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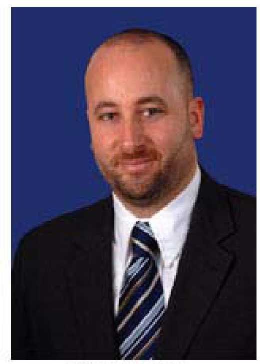
THE FACE THAT LAUNCHED A THOUSAND LAWSUITS - MADOFF'S LEGACY

By Thomas Telesca, Esq.



Thomas Telesca

We are all familiar with Bernie Madoff, the once Wall Street mavin turned scoundrel who siphoned billions of dollars from innocent – and some, maybe not so innocent – investors, in what is believed to be the largest Ponzi scheme of all time. Although it has been nearly two and a half years since Madoff's arrest, thousands of lawsuits arising from his Ponzi scheme are still making their way through the courts, many of which are venued in New York's federal court – the Southern District. This firm has been on the front lines of the many Madoff battles being waged in the courts. We (i) instituted the first class action against Madoff within days of his arrest; (ii) filed numerous SIPA claims on behalf of bilked investors; (iii) commenced lawsuits against hedge fund managers who funneled funds to Madoff for investors without direct access, despite numerous red flags suggesting that those hedge fund managers turned a blind eye to Madoff's fraud; and (iv) are defending so-called "net winners" against "claw backs" brought by Irving Picard, the trustee of Madoff's bankruptcy estate. The legal battles with which this firm has been involved point to one common denominator: the courts have prevented the various Madoff related cases from overburdening the system designed to remedy Madoff's fraud. Most recently, issues surrounding Picard's claw backs have pushed to the forefront.

The Bark of the Claw Back is Worse than its Bite

In what must feel like for some scorned Madoff investors who lost their life savings, proverbial salt in the wound, Irving Picard has initiated countless "avoidance" lawsuits in bankruptcy court against Madoff's so-called "net winners." A "net winner" is an investor who withdrew more from their Madoff account than their principle investment. By contrast, a "net loser" is a Madoff investor who withdrew less money than their principle investment. With hindsight, we now know that the monies withdrawn by the net winners which exceeded their principle investments were fictitious profits because Madoff operated a Ponzi scheme. Picard seeks to "avoid" or "claw back" Madoff's payments to the net winners as fraudulent transfers. If successful, Picard would add those clawed back funds to his coffers for eventual redistribution to the net losers.

Fraudulent transfers are payments made by an insolvent debtor – in this case Madoff – to a non-creditor – who are the net winners – for the purpose of avoiding the debtor's creditors – the net losers. Under the Bankruptcy Code, fraudulent transfers can be avoided if they occurred within two years of the bankruptcy filing – a two-year "look-back" period. The Bankruptcy Code also adopts applicable state law, which, in this case is New York, for fraudulent transfer claims. The look-back period under New York law is six years from the bankruptcy filing.

The most high-profile of such claw back cases was Picard's lawsuit against New York Mets owners Saul Katz and Fred Wilpon in which he sought to claw back one billion dollars. Early on, Katz and Wilpon successfully "withdrew the reference" of their case from the bankruptcy court, which meant that their case was moved to the district court before District Judge Jed Rakoff, because it involved issues beyond the reach of the Bankruptcy Code. As the trial was set to begin in mid-March, the case settled for $162 million to be paid over time, or if at all, as Katz and Wilpon are also net losers in other Madoff accounts, which losses may ultimately offset the amount they agreed to pay Picard. Although a settlement was reached, it was not before Judge Rakoff severely limited the scope of Picard's claw backs in a decision from September 2011.

According to Judge Rakoff, because Madoff's firm was a registered stockbrokerage, the "safe harbor" provision of section 546(e) of the Bankruptcy Code applied. Section 546(e) is at the intersection of the Bankruptcy Code and federal securities law. It was adopted to eliminate the substantial burden that would be placed on courts and litigants involved in fraudulent transfer lawsuits arising from securities transactions, if they attempted to unwind years of multiple securities trades involving numerous parties. That provision limits Picard's claw back cases in two ways. First, section 546(e) allows a net winner to retain monies he or she received "for value and in good faith." Madoff's return of the net winner's principle investment was presumably "for value." According to Judge Rakoff, Picard can only recover the net winner's principle investment if he proves that the net winner lacked good faith when investing with Madoff. This would require Picard to prove that a net winner was "willfully blind" to Madoff's securities fraud, an extremely high bar for Picard to hurdle in most, if not nearly all, claw backs.

Second, section 546(e) precludes the application of state law in fraudulent transfer cases. Thus, New York law's six-year look-back for fraudulent transfers does not apply. Although Judge Rakoff ruled that the net winner's fictitious profits could not have been received "for value," because they never existed, under section 546(e), Picard's recovery of those fictitious profits is limited to only withdrawals made during the last two years before Madoff imploded. By limiting Picard to a two-year instead of six-year look back, Judge Rakoff has severely limited the scope of Picard's potential recovery from the net winners. With no appeal of Judge Rakoff's ruling in the Katz/Wilpon case, because it settled, his ruling best describes the current legal landscape in the field of claw backs.

The Latest Battle: to Withdraw or not to Withdraw the Reference

Short of a reversal on appeal, Judge Rakoff's decision should prompt the settlement of many claw backs, as it did in the Katz/Wilpon case. That is not likely to occur in the near term as another issue has taken center stage. Following the lead of Katz and Wilpon, many other claw back defendants have sought to withdraw the reference of their case from the bankruptcy court to the district court and, in particular, to Judge Rakoff. In short, withdrawal of the reference is mandatory if the resolution of a case requires interpretation of both the Bankruptcy Code and other laws. For claw back defendants, Judge Rakoff is the best arbiter in light of his decisions in the Katz/Wilpon case. As a result of the anticipated number of motions to withdraw the reference, Judge Rakoff set April 2nd as the deadline for such motions. By April 2nd, hundreds of such motions were filed, many of which relied upon, in part, the Supreme Court's watershed decision from last summer in *Stern v. Marshall*, a case involving former Playboy Playmate Vickie Lynn Marshall a/k/a Anna Nicole Smith.

Following the death of her octogenarian husband, Vickie Lynn filed for bankruptcy. Vickie Lynn's step-son filed a proof of claim in her bankruptcy for damages arising from an alleged defamation claim. In response, Vickie Lynn filed an unrelated state law counterclaim against the step-son for tortious interference with a gift she expected from her late husband. In a complicated decision largely outside the purview of this writing, the Supreme Court ruled that the Constitution does not permit the bankruptcy court "to enter judgment on [Vickie Lynn's] state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." Such a decision requires the exercise of general judicial power, which according to the Supreme Court, rests only with the district courts, because they act with such express authority under Article III of the Constitution. The bankruptcy courts, in contrast, derive their authority from acts of Congress and, thus, cannot render final decisions impacting rights outside the scope of the Bankruptcy Code.

It is not settled whether the Supreme Court's decision in *Stern v. Marshall* also stands for the broader proposition espoused by the claw back defendants that the bankruptcy court has no jurisdiction to finally resolve fraudulent transfer lawsuits. Arguably, the claw backs affect the net winners' state law property rights to their assets, which rights are not necessarily governed by the Bankruptcy Code. In line with his prior rulings, Judge Rakoff has granted, in part, the hundreds of motions to withdraw the reference which were recently filed, but only for the limited purpose of deciding whether the bankruptcy court may finally resolve the fraudulent transfer claims in light of *Stern v. Marshall*. Judge Rakoff has directed the hundreds of claw back defendants – despite their varying positions and unique circumstances – to file only one joint brief addressing the import of *Stern v. Marshall*. Oral argument will be held on June 18.

As this alert "went to press," Judge Rakoff also directed consolidated, expedited briefing to address another argument raised in favor of withdrawing the reference beyond *Stern v. Marshall*: section 546(e)'s application of securities law.

Based on his prior decisions having already addressed, at least preliminarily, *Stern v. Marshall* and section 546(e), Judge Rakoff may likely withdraw the reference of Picard's claw back cases. As with other Southern District decisions related to Madoff's fraud, one thing seems clear: when circumstances permit, Judge Rakoff as well as other district court judges will look to apply Judge Rakoff's decision in the Katz/Wilpon case in order to limit the scope of the claw backs. That outcome would undoubtedly foster an atmosphere of settlement between Picard and the claw back defendants, as it did in the Katz/Wilpon case, and help lessen the strain that Madoff lawsuits have put on the Southern District's docket. Stay tuned.