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The Madoff Dissolution: A Consideration of the Bayou Precedent and Possible Next Steps

Last week, on December 11, Bernard L. Madoff (“Madoff”) was arrested and criminally charged after admitting to masterminding a \$50 billion Ponzi scheme that he operated for years through his brokerage firm, Bernard L. Madoff Investment Securities LLC (“BMIS”). The next day, the SEC obtained emergency relief, had a temporary receiver appointed for BMIS, and froze its assets. On December 15, the Securities Investor Protection Corporation (“SIPC”) commenced formal liquidation proceedings with respect to BMIS and named a SIPC Trustee to displace the SEC receiver. Although new details of the Madoff scheme are emerging each day and the facts will continue to emerge in the weeks and months ahead, the story thus far seems eerily reminiscent of the dramatic fall of the Bayou Funds in August 2005. The Bayou matter involved a multi-year, complex Ponzi scheme, whose perpetrators deceived hundreds of sophisticated investors by regularly issuing falsified account statements certified by bogus auditors. Even though the potential scale of losses in the Madoff scheme seems to dwarf the \$450 million at issue in Bayou, the lessons learned in the Bayou bankruptcy proceeding provide instructive guidance to investors and other affected parties as they consider the implications of this latest scandal.¹

Status of the Madoff Case

On December 12, one day after the arrest of Madoff, the SEC sought and obtained the appointment of a temporary receiver for the broker-dealer he controlled, BMIS, and the court froze the assets of the firm, based on the allegations in the criminal complaint. As Madoff apparently conducted his scheme through the broker-dealer, SIPC determined, after consultation with the SEC, that it was in the best interest of customers to liquidate the broker-dealer. On December 15, Judge Louis L. Stanton granted permission to SIPC to commence a liquidation proceeding against BMIS under the Securities Investor Protection Act (“SIPA”) and appointed a trustee to oversee the proceeding.²

1 K&L Gates currently serves as litigation counsel to the Official Committee of Unsecured Creditors in the Bayou Group bankruptcy.

2 Order, *SEC v. Madoff, et al.*, No. 08-cv-10791 (S.D.N.Y. Dec. 15, 2008).

A SIPA liquidation proceeding is a specialized form of liquidation for broker-dealers through which securities and other assets owned by customers of the defunct broker-dealer are transferred to other firms if possible, customer property is distributed ratably to customers, and the broker-dealer is liquidated for the benefit of customers.³ In addition, SIPC may provide customers of BMIS with protection for losses of customer property up to \$500,000.⁴ The case will be administered by the bankruptcy court for the Southern District of New York and ordinary bankruptcy law will govern the proceedings to the extent it is consistent with SIPA. With certain limited exceptions, all other actions by investors to recover assets from BMIS, including recently filed class actions, will be stayed.⁵ Claims against Madoff personally and other third parties related to this scheme are not stayed, but will likely be consolidated before Judge Stanton.

Unfortunately, however, SIPC protection may not provide substantial recovery for most investors. To the extent losses were suffered by clients of Madoff outside of BMIS customer accounts, SIPC does not offer protection. Moreover, if the broker-dealer's records are inaccurate, as is often the case with a Ponzi scheme, it may not be possible for SIPC to determine share ownership and individual account holdings, as SIPC noted in its press release announcing commencement of the liquidation proceedings.⁶

Recovery of the Estate's Assets

The SIPC Trustee's first order of business will be to identify and recover any remaining estate assets. As with most Ponzi schemes, however, the principals likely already have dissipated most of the tangible assets of the estate by the time of the collapse. If that is true here, the focus of the trustee likely will turn to recovering assets through claims against third parties.

As required by SIPA, the SIPC Trustee will initiate a claims process for which each customer of BMIS will have an opportunity to submit claims. The SIPC Trustee will manage the claims process and distribute pro rata the customer property as quickly as possible. The balance of any estate assets, including any recoveries from third parties, will not likely be distributed for some years.

Fraudulent Transfer Claims Against Early Redeemers

In the Bayou matter, most of the assets that were recovered were obtained through the pursuit of fraudulent transfer claims against investors that had redeemed some or all of their money prior to the commencement of the bankruptcy proceeding. Both the Bankruptcy Code and New York state law, which applied to the Bayou proceeding, provide that a transfer made with actual or constructive intent to hinder, delay or defraud creditors is a fraudulent transfer that can be rescinded.⁷ A number of courts have held that each individual redemption payment is presumptively a fraudulent transfer intended to actually hinder, delay or defraud other investors and may be rescinded by creditors or a trustee.⁸ Under

3 15 U.S.C. § 78aaa *et seq.*; see also SIPC Press Release, 12/15/08, available at: <http://www.sipc.org/media/release15Dec08.cfm>. Although the exact structure of the firm remains unclear, Madoff apparently operated as a broker-dealer with an investment management segment.

4 15 U.S.C. § 78fff(a)(1)(B).

5 11 U.S.C. § 362(a). Section 362(b) provides for certain exceptions to the automatic stay, including the right of counter parties to terminate or accelerate securities contracts.

6 SIPC Press Release, 12/15/08, available at: <http://www.sipc.org/media/release15Dec08.cfm>.

7 11 U.S.C. §§ 548(a) and 544; N.Y. Debt. & Cred. § 273-76.

8 See, e.g., *Terry v. June*, 432 F. Supp. 2d 635, 639 (W.D. Va. 2006); *Jobin v. Lalan (In re M & L Business Machine Co., Inc.)*, 160 B.R. 851, 857 (Bankr. D. Colo. 1993), *aff'd*, 167 B.R. 219 (1994) (“[I]n a Ponzi scheme the only inference that a court can make is that the Debtor had the requisite intent to hinder, delay or defraud under § 548(a) (1).”); *Merrill v. Abbott (In re Independent Clearing House)*, 77 B.R. 843, 860 (D. Utah 1987).

the Bankruptcy Code, the reach-back provision is two years from the date of commencement of the liquidation proceeding. The reach-back period under New York law is six years.⁹

Moreover, fraudulent transfer claims can seek to claw back both redeemed false profit and principal. An investor may defeat a fraudulent transfer claim by affirmatively showing that it redeemed in good faith and for value.¹⁰

In 2006, Bayou's court-appointed receiver brought over 130 fraudulent transfer adversary proceedings against Bayou investors that had redeemed fictitious profit and principal within two years of Bayou's bankruptcy filing. Later in 2008, the Bayou receiver brought New York state law claims against persons redeeming up to six years before the bankruptcy filing. In a series of rulings, the court held that redemption payments from a Ponzi scheme presumptively satisfied the "actual fraud" prong of the fraudulent transfer standard and that the "good faith" affirmative defense requires an objective test of whether a reasonable and prudent investor should have been on inquiry notice of the fraud, and, if on inquiry notice, the redeemer was diligent in its investigation.¹¹ In addition, the court ruled as a matter of law that redemption payments received by investors in excess of their original principal based on artificially inflated results, or so-called "fictitious profits," were required to be refunded to the estate, *regardless* of the redeemer's good faith.¹² Moreover, the court held that a redeeming investor cannot utilize the good faith affirmative defense unless it

can show it conducted a diligent investigation of each potential problem or red flag.¹³

As a result of these rulings, all of the investors in the Bayou matter who redeemed their investments within the six-year clawback period were ordered to return fictitious profits and may be required to pay pre-judgment interest on those profits. Over 90 redeemers have settled with the estate for the return of false profits and a portion of their principal. In addition, the court has ordered several dozen investors to refund all of their principal. The court upheld the good faith defenses of a small number of redeemers, and ordered trial of a handful more cases. To date, the Bayou receiver has recovered through settlement and legal rulings approximately \$68 million, with an anticipated litigation recovery for creditors of the Bayou estate, net of expenses, of between 15 and 20 cents per dollar.

Claims Against Third Parties

Claims against third parties, including financial advisors, auditors, financial counter parties, or other persons, are another potential source of recovery. The SIPC Trustee will be severely constrained from pursuing those claims on behalf of the estate because of legal defenses available to those third parties. While it is possible that pending class actions¹⁴ may provide an alternative source of recovery to individual investors for certain types of claims, Ponzi schemes like Madoff's may be particularly unsuitable to class treatment where the circumstances of each individual investor's recruitment and conduct may be different.

9 11 U.S.C. § 548(a)(1) (two-year statute of limitations from time of filing); N.Y. C.P.L.R. § 213 (six-year statute of limitations for actions based on fraud).

10 11 U.S.C. § 548(c) (transferees have an affirmative defense to the extent they took for value and in good faith); N.Y. Debt. & Cred. § 272 (same).

11 *In re Bayou Group, LLC*, 362 B.R. 624 (Bankr. S.D.N.Y. 2007); *In re Bayou Group, LLC*, 396 B.R. 810, *___ (Bankr. S.D.N.Y. 2008) (available, at this writing, only on Westlaw and not on Lexis).

12 362 B.R. at 631-36.

13 396 B.R. at *20-26.

14 *See, e.g., Kellner v. Madoff*, No. 08-cv-5026 (E.D.N.Y. Dec. 12, 2008).

Next Steps for Those Impacted by the Madoff Events

As the news regarding the Madoff scheme unfolds, those impacted by the Madoff fraud should take prompt steps to investigate the circumstances surrounding their investments in Madoff's investment vehicles and evaluate their own exposure to claims. Preservation of records is crucial and should be undertaken immediately. Further, anyone affected by the Madoff fraud should promptly review their insurance policies to determine the scope of their coverage, and whether the policies require notice of possible claims. Finally, as many facts regarding the Madoff scheme are unknown at this time, and given potential liabilities, all parties should be extremely cautious about making any public statements, or selectively providing information, regarding the extent of their connection to, knowledge of, and investments in the Madoff enterprise in order to avoid increasing their exposure.

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