'similar'" to a

contract for the purchase or sale of securities to fall within the statutory definition. *Id.* 24a (citing 11 U.S.C. § 741(7)). The court of appeals also concluded that the payments made were "in connection with" these contracts—even though payments in Ponzi schemes are, by definition, separate from any genuine securities contract. *Id.* 25a. The court reached that conclusion by holding that the "in connection with" language in the statute is sufficiently broad to encompass payments that are not contractually required. *Id.* 25a-26a.

The Second Circuit separately held that the transfers to customers constituted "settlement payments." *Id.* 26a-27a (citing 11 U.S.C. § 741(8)). Petitioner pointed out that the payments to respondents were not, in fact, made to settle any securities transactions. But here too, the court of appeals held that the customer's belief that BLMIS would dispose of securities and remit payment to the customer was enough. *Id.* 27a.

Finally, the Second Circuit rejected petitioner's argument that the stockbroker defense should not be read so broadly as "to allow customers to retain the fictitious profits Madoff arbitrarily bestowed on them amounts to giving legal effect to his fraud." *Id.* 28a. Although the court described this argument as "compelling," it concluded that the finality considerations embedded in the Bankruptcy Code trump the investor-protection principles enshrined in SIPA. *Id.* 28a-29a.

4. This Petition followed.

REASONS FOR GRANTING THE WRIT

I. The Questions Presented Are Of Surpassing Importance.

The Second Circuit's ruling in this case extends the stockbroker defense to encompass cash-for-cash transactions, in which no securities were ever bought or sold. The repercussions of that ruling for this case alone are profound. The ruling below directly precludes petitioner from recovering and distributing nearly $2 billion stolen from BLMIS investors, and it calls into question petitioner's authority to recoup more than $2 billion more. The Second Circuit's ruling moreover sweeps in a broad array of cases involving insolvent brokers, gutting SIPA in the process. This Court should grant certiorari to clarify the applicability of the stockbroker defense in such cases. Denying review would only perpetuate confusion and uncertainty at a time when investors can afford neither.

1. The nation's most recent financial crisis has revealed that investors are the victims of a remarkable number of Ponzi schemes. *See generally* Bart Chilton, Commodities Futures Trading Commission, Ponzimonium: How Scam Artists Are Ripping Off America (2011). When, as here, the Ponzi scheme triggers the insolvency of a broker-dealer, customers are protected by the regime supplied by SIPA.

As trustees attempt to achieve equitable results in these cases, clawbacks have grown more common. The district court thus correctly recognized that the extent of a trustee's clawback powers—and hence the

applicability of the stockbroker defense—is a "perennial issue," Pet. App. 31a, and commentators likewise predict that "clawback mechanisms of various sorts will be put to increasing use in the coming months and years" as more devastating fraudulent schemes come to light. Michael C. Macchiarola, *In the Shadow of the Omnipresent Claw: A Response to Professors Cherry and Wong*, Minn. L. Rev. Headnotes (2011), http://www.minnesotalawreview.org/headnotes/in-the-shadow-of-the-omnipresent-claw-in-response-to-professors-cherry-wong-2/.

The resulting body of cases gives rise to significant issues of federal law that this Court has not addressed, but should. At issue is whether the clawback authority provided by SIPA permits a trustee to recoup payments of fictitious profits that did not arise from securities transactions, or whether that power is instead vitiated by the Bankruptcy Code's stockbroker defense. This Court's intervention is warranted to stave off the "ad hoc development of the law, which threatens uniformity and predictability." Amy J. Sepinwall, *Righting Others' Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds*, 78 Brook. L. Rev. 1, 7 (2012).

2. Certiorari is also warranted because the decision below threatens to gut SIPA and contravenes this Court's century-old jurisprudence addressing Ponzi schemes. The essence of the SIPA regime is that the trustee aggregates all customer property for distribution ratably to brokerage customers. The statute thus implements the maxim—announced in connection with the bankruptcy of Charles Ponzi

himself—that "equality is equity," by ensuring that all of a broker-dealer's customers stand on an equal footing during the insolvency. *Cunningham v. Brown*, 265 U.S. 1, 13 (1924).

The statute can only function if funds are restored for a pro rata distribution to the broker's customers. The SIPA trustee's clawback power is therefore essential because insolvent brokers may dispose of large sums before the proceedings begin—for example, through the distribution of fictitious profits.

The stockbroker defense is a narrow exception to that power, designed to serve the particular purpose of preventing ripple effects in open securities markets. Congress created it as a direct response to the potential market instability that would result if a trustee were empowered to unwind large numbers of actual *securities trades* by the debtor. That would create the prospect that debtor's counterparties could not clear their own subsequent trades, causing the insolvency of one market participant to spread like a contagion throughout the market. *See* H.R. Rep. No. 97-420, at 2 (1982).

Congress did not write the stockbroker defense to address a case like this one, in which there were *no* securities transactions to unwind. Put another way, Congress obviously did not intend to protect the *beneficiaries* of a Ponzi scheme. Recovering funds paid to BLMIS customers who received fictitious profits from Madoff's massive fraud would not create ripple effects through the marketplace. To the contrary, it would facilitate the herculean task of achieving equity

for the victims of his fraud—and in the process augment confidence in the markets.

The Second Circuit, however, effectively gutted SIPA by reading the narrow stockbroker defense to effectively swallow the ordinary rule that the trustee may claw back customer property that was improperly distributed. By holding that the Account Documents constitute a "securities contract," and that the payments to customers were "in connection with" those contracts, the court of appeals effectively placed almost every transfer between a customer and his broker beyond the scope of SIPA.

The very fact that Congress went to the trouble of enacting SIPA is strong evidence that it did not intend to abrogate a SIPA trustee's avoidance powers in every instance in which the customer has signed a brokerage agreement—*i.e.*, almost all SIPA cases. As explained above, virtually all brokerage customers—and therefore all customers in SIPA liquidations—execute documents similar to the Account Documents when they open their accounts. Therefore, the Second Circuit's reasoning will lead to the absurd result that once a customer opens and funds an account, practically every transfer of funds by the broker to the customer will be shielded from avoidance under Section 546(e), regardless whether any securities transactions are executed for that customer. Similarly, the Second Circuit's holding that these transfers of fictitious profits were "settlement payments" suggests that virtually all payments between a broker and customer would qualify under the defense.

At bottom, the Second Circuit's ruling implausibly reads SIPA to give legal effect to Madoff's fraud in two ways. First, it permits those who received false profits from the fraud to keep their "gains." Congress could not have intended that result because those funds are—literally—stolen from others who relied on the same representations and were deceived in the exact same way, but simply had the misfortune not to request withdrawals before the scheme collapsed.

Second, the court of appeals' ruling inexplicably acts as if Madoff's fraudulent securities trading scheme was genuine. If Madoff had accurately disclosed the nature of his scheme—*i.e.*, if he had not told investors that he was selling securities but instead told investors that he was depositing their funds into a commingled checking account that he was then drawing down to create the illusion of returns—then not even a facially plausible argument could be made that the documents creating the relationship would be "securities contracts," and the payments would be "settlement payments" within the meaning of the Bankruptcy Code. That is so both because the scheme was fraudulent, and also because Madoff never contemplated engaging in actual securities trades.

The lower court's contrary conclusion elevates the fraudulent form of the Madoff transactions above their substance. Because the fraud succeeded—*i.e.*, because customers thought that they were engaging in securities transactions—the Second Circuit applied the Code's stockbroker defense to shield those trades from avoidance. But it makes no sense to believe that

Congress intended the defense's applicability to be dictated by the effectiveness of Madoff's lies.

Importantly, the consequences of the Second Circuit's ruling will not be limited to fraud cases—indeed, they may be worse in other SIPA insolvencies. In some SIPA cases, a broker-dealer's insolvency is not related to fraud like the one present here. As a consequence, the other principal source of the trustee's clawback authority—that the transfer was made with actually fraudulent intent, 11 U.S.C. § 548(a)(1)(A)—will be inapplicable. In those cases, SIPA's customer protection scheme relies principally on the SIPA trustee's ability to recover preferences, constructively fraudulent transfers, and transfers recoverable under applicable state law. But the Second Circuit's holding prevents those recoveries.

II. The Second Circuit's Decision Cannot Be Reconciled With The Statutory Text Or The Decisions Of Other Courts Applying It.

Certiorari is also warranted because the Second Circuit's decision cannot be reconciled with the plain text of 11 U.S.C. §§ 546(e) and 741, with SIPA itself, or with the decisions of other courts of appeals applying those provisions. Notwithstanding its acknowledgment that BLMIS never traded securities on behalf of its customers, the court of appeals nevertheless concluded that the payments to respondents were "settlement payments" in securities transactions, and that the customers' account opening documents were "securities contracts." Neither holding is sustainable.

1. The Bankruptcy Code defines a "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." 11 U.S.C. § 741(8). The text is circular, except in the important respect that it clarifies that the payment in question must be one "commonly used in the securities trade."

In the securities industry, settlement "refers to the completion of a securities transaction." *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.)*, 651 F.3d 329, 336 (2d Cir. 2011) (quotation marks and citation omitted).[4] The *sine qua non* of a "settlement" payment is thus that it concludes an *actual* transaction.

The Second Circuit held to the contrary that the definition of "settlement payment" was satisfied because "[e]ach time a customer requested a withdrawal from BLMIS, he or she *intended* that BLMIS dispose of securities and remit payment to the customer." Pet. App. 27a (emphasis added). On that view, it was irrelevant as a matter of law that BLMIS "failed to execute the trade and" instead sent "cash

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[4] *See also Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252, 258 (3d Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 985-86 (8th Cir. 2009) (citing *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990)); *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322, 325 (9th Cir. 1992).

stolen from another client." *Id.* But the court of appeals identified no persuasive basis to interject the customer's intent as the defining feature of a settlement payment, when the statutory definition does not refer to intent at all, and when "intent" is not the basis for Congress's concerns with the prospect of cascading brokerage insolvencies. Instead, the statute looks exclusively to whether an actual transaction occurred—here, it did not.

This mistaken expansion of the statutory text is particularly significant because the Second Circuit had already previously broadened the meaning of "settlement payment" in its *Enron* ruling to encompass the redemption of commercial paper to retire debt, even though the transaction in question did not involve a purchase or sale of that security. *See* 651 F.3d at 335. By "declin[ing]" to "read a purchase or sale requirement" into the definition of a "settlement payment," the court of appeals expanded the definition to encompass a range of debt transactions. *See id.* at 337. The dissent in *Enron* warned that by eliminating the requirement of the "purchase or sale" of an actual security, the Second Circuit had "imperil[ed] decades of cases" exempting ordinary debt-related payments from the stockbroker defense. *Id.* at 347 (Koeltl, J., dissenting). The majority responded that its decision would not apply to "non-tradeable" bank loans, which it recognized as beyond the statute's reach, *see id.* at 337 (majority op.); but the dissent pointed out that the elimination of a "purchase or sale" left no basis for this distinction. *Id.* at 346-47 (Koeltl, J., dissenting).

But not even the *Enron* dissent predicted that the Second Circuit would extend the stockbroker defense to *non-existent* transactions, given that "notes, bonds and debentures are 'securities' under the Bankruptcy Code." *Id.* The decision in this case, which sweepingly extends the stockbroker defense to encompass cash-for-cash transactions where no securities were ever implicated, has surpassed even the dissent's warnings.

In contrast to the Second Circuit, other courts have faithfully read the statute to require that a "settlement payment" be one "commonly used in the securities trade." 11 U.S.C. § 741(8). *See, e.g.*, *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 988 n.5 (8th Cir. 2009) (explaining that correct construction of "settlement payment" does not lead to abuse by fraudsters because the payment must be "commonly used in the securities trade"); *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.)*, 878 F.2d 742, 752 (3d Cir. 1989) (settlement payment "includes transfers which are normally regarded as part of the settlement process"); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 481 (S.D.N.Y. 2001) (holding that payments that were "steeped in fraud" could not qualify as "settlement payments" under Section 546(e)).[5]

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[5] *Cf. Michaelson v. Farmer (In re Appleseed's Intermediate Holdings, LLC)*, 470 B.R. 289, 302 (D. Del. Bankr. 2012) (explaining that for a settlement payment to occur, "both parties"

That correct understanding of the statute is illustrated by *Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.)*, 321 B.R. 527 (9th Cir. B.A.P. 2005), which considered a clawback action arising from the collapse of a Ponzi scheme. Reasoning "that non-public transactions in illegally unregistered securities are not 'commonly used in the securities trade,'" the court held that payments pursuant to such transactions are not "settlement payments." *Id.* at 529. After considering in detail the legislative history and purpose of the stockbroker defense, the court explained that "[w]hatever else a settlement payment may be, it is restricted to the securities trade and must be 'commonly used.'" *Id.* at 538. The court then explained that "[i]f integrity and compliance with securities laws are to be preserved as the hallmark of the brand name of the United States securities markets, then trades in illegally unregistered securities must flunk the common usage test." *Id.* "In short, the statutory protection of settlement payments presupposes that securities laws are not being offended." *Id.*

The Second Circuit, however, has rejected that reading. In *Enron*, which was the basis for the ruling in this case, the court of appeals held that the phrase

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must "exchange[] some value," and holding that a fraudulent dividend payment did not qualify); *Bond v. Nat'l Fin. Servs. (In re U.S. Mortg. Corp.)*, 491 B.R. 642, 674-75 (D.N.J. Bankr. 2013) (recognizing that fraudulent payments would not qualify, but declining to apply fraud exception because the relevant payments were "bona fide actual purchases of security").

"commonly used in the securities trade" limits only the definition's final reference to "any other similar payment." 651 F.3d at 335-36. Accordingly, the Second Circuit deemed the potentially fraudulent intent of the parties to the transfer to be irrelevant.

In sum, fraudulent payments in connection with a Ponzi scheme should not be regarded as settlement payments because they are not "commonly used in the securities trade," particularly given that Congress would not have intended to advantage the beneficiaries of such payments over the interests of the other investors that SIPA was designed to protect.

2. The Second Circuit also held that the transfers to respondents were "in connection with" "securities contracts"—specifically, the Account Documents. Pet. App. 15a-26a. But while customers believed that these documents authorized BLMIS to enter into unspecified future securities trades, in fact the documents did not effect any transaction in securities.

The perfunctory authorization forms at issue here are insufficient to satisfy the statutory definition of a "securities contract." The definition is technical and detailed, and sets forth a range of contracts that qualify. The common thread binding them, however, is that each relates to actual securities transactions—not fictitious ones. The first definition, for example, is that a securities contract is

> a contract for the purchase, sale, or loan of a security . . . a group or index of securities . . . or option on any of the foregoing, including an option to purchase or sell any such security, . . . group or index . . . and including any

> repurchase or reverse repurchase transaction on any such security, . . . group or index.

11 U.S.C. § 741(7)(A)(i). The Account Documents, by contrast, do not, by themselves, provide for the purchase, sale or loan of any security.

The court of appeals reasoned to the contrary that even though the Account Documents do not "require BLMIS to conduct any" purchases or sales, they "establish[ ] the broker-customer relationship" and "specify the terms by which BLMIS will acquire and dispose of securities for the customer." Pet. App. 17a-18a. Because "the transfers at issue originated with, and could not have been possible but for, the relationship created by the Account Documents," the court "conclude[d] that they fall within the statute's broad definition of a 'securities contract.'" *Id.* 18a.

That line of reasoning conflates necessity with sufficiency. Although the Account Documents may have been *necessary* to create the broker-customer relationship that would give rise to future securities contracts, that fact is not *sufficient* to render the account documents securities contracts. In the same way that a contract between a home purchaser and a real estate broker creates an agency relationship that may ultimately result in a real estate transaction, the Account Documents purported to create an agency relationship between the customers and BLMIS. But just as no contract for the purchase or sale of a home occurs until the buyer enters into a contract with a seller for a particular home, no contract to purchase, sell, or loan securities exists until that broker enters into that contract to purchase, sell, or loan securities.

The Second Circuit's reasoning also implausibly expands the definition of "transfers in connection with a securities contract" to encompass all transfers between brokers and their customers. Because virtually all broker-customer relationships have a contractual basis, and every transfer is at least arguably "in connection with" that relationship, no transfer between those parties would fall outside the definition. That would allow the stockbroker defense exception to swallow the clawback rule.

Nor do the Account Documents fall within the remaining definitions of a "securities contract." The court of appeals erroneously held that "[t]he function contemplated for the Account Documents" makes them equivalent to "a master agreement," which is another form of "securities contract." *See* 11 U.S.C. § 741(7)(A)(x). That conclusion was incorrect for two reasons.

First, the Account Documents are not "master agreements" as that term is used in the securities industry. A "master agreement" is effectively a template for a series of transactions with a large number of overlapping terms. When the parties to a master agreement wish to execute an actual securities transaction under the agreement, they use supplemental agreements to fill in transaction-specific terms. This process facilitates transactions and also ensures that the entire series of transactions occurs on comparable terms so that its value can be readily assessed.

Whether under the securities law or the Bankruptcy Code, a master agreement and all of its

supplements are treated as a single contract. Thus, a trustee may not "cherry pick" among the individual transactions, *i.e.*, reject a supplement that is not beneficial for the debtor, while accepting another. This is the very reason that the term "master agreement" was originally added to the Bankruptcy Code. *See* H.R. Rep. No. 101-285, at 9 (1990). All of the various rights and obligations between the parties to a master agreement and its supplements are thus netted out to prevent an inequitable result. *See Bankr. Treatment of Swap Agreements and Forward Contracts: Hearing on H.R. 2057 Before the Subcomm. on Econ. and Commercial Law of the H. Comm. on the Judiciary*, 101st Cong. 14 (1990).

The Account Documents do not resemble master agreements. Master agreements facilitate trades between the parties to those agreements, but the future securities transactions that the Account Documents contemplate would be between BLMIS and unknown third parties in the open market, who are not in privity with the customers, and who are not parties to the Account Documents. Moreover, the terms of those future trades will not be incorporated into the Account Documents, and the Account Documents will not dictate the terms of those trades.

Second, even if the Account Documents could be described as "master agreements," the statute provides that a "master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to" elsewhere in the definition. 11 U.S.C. § 741(7)(A)(x). Thus, if two

parties executed a master agreement, but then never executed any supplements to conduct transactions under that agreement, the master agreement itself would not qualify as a "securities contract" under the Bankruptcy Code. In this case, BLMIS did not engage in any securities transactions on the customers' behalf. Pet. App. 9a.

The court of appeals reasoned next that the definition of a securities contract also encompasses "any other agreement or transaction that is similar to" a defined security contract. Pet. App. 19a (citing 11 U.S.C. § 741(7)(A)(vii)). Focusing on the "expansive" words "any" and "similar," the court of appeals held that the Account Documents involved agreements that are sufficiently similar to "contracts for the purchase, sale or loan of a security." *Id.* 19a-20a.

The court of appeals' adoption of the broadest possible reading of those adjectives assigns a breadth to the stockbroker defense that Congress could not have intended. To be sure, the Account Documents are "similar" to securities contracts insofar as they are contracts that mention securities. But the essence of a securities contract is a securities transaction, which the Account Documents do not even purport to execute. Thus, the Account Documents are not "similar" to a contract to purchase, sell, or loan securities because the effect of executing the Account Documents bore no resemblance to bona fide purchase, sale, or loan contracts, and the parties' obligations under the Account Documents likewise bore no resemblance to the parties' obligations under a contract to purchase, sell, or loan securities.

Independently, the Court should not overlook the fact that the Account Documents were instruments in a fraudulent scheme, and in that sense were entirely *dissimilar* from legitimate securities contracts. Throughout the entire contracting process, BLMIS had no intention of trading securities on its customers' behalf. That fact alone forecloses treating the agreements as "similar" to bona fide purchase, sale, or loan agreements.[6]

For a similar reason, even if the Account Documents are securities contracts, the court of appeals incorrectly held that the transfer payments made by BLMIS to its customers were "in connection with" those contracts. As explained in the Statement of the Case, and acknowledged by the court of appeals, when BLMIS customers sought to withdraw money, BLMIS paid them fictitious profits using funds from the commingled checking account. The fictitious gains shown on the BLMIS customer statements were

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[6] In a single sentence, the court of appeals determined that "because the Account Documents obligate BLMIS to reimburse its customers upon a request for withdrawal," they fall within § 741(7)(A)(xi), which includes, "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." Pet. App. 19a. That is incorrect. A "security agreement" is defined as an "agreement that creates or provides for a security interest." 11 U.S.C. § 101(50). A "security interest" is a "lien created by an agreement." *Id.* § 101(51). The Account Documents neither create such a security interest in any other security contract, nor have any similar effect.

invented by BLMIS and had no basis in any securities transaction. Indeed, no such transactions had even taken place. The fact that the customers withdrew cash after they deposited cash does not transform the Account Documents into securities contracts and the transfers to customers are not in connection with any securities contracts. The payments were made for one simple reason alone: to conceal and perpetuate the ongoing fraud.

3. Any doubt about the foregoing is resolved by the fact that the Bankruptcy Code applies in SIPA liquidation proceedings *only* "[t]o the extent consistent with the provisions of" SIPA itself. 15 U.S.C. § 78fff(b); *see also Holmes,* 503 U.S. at 274 n.21 ("To the extent consistent with SIPA, bankruptcy principles apply to liquidations under the statute."). As set forth in greater detail in the parallel petition filed by SIPC, this statutory command requires courts to read the stockbroker defense narrowly in SIPA cases in order to achieve the principal goal of the statute, which is the creation of a complete pool of customer property for pro rata distribution.

Here, the Second Circuit did the opposite, reading the stockbroker defense broadly to undermine SIPA. In rejecting petitioner's argument that a narrow reading of the stockbroker defense is necessary to ensure that SIPA functions properly in cases like this one, the court of appeals dismissed the need to "harmonize" its interpretation "with the SIPA statutory framework as a whole" because "Section 546(e) . . . is part of the Bankruptcy Code, not SIPA." Pet. App. 28a. The court reasoned that the

Bankruptcy Code advances different policy objectives than SIPA, and that under the bankruptcy regime, "the need for finality is paramount even in light of countervailing considerations." *Id.* 29a. By ignoring SIPA's objectives, as well as the statutory provision that prioritizes SIPA above the Bankruptcy Code in cases such as this that proceed under SIPA, 15 U.S.C. § 78fff(b), the Second Circuit did not "respect the balance Congress struck." Pet. App. 29a. It upended it.

III. The Second Circuit's Decision Creates A Conflict In Principle With Other Ponzi Scheme Cases Denying The Stockbroker Defense.

In addition to creating a circuit conflict over the meaning of the phrase "settlement payments," the Second Circuit's decision creates a conflict in principle with other federal cases that have denied the use of the stockbroker defense with respect to payments from Ponzi schemes. In a series of cases involving ordinary bankruptcies—not SIPA liquidation proceedings—other courts of appeals have held that the stockbroker defense was unavailable altogether because the fraudsters were not properly regarded as "stockbrokers." That ground is not available to a SIPA trustee whose jurisdiction depends, in part, on the fact that the debtor is a stockbroker. But there is no reason why the clawback power in SIPA cases should be *narrower* than in ordinary bankruptcy litigation. In fact, the opposite is true: Congress enacted SIPA to provide *broader* protection to the customers of stockbrokers.

In *Johnson v. Neilson (In re Slatkin)*, 525 F.3d 805, 809 (9th Cir. 2008), a Chapter 11 bankruptcy trustee sought to recover payments to customers that exceeded their deposits into a Ponzi scheme—essentially the same recovery action here. The court of appeals held that the schemer was not properly regarded as a stockbroker because he was not actually "engaged in the business of effecting transactions of securities." *Id.* at 817 (citing 11 U.S.C. § 101(53A)(B) (definition of "stockbroker")). The court explained that the schemer was not "effecting" transactions because he was not in the business of "making securities transactions happen." *Id.* The court noted that "all but a very few of the transactions conducted by [the schemer] were *illegitimate*," which distinguished him from a true stockbroker. *Id.*[7]

Similarly, in *Wider v. Wootton*, 907 F.2d 570, 571 (5th Cir. 1990), the court of appeals held that the Ponzi schemer was not a stockbroker because he did not have "customers" as that term was used in the Bankruptcy Code. The court of appeals reasoned that a Ponzi scheme could never satisfy the part of the definition that transfers must occur "in the ordinary course of the debtor's business." *See id.* at 572. While the reasoning in *Wider* turned, in substantial part, on the specific structure of the scheme (whereby the schemer purported to execute trades *before* asking for

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[7] The court noted that the schemer had not held himself out as being a licensed, full-service brokerage firm. But it did not suggest that the result would be different if he had. *See id.*

money from his clients), the court's reasoning was broader. The court explained that "[t]o apply the stockbroker defense to shield the payments [the schemer] made to [one customer] 'would lend judicial support to 'Ponzi' schemes by rewarding early investors at the expense of later victims.'" *Id.* at 573 (quotation marks omitted). The court thus refused to "implicitly authorize fraudulent business practices through an unjustified extension of the stockbroker defense." *Id.*

These courts of appeals recognize the key fact also present in this case: that the narrow purpose of the stockbroker defense is to prevent contagion in the markets when a market participant becomes insolvent. It is not to protect particular beneficiaries of a Ponzi scheme from having to return false profits to the common pool of bankruptcy or customer property.

Those rulings also recognize that when, as here, purported stock trades are mere window-dressing, there is no reason consistent with bankruptcy law to preclude avoidance of those transactions under the stockbroker defense. As explained in Part I, *supra*, if Madoff had accurately disclosed the nature of his scheme, it is beyond dispute that the defense would not apply. Similarly, if he had perpetrated a different fraud—for example, telling his investors that their funds would be put into speculative real estate investments—the defense would not apply. The particular skin that Madoff chose to put on his Ponzi scheme is irrelevant to whether the transfers to respondents should be subject to clawback. The trustee should have the power to restore the debtor's

estate by recovering customer property to achieve an equitable distribution.

By contrast, other courts have acknowledged the division in authority and—consistent with the Second Circuit's ruling in this case—have refused to hold that there is anything special about Ponzi schemes that renders the stockbroker defense inapplicable. *See Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 747-50 (7th Cir. 2013); *Perkins v. Lehman Bros.*, No. 1:11-CV-1806-CAP, 2012 WL 11946959, at *12 (N.D. Ga. Mar. 30, 2012) (citing the district court's opinion in this case). These courts reason that even though protecting payments in a Ponzi scheme does not further the policies behind the stockbroker exception, the text of the statute compels that result.[8]

A ruling in this case would shed substantial light on that closely related circuit conflict.

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[8] The Fourth Circuit has noted, but not decided, the question. *See Grayson Consulting, Inc. v. Wachovia Sec., LLC (In re Derivium Capital LLC)*, 716 F.3d 355, 366 (4th Cir. 2013).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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