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SDNY DISTRICT COURT HOLDS THAT MADOFF TRUSTEE LACKS STANDING TO ASSERT COMMON LAW CLAIMS AGAINST THIRD PARTIES ON BEHALF OF MADOFF CUSTOMERS

On July 28, 2011, the United States District Court for the Southern District of New York (the "Court") handed down an important decision in *Picard v. HSBC Bank Plc, et al.*, dismissing common law claims brought against Pioneer Management Ltd., UniCredit S.pA., and various HSBC entities (the "Defendants") by Irving H. Picard (the "Trustee"), as trustee appointed pursuant to the Securities Investor Protection Act ("SIPA") for the consolidated liquidation of Bernard L. Madoff Investment Securities ("Madoff Securities"). In a rather harshly-worded opinion authored by District Judge Jed S. Rakoff, the Court held that the Trustee lacked standing to assert against the Defendants on behalf of Madoff Securities' customers various common law claims for conversion, unjust enrichment, money had and received, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty (hereinafter referred to as the "Common Law Claims").[1] By significantly limiting the Trustee's ability to assert the Common Law Claims on behalf of Madoff Securities' customers, this decision will likely have a ripple effect in numerous adversary proceedings in which the Trustee has asserted similar claims against other defendants. Ultimately, the decision will limit the Trustee's ability to obtain recoveries for the Madoff Securities estate on behalf of Madoff Securities' customers.

BACKGROUND

Alleging that "Bernard Madoff did not act alone in perpetrating the largest financial fraud in history," the Trustee filed an adversary complaint against the Defendants in Madoff Securities' SIPA liquidation case, seeking recovery of roughly $2 billion in preferential or fraudulent transfers from various third parties, and approximately $6.6 billion in damages under various common law theories premised on the Defendants' alleged failure to adequately investigate Madoff Securities despite clear indicia of fraud.[2]

[1] Opinion and Order, *Picard v. HSBC Bank Plc, et al.*, No. 11-CV-763 (JSR) (Docket No. 40) (S.D.N.Y. Jul. 28, 2011) (hereinafter, the "Opinion").

[2] *See* Amended Complaint, *SIPC v. Bernard L. Madoff Investment Securities LLC*, Adv. Pro. No. 09-1364 (BRL) (Docket No. 34) (Bankr. S.D.N.Y. 2009).

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On April 12, 2011, Judge Rakoff "withdrew the reference"[3] with respect to this action for the limited purpose of deciding whether the Trustee had standing to bring the Common Law Claims against the Defendants.[4]

DISTRICT COURT'S DECISION

As a threshold matter, the Court noted that, absent a basis in non-bankruptcy federal law, the Trustee was not entitled, merely by virtue of his role as trustee of the estate, to have standing in federal court to assert the Common Law Claims against the Defendants on behalf of Madoff Securities customers. Specifically, the Court noted that a SIPA trustee is vested with essentially the same powers as a bankruptcy trustee, and that it is well settled law that the Bankruptcy Code does not itself confer standing on a bankruptcy trustee to assert claims against third parties on behalf of the estates' creditors, because the trustee stands in the shoes of the estate – not its creditors.[5] In addition, under the common law doctrine of *in pari delicto*, the trustee of an estate of a wrongdoer (*i.e.*, Madoff Securities) is generally precluded from bringing claims on behalf of such an estate against other alleged wrongdoers (*i.e.*, the Defendants).[6]

The Trustee argued he had standing to pursue the Common Law Claims against the Defendants as (i) a bailee of customer property, (ii) a subrogee to customer claims and (iii) an assignee of customer claims.[7] The Court rejected all of the Trustee's "convoluted theories" in turn.[8]

a) *The Trustee is not a Bailee of Customer Property*

The Trustee claimed standing to pursue the Common Law Claims against the Defendants as a bailee of the property of Madoff Securities customers, arguing such authority could be derived from (i) SIPA, (ii) the Securities Exchange Act of 1934 (the "Exchange Act") and (iii) the common law of bailment.

First, the Trustee relied upon a provision of SIPA authorizing a trustee to investigate "and report to the court any facts ascertained by the trustee with respect to fraud, misconduct, mismanagement and irregularities, and any causes of action available to the estate."[9] The Trustee claimed that, absent authority to bring suits on behalf of defrauded creditors, the investigative authority conferred by SIPA would be "academic."

The Court dismissed this argument out of hand, commenting, "[t]hat Congress would want a SIPA trustee to publicly report to a court, and hence to the public, any fraud the trustee uncovers is hardly an 'academic' exercise." The Court concluded that the Trustee's statutory interpretation did not comport with accepted legal principles defining implied rights of action. The Court also noted that the Supreme Court had already rejected a similar argument in *Caplin*, when it refused to treat a similarly drafted bankruptcy code provision as granting a trustee standing to bring claims on behalf of creditors on the grounds that there was nothing in the provision that enabled a trustee to collect money not owed to the estate itself.

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3 Jurisdiction over bankruptcy matters is originally conferred upon the United States District Courts. However, by standing orders in place in most, if not all, United States judicial districts, including the Southern District of New York, bankruptcy matters are "referred" to the bankruptcy judges for that district. *See* 28 U.S.C. § 157. Where certain "non-core" matters arise in connection with a bankruptcy case, such matters can, or in some cases, must be heard by the district court judges and, in such cases, the reference to the bankruptcy court is "withdrawn." *Id.*

4 The District Court also withdrew the reference to determine whether the Securities Litigation Uniform Standards Act ("SLUSA") pre-empted the Common Law Claims. Because the Court ultimately concluded that the Trustee did not have proper standing to assert the Common Law Claims, it did not reach the issue of whether such claims would be pre-empted pursuant to SLUSA.

5 Opinion at 5, *citing Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 434 (1972).

6 Opinion at 5-6, *citing Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991).

7 A "bailee" is a person to whom personal property is delivered pursuant to a contract. A "subrogee" is a person or entity who assumes the legal right to attempt to collect a claim of another person or entity, and an "assignee" is a person to whom property rights or powers are transferred by another.

8 Opinion at 6.

9 *See* 15 U.S.C. § 78fff-1(a).

The Trustee further argued that because SIPA defines "customer property" to include securities, cash and "any other property of the debtor, which upon compliance with applicable laws, rules and regulations, would have been set aside or held for the benefit of customers,"[10] it had the authority to bring the Common Law Claims on behalf of customers because such claims either seek recovery of customer property or are themselves customer property under SIPA. The court rejected this argument because (i) the fact that *if* the Trustee could bring such claims, any recovery might be treated as customer property does not provide the Trustee with standing to bring the claims in the first instance and (ii) such an expansive reading of SIPA's definition of "customer property" is inconsistent with a generally accepted canon of contractual construction requiring a court to interpret a general statutory term which follows a list of more specific terms as of the same kind or class as the specific terms. The Court further reasoned that even if the definition of customer property "could be so stretched as to include rights in putative lawsuits, this itself would not convey standing on the Trustee to bring such a lawsuit."

Alternatively, the Trustee argued that Rule 15c3-3 of the Exchange Act, which was meant to facilitate the liquidation of insolvent broker-dealers by segregating customer property from a broker-dealer's own assets, impliedly granted the Trustee authority to pursue the Common Law Claims against the Defendants as a bailee of customer property. The Court noted that SIPA itself sets out the powers and duties of a SIPA trustee, which powers are the same as those of an ordinary bankruptcy trustee. As such, the Court was "mystified" by the suggestion that a provision of the Exchange Act could somehow confer upon the Trustee authority not granted by SIPA or available to an ordinary bankruptcy trustee. In rejecting the argument outright, the Court noted that Rule 15c3-3 of the Exchange Act provision is "undisputedly not a part of SIPA," and does not create standing for a SIPA trustee to bring the Common Law Claims against third parties.

The Trustee also sought support from the common law of bailment for a determination that it is a bailee of customer property and, therefore, has authority to pursue the Common Law Claims against the Defendants on behalf Madoff Securities customers.[11] The Court held that the Trustee was not a bailee in the common law sense because he was not seeking to return any recovered bailments to the individual bailors (*i.e.*, Madoff Securities customers), but rather to distribute customer property *pro rata* pursuant to a SIPA distribution scheme. The Court also rejected the Trustee's arguments that he was a common law bailee on the grounds that: (i) the Defendant's fraudulent conduct in funneling money to Madoff Securities allegedly occurred prior to the purported bailment, (ii) the alleged bailment caused a short term *gain* in the property value, rather than a loss and (iii) "no bailment can exist where the would-be bailee is a thief and, here, Madoff acquired investments with the intent to further his Ponzi scheme."[12] Finally, the Court reiterated that it saw no reason to conclude that the common law should vest a SIPA trustee with broader powers than those afforded to an ordinary bankruptcy trustee or otherwise expressly provided for by SIPA.

b) *The Trustee is not a Subrogee of SIPC*

The Trustee asserted that he had standing to prosecute the Common Law Claims against the Defendants as an enforcer of subrogation rights held by the Securities Investor Protection Corporation ("SIPC") pursuant to SIPA. Specifically, the Trustee argued that because he had already distributed approximately $800 million to customers from funds advanced by SIPC and had been assigned SIPC's subrogation rights for amounts advanced to Madoff Securities customers, the Trustee had standing to assert SIPC's subrogation rights for at least that amount against the Defendants. The Court found that "the plain language of SIPA makes clear that SIPC is only subrogated to customer net equity claims against the estate, not to all customer claims against third parties." In addition, neither SIPC nor the Trustee could recover against the Defendants without violating the priority scheme provided by SIPA until Madoff Securities customers had been made whole.

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10 *See* 15 U.S.C. § 78lll(4).

11 Bailment is the delivery of personal property by one person (the *bailor*) to another (the *bailee*) who holds the property for a certain purpose under an express or implied in fact contract. Black's Law Dictionary (9th ed. 2009).

12 Opinion at 13, *citing Pivar v. Graduate Sch. of Figurative Art*, 290 A.D.2d 212, 213 (N.Y. App. Div., 1st Dep't 2002), for the proposition that a bailment only arises where the bailee obtains lawful possession of the bailed property without present intent to appropriate it.

c) *Redington Does Not Confer Standing to Trustee as a Subrogee or Bailee*

The Trustee and SIPC argued that the Second Circuit's decision in *Redington v. Touche Ross & Co.*[13] supported their arguments that the Trustee may be viewed as either a bailee or subrogee of Madoff Securities customer property. The Court noted that in *Redington*, the Second Circuit held that section 17(a) of the Exchange Act created a private right of action on the basis of which customers of a failed brokerage firm could bring suits against the broker's accountants, and further held that SIPC (as subrogee of customers whose claims it had paid) and the SIPA trustee (as bailee of customer property) had standing to pursue claims against third parties on behalf of the customers. The Court rejected the Trustee's and SIPC's positions with respect to *Redington*, reasoning that because the Supreme Court overturned *Redington's* primary holding that section 17(a) of the Exchange Act created a private right of action, *Redington's* secondary holding – that a SIPA trustee had standing as a bailee – is no longer good law. Finally, the Court determined that, even if *Redington's* holdings with respect to subrogee and bailee standing were still good law, the facts in the instant case were sufficiently unlike the traditional bailor-bailee scenario in *Redington* to confer standing to the Trustee.

d) *The Trustee is not an Assignee of Customer Claims*

The Court also addressed the Trustee's theory that he was entitled to bring the Common Law Claims of Madoff Securities customers against the Defendants as an assignee of such claims. The Court noted that although SIPA authorizes a SIPA trustee to obtain assignments of net equity claims from customers, at least four different courts have rejected the proposition that SIPA authorizes assignments of customer claims against third parties. The Trustee also apparently conceded that he had received no assignments from third parties.

e) *The In Pari Delicto Doctrine Bars the Trustee's Claims*

Lastly, noting that the doctrine of *in pari dilecto* bars a trustee from suing to recover for a wrong in which the debtor whose estate the trustee represents participated, the Court held that the doctrine would prevent the Trustee from obtaining standing for all of the Common Law Claims, other than contribution claims.[14] Although the doctrine is generally asserted as an affirmative defense, the Court noted that in federal court the doctrine also goes to the issue of standing, where, based on prudential concerns, a federal court will decline to hear a claim that would clearly be defeated by the doctrine.[15] Furthermore, the Court found that even the contribution claims would fail because the Trustee cannot rely on state law to seek contribution where the comprehensive scheme pursuant to which the payments to Madoff Securities customers are being made (*i.e.*, SIPA), does not expressly provide for contribution.

IMPLICATIONS OF DECISION

The Court's decision is likely to have wide impact in the Madoff cases and beyond. Similar standing issues have been raised by JP Morgan Chase in a motion to dismiss the suit brought against it by the Trustee in *Picard v. JP Morgan Chase & Co., et al.,*[16] and other defendants can be expected to attempt to make use of the precedent as well. Unless the Trustee is able to effectively distinguish the Court's decision, the Trustee will be severely limited in its ability to recover from third party defendants against whom the Trustee has asserted common law claims on behalf of Madoff Securities customers.

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13 592 F.2d 617 (2d Cir. 1978), *rev'd on other grounds*, 442 U.S. 560 (1979).
14 Contribution claims are claims brought by wrongdoers (*e.g.*, Madoff Securities) against alleged-fellow wrongdoers (*e.g.*, the Defendants).
15 Opinion at 23, *citing Wagoner*, 944 F.2d at 118.
16 No. 11-CV-913 (S.D.N.Y. 2011).

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