Insolvency & Restructuring - USA

Appeal court expands stockbroker defence to non-securities transactions

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Introduction

On December 8 2014 the US Court of Appeals for the Second Circuit handed down a remarkable decision concerning Section 546(e) of the Bankruptcy Code in the *Madoff* clawback cases.(1) Section 546(e) is a statutory safe harbour that is sometimes referred to as the 'stockbroker defence'. Among other things, Section 546(e) precludes a bankruptcy trustee from avoiding and recovering payments made to complete or 'settle' securities transactions involving stockbrokers, financial institutions, securities clearing agencies and certain other entities.(2) Congress enacted Section 546(e) to minimise systemic upheaval in the securities markets that would result if trustees were permitted to reverse or unwind, through their avoidance powers, a host of transfers or trades that had been settled.(3) In an apparent effort to ensure market stability, Congress worded Section 546(e) "very broadly".(4) In *Madoff* the payments at issue had not originated from any securities trading; they were drawn merely from a checking account in which the funds received from customers were commingled. It was only by dint of fraud that the payments carried the veneer of a securities-related transaction. Yet the Second Circuit found the veneer, however false, to be sufficient to invoke Section 546(e). Relying on the statute's broad wording, the Second Circuit extended the Section 546(e) safe harbour to shield those payments from recovery even though the payments were not related to any actual transactions in securities.

Facts

Madoff arose from the massive Ponzi scheme perpetrated by Bernard L Madoff through his investment advisory company, Bernard L Madoff Investment Securities LLC (BLMIS). Customers who opened an account with BLMIS signed agreements authorising BLMIS to purchase stocks and to hedge those purchases with options contracts.(5) However, BLMIS conducted no actual securities or options trading on behalf of its customers. Instead, BLMIS stashed its customers' investments in a commingled checking account and fabricated customer statements to show fictitious trading activity and investment returns.(6) When customers sought to withdraw money from their accounts, BLMIS sent them cash from the commingled checking account.(7)

After the Madoff scheme was exposed, BLMIS was placed into liquidation under the Securities Investor Protection Act. Irving Picard was appointed the trustee under the Securities Investor Protection Act to administer the liquidation. Whenever customer property in a Securities Investor Protection Act liquidation is insufficient to pay customer claims in full, the trustee is empowered to claw back "any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void" under the Bankruptcy Code.(8) Invoking his clawback power, Picard sued hundreds of BLMIS customers who had withdrawn more money from their accounts than they had invested with BLMIS and had thus profited from Madoff's scheme.(9) Several defendants moved to dismiss on the basis that the moneys withdrawn from BLMIS were securities-related payments shielded from avoidance and recovery under Section 546(e). The US District Court for the Southern District of New York agreed and, except for a narrow class of actual-fraud claims that Section 546(e) cannot block, dismissed the clawback claims.(10) The trustee appealed the dismissals to the Second Circuit.

Decision

On appeal, the Second Circuit affirmed the district court, concluding that the payments satisfied Section 546(e). In relevant part, Section 546(e) provides that a trustee:

> "*may not avoid a transfer that is a...* settlement payment*, as defined in [the Bankruptcy Code], made by [a] stockbroker... or that is a transfer made by [a] stockbroker...* in connection with a securities contract*, as defined in [the Bankruptcy Code].*"(11)

No party disputed that BLMIS was a 'stockbroker' under Section 546(e), so the appeal turned on whether the payments made by BLMIS were transfers made "in connection with a securities contract" or were "settlement payment[s]". At the outset, the Second Circuit noted that the Bankruptcy Code's definition of 'securities contract' "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".(12) The Second Circuit concluded that the account-opening documents fit the definition of 'securities contract' since, among other reasons, the documents "established the broker-customer relationship" and "authorized BLMIS to trade in securities for the customer's account".(13)

With the definition of 'securities contract' satisfied, the Second Circuit went on to hold that the payments made to BLMIS's customers were transfers made "in connection with" a securities contract.(14) In the context of Section 546(e), opined the court, "a transfer is 'in connection with' a securities contract if it is 'related to' or 'associated with' the securities contract".(15) "Here, BLMIS promised its customers that it would transact securities, and BLMIS's customers deposited money relying on that promise."(16) That agreement constituted "a securities contract as defined in the statute and the customers' subsequent withdrawals from their accounts were therefore related to, and associated with, this securities contract".(17) In the Second Circuit's estimation, the words 'in connection with' established a "low bar" for Section 546(e) eligibility.(18) "Congress could have raised the bar", the court said, "by requiring that the transfer be made 'pursuant to,' or 'in accordance with the terms of,' or 'as required by,' the securities contract".(19) But Congress did not do so. Instead, it "merely required that the transfer have a connection to the securities contract, which [the BLMIS] payments do".(20)

As an alternative ground, the Second Circuit concluded that the customer withdrawals each constituted a "settlement payment" qualifying for Section 546(e) protection. The BLMIS trustee had argued that the withdrawals could not have been settlement payments because BLMIS never engaged in actual securities trading. But the Second Circuit found that the trustee's argument ran counter to the Bankruptcy Code's definition of 'settlement payment', which "should be broadly construed to apply to 'the transfer of cash or securities made to complete [a] securities transaction'".(21) "That is what the BLMIS clients received", the court reasoned.(22) "[I]f I instruct my broker to sell my shares of ABC Corporation and remit the cash, that payment is a 'settlement' even if the broker may have failed to execute the trade and sent me cash stolen from another client".(23) This reasoning runs parallel to a suggestion made earlier in the decision that the reach of Section 546(e) should be guided by the expectations or beliefs of the broker's customers. As the Second Circuit put it:

> "*[t]he clawback defendants, having* every reason to believe *that BLMIS was actually engaged in the business of effecting securities transactions,* have every right *to avail themselves of all the protections afforded to the clients of stockbrokers, including the protection offered by § 546 (e).*"(24)

Section 546(e) says nothing in its text about customer beliefs or expectations. Thus, the statement seems out of place in a decision that is otherwise grounded in the language of the statute. Moreover, to the extent that customer beliefs or expectations are relevant to the analysis, the decision leaves unanswered whether Section 546(e) should apply if the customers knew, or reasonably should have known, of the broker's Ponzi scheme and the fact that the payments did not stem from actual securities transactions.

Departing from the statute's language, the BLMIS trustee addressed its legislative purpose, arguing that Congress enacted Section 546(e) to "minimiz[e] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries".(25) Because there were no securities transactions to unwind, the trustee argued, Section 546(e) was inapplicable. The Second Circuit was unmoved, noting that the "magnitude of BLMIS's scheme, which included thousands of customers and billions of dollars under management", was "unprecedented".(26) Hence, the court warned, allowing the trustee to claw back "millions, if not billions, of dollars from BLMIS clients – many of whom are institutional investors and feeder funds – would likely cause the very 'displacement' that Congress hoped to minimize in enacting § 546(e)".(27)

Interestingly, in a decision rendered earlier this year in the *Lyondell* bankruptcy case, the US Bankruptcy Court for the Southern District of New York (whose decisions are reviewable by the Second Circuit) reached a somewhat different conclusion with respect to potential "displacement". The fraudulent transfer litigation in *Lyondell* arose from a pre-bankruptcy leveraged buy-out of the Lyondell Chemical Company, in which the selling shareholders received, in connection with that leveraged buy-out, approximately $12.5 billion for their shares. The defendants in that litigation – several of which were institutional investors – raised Section 546(e) as a defence. In its analysis, the bankruptcy court reviewed the legislative history of Section 546(e) and concluded that Congress enacted that statute out of concern to protect markets and market intermediaries from the harmful "ripple effects" that would result from unwinding market transactions.(28) However, the court found nothing in the legislative history that evinced "a desire to protect individual investors who are beneficial recipients of insolvents' assets".(29) Clawing back leveraged buy-out payments from stockholders at the end of the asset transfer chain did not pose the same systemic risk to markets that Section 546(e) was intended to protect. The *Lyondell* court said those stockholders could give back the leveraged buy-out payments "with no damage to anyone but themselves".(30) "Protecting the financial markets", the *Lyondell* court said, "is not necessarily the same thing as protecting investors in the public markets, even if they happen to be stockholders who are major investment banks".(31) Whatever its merits may be, the vitality of the *Lyondell* court's conclusion now seems, at the very least, cast into doubt in light of *Madoff*.

Finally, the Second Circuit in *Madoff* turned to the trustee's argument that allowing the clawback defendants to retain the fictitious profits bestowed on them would give legal effect to Madoff's fraud. The Second Circuit found that argument "compelling", but "ultimately not convincing".(32) The outcome here, the court suggested, was the product of "careful balances" struck by Congress between "the need for an equitable result for the debtor and its creditors, and the need for finality".(33)

> "*[B]y enacting § 546(e), Congress provided that, for a very broad range of securities-related transfers, the interest in finality is sufficiently important that they cannot be avoided by a bankruptcy trustee at all, except as actual fraudulent transfers under § 548(a)(1)(A).*"(34)

It was not the province of the courts, the Second Circuit implicitly suggested, to upset the careful balances reached by Congress, even if equitable considerations might point to a different result.

Comment

The *Madoff* decision joins a line of cases that have arguably applied Section 546(e) beyond the confines of what Congress originally intended to protect. Congress enacted Section 546(e) out of concern to protect markets and market intermediaries, such as exchanges, clearing associations and depositories for investors, from the harmful "ripple effects" that would result from reversing market transactions.(35) Stated another way, the policy underlying Section 546(e) is to insulate the modern clearance and settlement system serving the public securities markets from claims to avoid preferential transfers and most kinds of fraudulent transfers. Yet some courts have relied on the plain language of Section 546(e) to extend its safe harbour to transactions involving stock that was not traded in public financial markets.(36) In *Madoff* the Second Circuit reached a similar result: based on its broad and literal interpretation of the statute, the court applied Section 546(e) to protect payments that did not stem from the sale and purchase of publicly traded securities.

The expansion of Section 546(e), arguably beyond its intended purview, has spurred calls for legislative reform. On the same day that the *Madoff* decision was handed down, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 released its report of findings and recommendations, which included recommendations concerning Section 546(e).(37) The report observed that "[a]s written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts... and similar transactions, even if the securities were privately issued".(38) "This outcome appears anomalous", the report found, "in light of the policy underlying section 546(e)", which is "to insulate the *securities transfer system* from fraudulent conveyance and preference actions".(39) The report recommends that Section 546(e) be amended "to remove protection from avoidance actions for beneficial owners of privately issued securities in connection with prepetition transactions using some or all of the debtor's assets".(40) The report further recommends that Section 546(e) protection remain in place "for (i) securities industries participants who act as conduits in both public and private securities transactions and (ii) public securities holders".(41) The *Madoff* decision now adds a new question to the reform discussion regarding the extent to which those same "public securities holders" should be shielded from avoidance attack when the payments made to them did not originate in the securities transfer system at all, but in purported securities transactions that in reality were mere shams.

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Endnotes

(1) See *Picard v Ida Fishman Revocable Trust (In re Bernard L Madoff Inv Sec LLC)*, No 12-2557-bk (L), 2014 WL 6863608, ___ F 3d ___ (2d Cir December 8 2014).

(2) See 11 USC § 546(e).

(3) *In re Adler, Coleman Clearing Corp*, 263 BR 406, 477 (SDNY 2001).

(4) *Madoff*, 2014 WL 6863608, at *2.

(5) *Id* at *1.

(6) *Id*.

(7) *Id*.

(8) 15 USC § 78*fff*-2(c)(3).

(9) *Madoff*, 2014 WL 6863608, at *1.

(10) *Id* at *3.

(11) 11 USC § 546(e) (emphasis added).

(12) *Madoff*, 2014 WL 6863608, at *4 (citation omitted and emphasis in original).

(13) *Id* at *5 (citation omitted).

(14) *Id* at *8.

(15) *Id* (citing *Webster's 3d Int'l Dictionary* 481 (1993)).

(16) *Id*.

(17) *Id*.

(18) *Id*.

(19) *Id*.

(20) *Id*.

(21) *Id* at *9 (quoting *In re Enron Creditors Recovery Corp*, 651 F 3d 329, 334 (2d Cir 2011)).

(22) *Id*.

(23) *Id*.

(24) *Id* at *6 (emphasis added).

(25) *Id* (citation omitted).

(26) *Id*.

(27) *Id* (citation omitted).

(28) *In re Lyondell Chem Co*, 503 BR 348, 369-73 (Bankr SDNY 2014).

(29) *Id* at 373.

(30) *Id* at 372-73.

(31) *Id* at 373.

(32) *Madoff*, 2014 WL 6863608, at *9.

(33) *Id* (citation omitted).

(34) *Id*.

(35) See *supra* note 28.

(36) See, for example, *In re QSI Holdings, Inc*, 571 F 3d 545, 547, 549-50 (6th Cir 2009); *Contemporary Indus Corp v Frost,* 564 F 3d 981, 985-87 (8th Cir 2009). Notwithstanding the aforementioned cases cited, courts are split on this issue. See generally 5 *Collier on Bankruptcy* ¶ 546.06[2][b][i], at 546-53 (Alan N Resnick and Henry J Sommer, eds, 16th ed 2012) (stating that "there is much disagreement over whether section 546(e) applies to both public and nonpublic securities transactions") (citing cases).

(37) American Bankruptcy Institute Commission to Study the Reform of Chapter 11, *Final Report and Recommendations* (2014), available at http://commission.abi.org/.

(38) *Id* at 97.

(39) *Id* (emphasis in original).

(40) *Id* at 95.

(41) *Id*.