

Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—2d Cir.: Trustee may not claw back withdrawals by Madoff investors, (Dec. 8, 2014)

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By Amy Leisinger, J.D.

The Second Circuit affirmed a ruling preventing the bankruptcy trustee for Bernard L. Madoff Investment Securities LLC (BLMIS) from “clawing back” money paid out to investors requesting withdrawals prior to the discovery of Madoff’s massive Ponzi scheme. According to the court, the transfers to customers constituted payments made in connection with securities contracts or settlement payments that, under Section 546(e) of the Bankruptcy Code, cannot be avoided in bankruptcy proceedings. BLMIS’ fraudulent activities do not negate the existence of the contracts with customers in the first instance, the court found (*In re Bernard L. Madoff Investment Securities LLC*, December 8, 2014, Parker, B.).

Background. Following the collapse of BLMIS’ Ponzi scheme, Irving H. Picard was appointed trustee for BLMIS, and, under the Securities Investor Protection Act (SIPA), was empowered to recover money paid out by the company, as long as the money “would have been customer property” had the payment not occurred and the transactions were voidable under the Bankruptcy Code. The trustee sought to claw back money from customers who, over time, were able to take out more than they had invested with BLMIS. Several of the defendants moved to dismiss, claiming protection under Bankruptcy Code Section 546(e), which provides that certain securities-related payments, such as transfers made by a stockbroker “in connection with a securities contract” or “settlement payments,” cannot be avoided in bankruptcy. The Southern District of New York concluded that the payments to BLMIS to customer were in fact shielded by this provision and dismissed the relevant claims.

Securities contracts. The trustee argued that Section 546(e) should not apply because BLMIS never initiated or completed the securities transactions contemplated under the agreements the company had with customers. The court noted that, under the Bankruptcy Code, the definition of “securities contract” is broad and “expansively includes 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.” The customer defendants had agreements with BLMIS that authorized the company to maintain accounts and engage in securities transactions on their behalf and obligated BLMIS to reimburse them upon requests for withdrawal, the court stated, and the transfers were only possible because of the relationship created by these documents. At a minimum, the court found, the documents involved agreements “similar to” purchase and sales contracts, which are also protected under Section 546(e). “The existence of a securities contract is not vitiated because a broker fails to make good on his commitment,” and the customers’ subsequent withdrawals were therefore related to a securities contract, the court stated.

Settlement payments. The court also rejected the trustee’s contention that the transfers did not constitute settlement payments because BLMIS never engaged in actual trading. According to the court, the Second Circuit has held that the statutory definition should be broadly construed to apply to “the transfer of cash or securities made to complete [a] securities transaction.” BLMIS had discretion to liquidate securities to the extent necessary to fulfill withdrawal requests, and each transfer in respect of a request constituted a settlement payment, the court reasoned. This provides a further basis to protect the transfers to customers from avoidance under Section 546(e), the court explained.

Equity considerations. The trustee also contended that affirming the district court’s decision would be inconsistent with an earlier opinion in the Madoff series of actions determining that to calculate customers’ net equity using BLMIS’ fictitious account statements would be tantamount to giving legal effect to Madoff’s fraud. The court declined to follow this reasoning, noting that the Bankruptcy Code balances the needs for an equitable result and for finality and that courts must “respect the balance Congress struck among these complex competing considerations.”

The case is No. 12-2557-bk(L).

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Companies: Bernard L. Madoff Investment Securities LLC; Fiterman Investment Fund

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