Shockwaves from a global scandal: The Madoff recovery effort and the legal and economic landscape

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Bernard Madoff's Ponzi scheme, which is now more than a decade old, was a financial tsunami, inflicting global devastation the likes of which has arguably never been seen before.[1] What emerged from the wreckage was an extraordinary legal and equitable recovery initiative the likes of which has also arguably never been seen before — and which, by any objective measure, has been the most successful and powerful recovery in the history of jurisprudence.

Since its inception, the Madoff case has often read like a first-year law school examination with a maze of challenging legal issues, often concerning matters of first impression. The breadth of litigation spans across a wide spectrum of interconnected disciplines, including appellate, bankruptcy, criminal, regulatory and securities. As the case enters its 11th year, three recent developments make it clear that the recovery efforts are not slowing down anytime soon. In fact, incredible as it may seem, dozens of cases are just getting started.

Since its inception, the Madoff case has often read like a first-year law school examination with a maze of challenging legal issues, often concerning matters of first impression.

First, the 2nd U.S. Circuit Court of Appeals just handed a crucial global victory to the trustee appointed to oversee the liquidation of Bernard L. Madoff Investment Securities LLC. The shockwaves of this decision will be felt by "subsequent transferees" who received proceeds from Madoff's fraud, including world-class banking institutions, money and hedge fund managers, investment pools, other institutional investors, and individuals who reside or are organized outside the United States.

Second, the trustee recently filed for approval with the U.S. Bankruptcy Court for the Southern District of New York a proposed settlement agreement with individuals and entities associated with one of Madoff's largest "feeder funds" nearly a decade after the initial adversary proceeding against that fund was filed.

Third, the trustee recently distributed close to another half a billion dollars to Madoff customers with valid claims. With each mounting distribution the trustee, his team and the Securities Investor Protection Corp. inch ever closer to a return of 100% of the nearly $18 billion in principal originally lost to the scheme.

Whether viewed alone or in tandem, each of these developments signal loudly that the relentless pursuit of billions of dollars shall continue to be waged in the courts and against transferees both here and abroad for many years to come.

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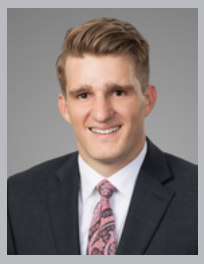
AUTHORIZATION TO SUE FOREIGN SUBSEQUENT TRANSFEREES

On Feb. 25, the 2nd Circuit handed down a landmark ruling in favor of the Madoff trustee,[2] reversing and vacating decisions from the U.S. District Court for the Southern District of New York, handed down five years earlier, as well as the 2016 decision of the U.S. Bankruptcy Court for the Southern District of New York.[3]

The prior decisions had the impact of stopping the trustee at the U.S. border and choking off over seven dozen cases valued at approximately $4 billion. The 2nd Circuit decision (barring a successful appeal to the U.S. Supreme Court by the defendants) allows the trustee to proceed with the filing of amended complaints against subsequent transferees who received transfers initiated from BLMIS in New York.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The court found that neither "the presumption against extraterritoriality" nor principles of international comity barred the recovery actions under the Bankruptcy Code. It rejected the prior holdings that the trustee of a domestic debtor, BLMIS (located in New York), could not recover property transferred to a foreign entity that subsequently transferred property to another foreign transferee.

In construing the Bankruptcy Code, the court examined both the initial fraudulent transfer by BLMIS to a number of Madoff's largest feeder funds (incorporated abroad) as well as the subsequent transfers from those funds to other foreign transferees (including lenders, managers and shareholders of the feeder fund).

The court determined that the applicable provisions for avoidance of the initial transfers under Section 548(a)(1)(A), and the recovery provisions under Section 550(a), work "in tandem," such that the focus of the trustee's actions against foreign, subsequent transferees — when not analyzed "in a vacuum" — involved a domestic rather than foreign application of the code.[4]

Specifically, applying the reasoning of a recent Supreme Court decision for evaluating a statute's focus,[5] the court held that Madoff's fraudulent activity in transferring property from the United States was domestic activity for purposes of both the avoidance and recovery of transfers, and that as such, the trustee was not barred from recovering money regardless of where any transferee (initial or subsequent) was located.

The court stressed that the "relevant conduct in these actions is the debtor's fraudulent *transfer* of property, not the transferee's *receipt* of property," and that "recovery is the business end of avoidance."

The court also rejected an interpretation of the statute that would allow fraudsters and transferees to shield a trustee from recovery by merely sending property offshore.

As for "international comity" the court held that:

- "The United States has a compelling interest in allowing domestic estates to recover fraudulently transferred property."
- The prospect of recovery assures creditors/investors their fair share of property.
- Such safeguards are an important goal of the code.
- Protecting the American economy, individual investors and our security markets are all key purposes of the Securities Investor Protection Act.

By contrast, the court found that the foreign jurisdictions' interests in the U.S. proceedings were not "compelling" because the trustee was not a creditor in those proceedings and because his U.S. claims are not duplicating any foreign proceeding.

The court again squarely rejected the lower courts' attempt to divorce the initial transfer from the subsequent ones, reiterating that the domestic nature of the fraudulent transfers and our nation's interest in regulating them require domestic adjudication.

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MORE MONEY GOING TO CUSTOMERS

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DEFENDANTS AFFILIATED WITH THE FAIRFIELD FEEDER FUNDS

In February, the trustee filed a motion seeking approval of a settlement between the trustee and 16 separate defendants for subsequent transfers they purportedly received from BLMIS through Fairfield Sentry Limited, Greenwich Sentry LP and Greenwich Sentry Partners, collectively referred to as the Fairfield funds.

Under the settlement the trustee will receive nearly $20 million in cash, assigned claims and deferred compensation, as well as cooperation and discovery with regard to ongoing litigation the trustee continues to pursue on behalf of the customer fund.

This settlement comes nearly 10 years after the initial adversary proceeding was commenced and nearly nine years after the trustee filed an extensive amended complaint seeking the recovery of subsequent transfers from the settling defendants.

It also comes nearly eight years after both the U.S. Bankruptcy Court and the Eastern Caribbean Supreme Court in the High Court of Justice of the Virgin Islands independently approved a firstofitskind settlement and cooperation agreement between the trustee and Fairfield Sentry's joint liquidator, which along with parallel settlements reached with the domestic Greenwich Sentry Fund allowed the trustee to achieve over $1 billion in value for Madoff's customers.[6]

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THE 10TH PRO RATA DISTRIBUTION

On Feb. 22, the trustee announced a 10th interim distribution of nearly another half billion dollars ($464 million). With this distribution, customers of BLMIS with valid, legal claims of $1.5 million or less will have been repaid in full. More than half of the total allowed claims to date will now have been satisfied.

In addition, over $13 billion has been recovered (from settlements and other recoveries) and nearly $12 billion has been distributed. These numbers, whether viewed from the perspective of initial expectations

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or on either a percentage or gross dollar amount of principal recovered basis, are unprecedented.

THE RECOVERY INITIATIVE: LESSONS LEARNED

The Madoff recovery effort reinforces that exposure to litigation and potentially millions, if not billions, in liability from financial schemes extends well beyond just the fraudster. Inevitably, when the fraudulent house of cards collapses under its own weight (due to the absence of new money to fuel it), recovery will be sought from third parties, including banks and other sophisticated investment managers and professionals.[7]

WHAT'S NEXT?

With the revival of about $4 billion in recovery proceedings against subsequent transferees around the world (tied to Madoff's largest feeder funds), it is safe to predict:

- Fierce appellate activity from the defendants.
- A bevy of new, amended complaints eventually being filed by the trustee.
- Motion practice from the transferee defendants seeking to dismiss the subsequent transferee suits.
- The negotiation and execution of more settlements like the most recent one from Fairfield.
- Ultimately, hundreds of millions, if not billions, in future distributions to customers.

If recent events are any indication, the trustee and his team will continue to thunder away until the very last dollar is recovered — for however many years it takes.[8] WJ

NOTES

[1] *See* Mark Kornfeld, Sara D. Accardi, & Nicholas D'Amico, *The Legacy of Madoff, A Decade Later*, Law360 (Nov. 19, 2018).

[2] *In re Picard*, 917 F.3d 85 (2d Cir. 2019).

[3] *Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 222 (S.D.N.Y. 2014), *supplemented by Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC.*, No. 12-mc-115, 2014 WL 3778155 (S.D.N.Y. July 28, 2014); *and see Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, No. 08-1789, 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016).

[4] *In re Picard*, 917 F.3d at 96. The court declined to express any opinion on whether Section 550(a) clearly indicates it has or intends to have extraterritorial reach.

[5] "The focus of a statute is 'the object of its solicitude,' which can include the conduct 'it seeks to regulate,' as well as the parties and interests it 'seeks to protect' or vindicate." *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129, 2137 (2018), quoting *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010).

[6] *See Picard v. Fairfield Inv. Fund Ltd. (In re Bernard L. Madoff)*, Doc. 18501 (Feb. 21, 2019); and *Picard v. Fairfield Sentry Ltd. et al.*, No. 08-1789, Adv. Pro. No. 09-01239 (Bankr. S.D.N.Y. June 7, 2011).

[7] Mark A. Kornfeld & Nicholas D'Amico, *Banks' Exposure to the Enron Fraud Lives 17 Years Later*, Bus. Law Today, Dec. 18, 2018, https://bit.ly/2Jk3vQb.

[8] It is also safe to predict — based on prior rulings involving the Madoff trustee — that other, significant legal issues remain on the horizon and that such matters will be contested at both the bankruptcy and appellate levels. These include (without limitation) the trustee's pleading burden (if any) in recovery actions against subsequent transferees, as well as whether a transferee's affirmative defense of good faith is properly governed under a standard of whether a transferee subjectively believed with knowledge (or by turning a blind eye) that Madoff was not actually trading securities, or under an objective standard of "inquiry notice" to Madoff's fraud. *Compare, e.g., Picard v. Cohmad Sec. Corp.*, 454 B.R. 317 (Bankr. S.D.N.Y. 2011) (denying motion to dismiss); *Picard v. Katz*, 462 B.R. 477 (S.D.N.Y. 2011) (denying motion to dismiss in part); *Picard v. Katz*, No. 11-cv-3605, 2012 WL 691551 (S.D.N.Y. Mar. 5, 2012) (denying defendants' motion for summary judgment); *Picard v. Ceretti et al.*, 08-99000, 2015 WL 4734749 (Bankr. S.D.N.Y. Aug. 11, 2015) (denying motion to dismiss), *with Picard v. Legacy Capital Ltd.*, 548 B.R. 13 (Bankr. S.D.N.Y. 2016) (granting motion to dismiss); *Picard v. BNP Paribas et al.*, 594 B.R. 167 (Bankr. S.D.N.Y. 2018) (granting motion to dismiss in part).

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