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Second Circuit Prohibits Madoff Trustee From Bringing Common Law Claims Against Financial Institutions

SIPA Trustee Has "Unclean Hands" And Lacks Standing To Sue

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On June 20, 2013, the U.S. Court of Appeals for the Second Circuit prohibited Irving Picard ("Mr. Picard" or "Trustee"), court-appointed trustee of Bernard L. Madoff Investment Securities LLC ("BLMIS"), from bringing various tort-based claims against several major financial institutions for their alleged involvement in the wrongdoing associated with the Bernard Madoff Ponzi scheme.[1] The Second Circuit affirmed the district court's ruling that the Trustee was prohibited from recouping losses based on the doctrine of *in pari delicto*. The court further held that Mr. Picard lacked standing to sue the financial institution defendants on behalf of BLMIS customers. The decision is a significant defeat for the Trustee and will likely limit future common law claims brought by SIPA trustees against large financial institutions on behalf of victims of mass financial fraud.

Background

In December 2008, Bernard L. Madoff was arrested for his involvement in the largest revealed Ponzi scheme in history. He later pled guilty to securities fraud and admitted to using his brokerage firm, BLMIS, as a vehicle for this widespread scheme.[2] Mr. Picard was subsequently appointed by the district court as trustee for BLMIS pursuant to an application filed under the Securities Investor Protection Act ("SIPA").[3] As SIPA trustee, Mr. Picard was charged with, among other things, assessing BLMIS's customer claims and investigating the underlying circumstances surrounding the firm's insolvency.

During his investigation into the Madoff scheme, Mr. Picard claims to have uncovered evidence of wrongdoing by the financial institutions who serviced BLMIS, including J.P. Morgan Chase & Co., UBS AG, Unicredit Bank Austria AG, and HSBC Bank. Subsequently, Mr. Picard commenced adversary proceedings in the United States Bankruptcy Court for the Southern District of New York against these firms and others seeking billions of dollars in damages on behalf of BLMIS customers. The Trustee alleged common law claims for aiding and abetting fraud, unjust enrichment, and conversion and claimed that the institutions were complicit in the massive Ponzi scheme. Mr. Picard further alleged that when confronted with evidence of Madoff's scheme, the institutions' banking fees gave them an incentive to "look away" or caused an overall failure to perform the proper due diligence that would have revealed Madoff's fraud.[4]

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In November 2011, two District Courts granted the defendants' motions to dismiss the Trustees' claims. On June 20, 2013, the Second Circuit affirmed the decisions, holding that: (1) the doctrine of *in pari delicto* bars the Trustee from asserting claims directly against the defendants on behalf of BLMIS; and (2) the Trustee does

1 *In re: Bernard L. Madoff Inv. Sec. LLC*, 11-5044, 11-5051, 11-5175, 11-5207 at p. 7 (hereinafter "Decision").

2 *See In re: Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229 (2d Cir. 2011).

3 SIPA was enacted in 1970 in order to expedite the distribution of "customer property" back to investors following a firm's financial collapse. *See Securities Investor Protection Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 649 (S.D.N.Y. 1999).

4 Decision at p. 7.

not have standing to pursue common law claims against the defendants on behalf of BLMIS customers.

Claims On Behalf of BLMIS Estate Barred On Principle of "In Pari Delicto"

Mr. Picard's claims against the defendants on behalf of the BLMIS estate were barred by the doctrine of *in pari delicto*, or "unclean hands." Under the principle, the court held that one wrongdoer – or importantly here, a SIPA trustee standing in his shoes – is barred from recovering against another wrongdoer and profiting from his own misconduct.[5] New York courts have consistently applied the doctrine of *in pari delicto* to bar debtors from suing third parties for a fraud in which the debtor participated.[6] In so finding, the court applied the standard set forth in *Shearson Lehman Hutton, Inc. v. Wagoner,* holding that a "claim against a third party for defrauding a corporation with the cooperation of management accrues to [its] creditors, not to the guilty corporation."[7] The court found that Mr. Picard, as trustee for BLMIS, "stands in the shoes" of BLMIS. As such, the court concluded that he was not permitted to "assert claims against third parties for participating in a fraud that BLMIS itself orchestrated." [8]

Mr. Picard's arguments that a SIPA trustee is exempt from the rule established in *Wagoner* and that the *in pari delicto* doctrine should not apply due to the "adverse interest" exception were both flatly rejected by the court. The court found no authority to support Mr. Picard's argument that a SIPA trustee is exempt from the rule established in *Wagoner.* The court further noted that the "adverse interest" exception is narrow and reserved only for cases of "where the fraud is committed against a corporation rather than on its behalf."[9] The court concluded that because it was not possible to separate BLMIS from Madoff and his scheme, the narrow exception could not apply here.[10]

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SIPA Trustee Lacks Standing To Sue On Behalf of BLMIS Customers

Next, the court found the Trustee lacked standing to assert claims on behalf of BLMIS's customers. Mr. Picard offered two theories for why, as a SIPA trustee, he should enjoy standing. First, he argued that existing Second Circuit precedent allowed third-party standing in SIPA liquidations. Second, Mr. Picard argued that SIPA itself conferred standing by creating a bailment relationship between the trustee and customers and, that as SIPA trustee, he is enforcing the Securities Investor Protection Corporation's ("SIPC's") rights of equitable and statutory subrogation to recoup funds advanced to Madoff's customers. The court refused to recognize standing on all grounds.

The court distinguished the authority cited by the Trustee, holding that *Caplin v. Marine Midland Grace Trust Co.*, and its progeny do not confer standing on bankruptcy trustees – and by extension SIPA trustees- to file suit on behalf of the bankrupt estate's creditors.[11] Rather, the court held that under *Wagoner* it was well settled that "a bankruptcy trustee has no standing to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself."[12]

5 *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 964 (N.Y. 2010).
6 *See Barnes v. Hirsch*, 212 N.Y.S. 536 (App. Div. 1st Dep't 1925).
7 *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F. 2d 114, 120 (2d Cir. 1991).
8 Decision at p. 23.
9 *See The Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 827 (2d Cir. 1997); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952 (N.Y. 2010).
10 Decision at p. 25-6.
11 *See Caplin v. Marine Midland Grace Trust Co.* 406 U.S. 416 (1972)
12 *Shearson Lehman Hutton, Inc.*, 944 F. 2d at 117-118 (2d Cir. 1991) *(citing Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 434 (1972)).

The court also rejected the Trustee's reliance on a bailee or subrogee relationship in order to establish his legal standing to bring suit, finding that Mr. Picard's primary authority on the issue was non-binding. Mr. Picard argued that *Redington v. Touche Ross & Co.*, established his standing to sue on behalf of customers as a bailee and/or subrogee for their claims.[13] The court rejected these arguments. While the Second Circuit's decision in *Redington* supported Mr. Picard's contention, the court found that a subsequent Supreme Court reversal on other grounds had the effect of divesting the *Redington* circuit court of subject matter jurisdiction.[14] Accordingly, the court found that the Second Circuit holding with respect to standing as bailee or subrogee was no longer good law, having little persuasive value and no precedential value.[15]

Mr. Picard also argued that as trustee he may assert creditors' claims if they are "generalized in nature," and not particular to any individual creditor.[16] The court dismissed this argument as well. A debtor's claim against a third party is "general" if it seeks to augment the fund of customer property and thus affects all creditors in the same way. Here, Mr. Picard sought to assert claims on behalf of thousands of customers against third-party financial institutions for their handling of individual investments made on various dates in varying amounts. As such, the court concluded that the defendants' alleged wrongful acts could not have possibly harmed all customers in the same way.[17]

13 *Redington v. Touche Ross & Co.*, 592 F.2d 617, 618 (2d Cir. 1978), rev'd, 442 U.S. 560 (1979).
14 Decision at p. 36.
15 *Id.* at p. 38-9.
16 *See St. Paul Fire & Marine Insurance Co. v. PepsiCo, Inc.*, 884 F.2d 688 (2d Cir. 1989).
17 Decision at p. 43.

Conclusion

The court's refusal to acknowledge Mr. Picard's legal standing and its reliance on *in pari delicto* as a restriction on the pursuit of his claims has decimated the Trustees' multibillion dollar claims against these large financial institutions.[18] Although the decision leaves open the possibility of individual lawsuits by BLMIS customers to recover from those alleged to have a role in the Madoff fraud, it marks a significant victory for financial institutions and could significantly limit the eventual distribution for BLMIS customers. ■

18 Notably, the Trustee retains the authority to pursue fraudulent conveyance and preference claims against the financial institutions, which claims are currently pending before the bankruptcy court.

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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