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# New York District Courts Differ Regarding the Scope of the Bankruptcy Code's "Safe Harbors" for Protected Contracts

BRIAN TRUST AND RICK HYMAN

*Judge Rakoff's ruling in the Trustee's suit against the owners of the New York Mets (along with certain of their friends, family, and associates) has the potential to substantially alter the litigation landscape in the Madoff proceedings, as it further clarifies the applicability of the Bankruptcy Code's so-called "protected contracts" provisions in the context of insolvent stockbrokers. The authors discuss this decision and an apparent conflict with another order made in connection with an appeal brought by another Madoff customer.*

**T**he District Court for the Southern District of New York recently issued an opinion in *Picard v. Katz, et al., (In re Bernard L. Madoff Investment Securities LLC)*,<sup>1</sup> which limits avoidance actions against a debtor-broker's customers to those arising under federal law based on actual, rather than constructive, fraud. The decision was issued by U.S. District Judge Rakoff in the Trustee's suit against the owners of the New York Mets (along with certain of their friends, family and associates). It has the potential to substantially alter the litigation landscape in

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the *Madoff* proceedings, as it further clarifies the applicability of the Bankruptcy Code's so-called "protected contracts" provisions in the context of insolvent stockbrokers.

Importantly, this opinion is in apparent conflict with a recent order issued by U.S. District Judge Wood in connection with an appeal brought by another Madoff customer. Accordingly, these issues may not be completely resolved until they are addressed by the Second Circuit Court of Appeals.

## **BACKGROUND**

The dispute underlying Judge Rakoff's decision originated from the infamous Madoff Ponzi scheme. Following the revelation of Madoff's fraud, Irving H. Picard was appointed under the Securities Investor Protection Act of 1970 ("SIPA") as the Trustee in charge of the liquidation of Bernard L. Madoff Investment Securities LLC. As part of his duties, Picard has sued many of Madoff's former customers in an attempt to recover and, ultimately, redistribute, payments that Madoff made to such customers. To this effect, in December of 2010, Picard sued the defendants in this case seeking to recover more than one billion dollars on theories of actual fraud, constructive fraud, and preferential transfer, in violation of various provisions of the Bankruptcy Code and New York state debtor and creditor law.

## **JUDGE RAKOFF'S DISMISSAL ORDER**

Judge Rakoff's decision grants, in large part, a motion to dismiss made by the defendants, resulting in the dismissal of all of Picard's claims to recover preferential transfers and constructively fraudulent conveyances. Judge Rakoff held that these claims are barred by the "protected contracts" provisions of Section 546(e) of the Bankruptcy Code. Section 546(e) provides that, notwithstanding other provisions in the Bankruptcy Code that authorize the recovery of preferential transfers and constructively fraudulent transfers, trustees (such as Picard) may not avoid a transfer that is a "margin payment" or a "settlement payment" made by, to or for the benefit of a "commodity broker," "forward contract merchant," "stockbroker," "financial institution," "financial participant" or "securities clearing

agency” (as those terms are defined elsewhere in the Bankruptcy Code).

Relying on the Second Circuit Court of Appeals’ recent decision in *In re Enron Creditors Recovery Corp.*,<sup>2</sup> which greatly clarified the scope and applicability of Section 546(e), Judge Rakoff found that Madoff was a stockbroker (despite the fact that Madoff had never actually traded any securities), and that payments to customers were made pursuant to securities contracts and thereby protected from avoidance by Section 546(e), with certain exceptions. Given the applicability of Section 546(e), Picard’s avoidance powers are limited to recovering those transfers made with actual intent to defraud under Section 548(c) of the Bankruptcy Code. Judge Rakoff also permitted Picard’s claim for equitable subordination to proceed.

Under Section 548(c), Picard is only entitled to recover transfers made within the two-year period prior to the commencement of the SIPA proceeding, rather than the extended period permitted under state law. Moreover, with respect to such claims, Picard will be precluded from recovering amounts to the extent they constituted a return of principal and the customer received them in “good faith.”

With regard to the standard for establishing good faith in SIPA proceedings, Judge Rakoff noted that a securities investor has no inherent duty to inquire about a stockbroker, and that SIPA creates no such duty. Judge Rakoff went on to hold that if an investor intentionally chooses to be blind to red flags, such “willful blindness” is tantamount to lack of good faith, but, if simply confronted with suspicious circumstances, the investor fails to launch an investigation of the broker’s internal practices, the investor’s lack of due diligence cannot be equated with a lack of good faith. Whether or not the defendants acted in good faith so as to protect against any recovery of principal is a matter yet to be decided.

As noted above, the Bankruptcy Code only permits the Trustee to avoid actually fraudulent payments that were made within two years of the filing of the bankruptcy petition. With this in mind, and in light of the fact that the defendants may have been reaping “profits” within this two-year period that were the result of principal investments made outside of such period, Judge Rakoff noted that an open question remains as to what portion of the total amount of all transfers should be considered principal, and what portion should be considered profits.

## CONFLICTING DISTRICT COURT DECISIONS

Aspects of Judge Rakoff's decision are in conflict with another Southern District of New York decision by Judge Wood. On August 31, 2011, in another of Picard's Madoff-related "claw-back" suits, Judge Wood denied the defendants' request for an appeal of a bankruptcy court decision that refused to dismiss avoidance actions on similar grounds to those presented in the instant case.

The bankruptcy court had ruled that it could not, on a motion to dismiss, find as a matter of law that Madoff was a stockbroker, or that the underlying account agreements constituted securities contracts, given that Madoff allegedly never purchased the securities claimed to be purchased. In determining whether to permit leave to appeal, Judge Wood considered, among other things, whether there was genuine doubt as to whether the bankruptcy court applied the correct legal standard. Because the defendants failed to present precedent of the applicability of Section 546(e) in the context of a Ponzi scheme operator that allegedly failed to execute trades, Judge Wood failed to find the request doubtful to permit the appeal to move forward.

Whereas Judge Wood permitted Picard's avoidance claims to withstand a motion to dismiss, Judge Rakoff has dramatically reduced the scope of Picard's potential claims at the pleading stage. Because U.S. district court judges are not bound by the decisions of other U.S. district court judges, these issues may remain in flux unless and until an appeal of one of these decisions is decided by the Second Circuit Court of Appeals.

## CONCLUSION

Judge Rakoff's recent decision, along with the *Enron* decision relied upon therein, provide a strong basis to argue that Section 546(e) of the Bankruptcy Code establishes a comprehensive "safe harbor" against avoidance actions in cases involving the liquidation of a broker. If upheld, this decision will almost entirely bar SIPA trustees from suing to recover on constructive fraudulent conveyance and preference claims. Additionally, when pressing claims for actual fraud, SIPA trustees will be required

to show that the defendant was “willfully blind” to its stockbroker’s fraudulent activity, and will not be able to recover transfers that were made more than two years prior to the commencement of the bankruptcy case. However, in light of the conflicting decisions between Judge Rakoff and Judge Wood, it is likely that these questions will not be resolved until the Second Circuit Court of Appeals hears these cases on appeal.

## NOTES

<sup>1</sup> Opinion and Order on Defendants’ Motion to Dismiss, *Picard v. Katz, et al.*, No. 11-cv-3605 (S.D.N.Y. Sept. 27, 2011), ECF No. 40.

<sup>2</sup> *In re Enron Creditors Recovery Corp.*, \_\_\_ F.3d \_\_\_, 2011 WL 2536101 (2d Cir. June 28, 2011).