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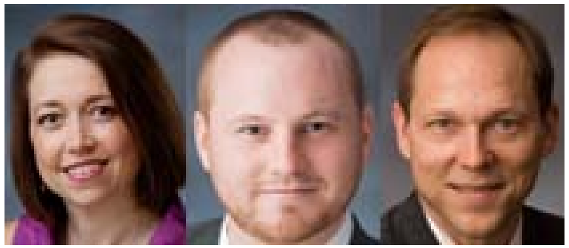
DRI Resources

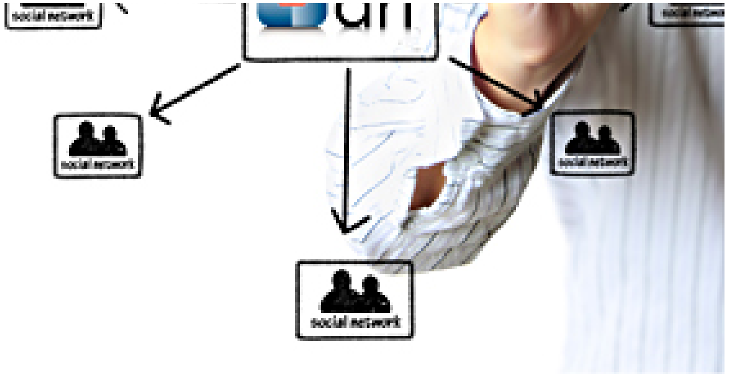
Featured Articles

Pointing the Finger: Bernie Madoff and the Potentially Changing Landscape of Trustee Claims

by Laura Caldera Taylor and Nels Vulin with contribution from Thomas Hutchinson



Over a period of three decades, Bernard Madoff masterminded what is alleged to be the world's largest Ponzi scheme. *See* Petition for Writ of Certiorari, *Trustee v. JPMorgan Chase & Co., et al.*, (*In re Bernard L. Madoff Investment Securities LLC*) (October 9, 2013)(page 1). When it collapsed, nearly $20 billion invested in Madoff's Ponzi scheme had disappeared. *Id.* This is not new information. After Madoff's arrest in December 2008, it was frequently front-page news, and became the topic of many CLEs in the years that followed. Some five years later, does the Madoff debacle offer anything new or interesting for lawyers representing professionals and financial institutions? The short answer is yes. On October 9, 2013, the trustee in the SIPA liquidation



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bankruptcy of Madoff's firm, Bernard L. Madoff Investment Securities LLC ("BLMIS") filed a Petition for Writ of Certiorari that raises interesting issues regarding a trustee's standing to bring third-party claims, and preemption for conversion claims.

On December 3, 2010, in the United States Bankruptcy Court, Southern District of New York, BLMIS's Trustee, Irving Picard, filed one of the adversary actions against financial institutions alleged to have aided Madoff's Ponzi scheme. That action was brought against various entities under the JPMorgan umbrella ("JPMorgan" or "JPMorgan Defendants"). After the district court removed the reference from the bankruptcy court, an Amended Complaint was filed that alleged twenty-eight claims for relief including, among others: preferential or fraudulent transfer claims; tort claims ranging from aiding and abetting fraud and breach of fiduciary duty to fraud on the regulator; and contribution. *Picard v. JPMorgan Chase & Co., et al.* (*In re Bernard L. Madoff Investment Securities LLC*) Case No. 1:11-cv-0093, Adv. No. 08-01789, (SDNY 06/24/2011) (Docket No. 50). The Amended Complaint alleged that beginning in 1986, all of the money Madoff stole from his customers passed through the "703 Account" at JPMorgan where it was comingled and ultimately washed. *Id.* at ¶ 3. The Amended Complaint goes on to allege that virtually none of the money was used to buy securities—something Picard alleges JPMorgan knew or should have known. *Id.* JPMorgan did nothing to stop the fraud, the Amended Complaint alleges, allowing it to make at least half a billion dollars in revenue on Madoff's Ponzi scheme. *Id.* at ¶ 12. JPMorgan responded to these allegations by moving to dismiss a number of the claims.

JPMorgan was successful on its standing argument before the District Court. It argued that the Second Circuit's holding in *Shearson Lehman Hutton, Inc. v. Wagoner,* 944, F.2d 114 (2d. Cir. 1981)—that a claim against a third party for defrauding a failed corporation

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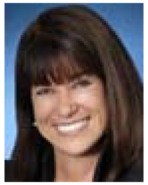

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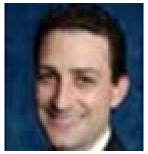

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with the cooperation of management "accrues to the creditors not the guilty corporation"—is consistent with the Supreme Court's holding in *Caplin v. Marine Mindland Grace Trust Co. of N.Y.*, 406 U.S. 416 (1972), that a bankruptcy trustee "has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself." *See* Picard v. JPMorgan Chase &Co., 460 B.R.84 (S.D.N.Y. 2011). As JPMorgan explained, the *Wagoner* rule is based on the doctrine of *in pari delicto* and "because a trustee stands in the shoes of the corporation, the *Wagoner* rule bars a trustee from suing to recover for a wrong that he himself essentially took part in." *See Picard v. JPMorgan Chase & Co., et al.* (*In re Madoff*), Case No. 1:11-cv-0093, Adv. No. 08-01789, JP Morgan Defendant's Memo ISO Motion to Dismiss at p. 11, *citing to and quoting Kirschner v. KPMG LLP*, 15 N.Y. 3d 446, 457 (2010).

The Trustee, on the other hand, unsuccessfully focused on numerous cases holding that a SIPA trustee has standing to sue third parties as a bailee of customer property. *See Picard v. JPMorgan Chase & Co., et al.* (*In re Bernard L. Madoff Investment Securities LLC*) Case No. 1:11-cv-0093, Adv. No. 08-01789, Memorandum of Law of the Securities Investors Protection Corporation in Opposition to Motion to Dismiss at p. 8 (Docket No. 61) (Trustee's Memo in Opposition to Motion to Dismiss). The trustee's most persuasive authority before the District Court was *Redington v. Touche Ross & Co.*, 442 U.S. 560 (1979) where the Supreme Court upheld the Second Circuit's finding that a SIPA trustee had standing to bring third-party claims as a subrogee or baliee of customer property. The Trustee also addressed *Wagoner*, arguing that *in pari delicto* does not apply to a bailee, and even if it did the issue is not appropriately resolved at the pleading stage. *Id.* at pp. 24 – 29.

The District Court dismissed most of the Trustee's claims, finding that the common law causes of action belonged to the creditors and not the Trustee. *See Picard v. JPMorgan*


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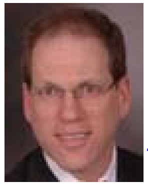

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Chase & Co., et al. (*In re Bernard L. Madoff Investment Securities LLC*) Case No. 1:11-cv-0093, Adv. No. 08-01789, Decision and Order Granting Defendants' Motion to Dismiss Certain Common Law Claims (Doc. No. 70) ("Order"). The District Court also found that the Trustee's claims were barred by *in pari delicto*. *Id.* Finally, as to the issue of contribution, the District Court found that the Trustee lacked standing on any other basis, and had no right to contribution under New York law when the source of his obligation to creditors arose under SIPA. *Id.* at 8.

On December 1, 2011, the Trustee appealed to the Second Circuit, which affirmed the district court's decision on the basis that (1) the doctrine of *in pari delicto* bars the Trustee's claims; (2) SIPA provides no right of contribution; and (3) the customer claims are not common or general, even if aggregated and thus cannot be brought by the Trustee. *In re Bernard L. Madoff Investment Securities LLC*, Nos. 11-5044, 11-5051, 11-5175 and 11-5207, 2013 WL 3064848 (2d Cir. June 20, 2013). (The appeal to the Second Circuit was combined with two other third-party adversaries in the Madoff Investment Securities bankruptcy.)

On October 9, 2013, the Trustee filed a Petition for Writ of Certiorari to the United States Supreme Court. *See* Petition for Writ of Certiorari, *Trustee v. JPMorgan Chase & Co., et al.*, (*In re Bernard L. Madoff Investment Securities LLC*) (October 9, 2013). The Trustee's Petition argues that Section 544(a) of the Bankruptcy Code provides that a trustee has all of the "rights and powers" of a hypothetical creditor with a judicial lien on all property of the pre-bankruptcy estate. *Id.* at p. 32. For that reason, the Petition argues, a trustee may bring claims against third-parties that are "general" to all creditors.

The Trustee cites *Koch Ref. V. Farmers Union Cent. Exch*, 831 F.2d 1339, 1341 (7th Cir. 1987) for the proposition that a trustee may bring general claims where "the liability is to all creditors of the corporation without regard to the personal dealings between such officers and such creditors."*Id.* at 33 – 34. In *Koch*, a group of oil companies sued the debtor – an energy cooperative – for declaratory relief seeking, among other things, to pierce the corporate veil and hold the member-owners responsible for any amounts the bankruptcy trustee recovered from the oil companies as preferences because the owner-members of the debtor allegedly breached their fiduciary duties to the corporation. *Koch*, 831 F.2d at 1349. The Seventh Circuit held that the oil company's claims were general to all creditors, and could therefore be brought by the bankruptcy trustee, but the oil companies/creditors had no standing to bring them. *Id*. The Petition notes that the First Circuit also adopted this distinction in *City Sanitation, LLC v. Allied Waste Servs. Of Mass., LLC (In re Am. Cartage, Inc.)*, 656 F.3d 82, 90 (1st Cir. 2011). In his Petition to the Supreme Court, Picard argues that the claims of the Madoff estate are general, and therefore, are properly brought by the Trustee. *See* Petition for Writ of Certiorari, *Trustee v. JPMorgan Chase & Co., et al.*, (*In re Bernard L. Madoff Investment Securities LLC*) (October 9, 2013) (page 36).

As to contribution, the Trustee argues that New York law allows the Trustee to sue joint torfeasors for payments made under SIPA whether they are liable under the same or different theories, and that New York law allows such claims to be brought even against intentional tortfeasors. The Trustee asserts that the Second Circuit dismissed the contribution claims without considering whether they conflict with federal law. Picard argues that New York law should control unless Congress specifically intended that federal law preempt the state law. *See* Petition for Writ of Certiorari, *Trustee v. JPMorgan Chase & Co., et al.*, (*In re Bernard L. Madoff Investment Securities LLC*) (October 9, 2013) (page 26). This claim is important for the Trustee as it has the potential to increase the amount of damages it could pursue up to the amount of the prayer: $19 billion.

If the Supreme Court grants certiorari in this case it could have substantial implications for financial institutions, accountants, lawyers, and other professionals who have involvement in entities that end up in bankruptcy with allegations of fraud or other substantial wrongdoing on the part of the entities' principals. Presently, as highlighted by the Petition, there is a split of authority on whether a bankruptcy trustee has standing under these circumstances to bring certain third-party claims.

As to the standing issue, in addition to the split of authority regarding whether a Trustee has the ability to bring claims on behalf of all creditors, there is a split of authority regarding whether the standing issues and *in pari delicto* issues are, or should be, addressed together. In *In re Senior Cottages of America, LLC*, 482 F.3d 997 (8th Cir., 2007), the Eighth Circuit joined the First, Third, Fifth, and Eleventh Circuits in holding that the *in pari delicto* defense does not deprive the corporation, and by extension the trustee, of standing to sue third parties. In so concluding, the Eighth Circuit cited approvingly to this language from the Third Circuit, "An analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*. Whether a party has standing to bring claims and whether a party's claims are barred by an equitable defense are two separate questions, to be addressed on their own terms." *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 346 (3dCir.2001).

Even where the issue of standing and the defense of *in pari delicto* are treated separately, there is a split of authority on the application of that doctrine with several circuits finding that itbars "claims of a bankruptcy trustee, standing in the shoes of the debtor, against third-parties, without regard to the trustee's status as an innocent successor." *See Successor Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001) (invoking *in pari delicto* as a bar to debtors' claims against third parties, even though trustee was "innocent"); *In re Dublin Sec., Inc.*, 133 F.3d 377(6th Cir. 1997) (*in pari delicto* barred trustee's malpractice action against law firms and attorneys who allegedly represented debtors-securities companies in connection with fraudulent public stock offerings); *In re Hedged-Investments Associates, Inc.*, 84 F.3d 1281 (10th Cir. 1996) (doctrine barred third-party claims by trustee of limited partnership used in Ponzi scheme).

But, other circuits find that it could be inequitable to apply *in pari delicto* "where prior management was at fault but the claim was asserted on behalf of creditors or shareholders." *Baena v. KPMG LLP*, 453 F.3d 1, 10 (1st Cir. 2006), (citing *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir.1995); *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir.)).

Of particular note are decisions out of the California district courts where equity considerations are given considerable weight. There, district courts have noted that where a receiver, or trustee, "was not a party to the original inequitable conduct . . . application of the *in pari delicto* defense would place losses on innocent creditors rather than the allegedly culpable defendant." *Mosier v. Stonefield Josephson, Inc.*, 2011 WL 5075551 (C.D. Cal. Oct. 25, 2011). California courts, it seems, are beginning to challenge the notion that a debtor's fault should automatically be imputed to a receiver or trustee. *See also F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995)* (unpublished) ("[D]efenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver. While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law.").

In considering Picard's Petition, the Supreme Court has the opportunity to resolve the split of authority in the circuit courts regarding how to address the issue of a trustee's standing and whether to merge the issues of standing and the defense of *in pari delicto* into a single analysis, or to separately consider them on their own merits. The Court will also have the opportunity to address the equity issues the California district courts have been grappling with regarding the defense of *in pari delicto*. And finally, the Court will be called upon to answer what could be a $19 billion question regarding the viability of the Trustee's conversion claim. Because of its potential impact, the Madoff Trustee's Petition for Writ of Certiorari should be on the must watch list for lawyers representing financial institutions, and professionals such as financial and legal advisors.

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