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MARCH 17, 2016

Bankruptcy court eviscerates Madoff trustee's $220m clawback suit for failing to show investor's actual knowledge of fraud

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On March 14, 2016, Judge Stuart Bernstein of the U.S. Bankruptcy court dealt a severe blow to the efforts of Trustee Irving Picard to claw back over $220 million in transfers from Bernard L. Madoff Investment Securities ("BLMIS") to investment vehicles that profited from Bernie Madoff's Ponzi scheme. In the case, *In re: Bernard L. Madoff Investment Securities (Irving H. Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC v. Legacy Capital Ltd.)*, No 08-99000, Adv. Proc. No. 08-01789; Adv. P. No. 10-05286, Judge Bernstein dismissed most of the claims brought by The Trustee against Legacy Capital Ltd ("Legacy"), a British Virgin Islands-based investment vehicle and Khronos LLC ("Khronos"), a provider of accounting services to Legacy and of other services to certain funds that invested in Legacy. Specifically, Khronos' Motion to Dismiss the Amended Complaint was granted in its entirety, and Legacy's Motion to Dismiss was granted except to part of the first count of the Trustee's Amended Complaint, seeking to recover fictitious profits transferred to Legacy within two years of the BLMIS bankruptcy filing date.

At the heart of the Trustee's Amended Complaint was the so-called Renaissance Report by Hedge Fund Renaissance Technology, which attempted to replicate Madoff's trading strategy but found it to be unsustainable under a number of different markers. Communications around the Renaissance Report and additional calculations and due diligence performed by Khronos for Legacy showed that people involved with both Legacy and Khronos were aware of the report and "knew," among other things, that Madoff's purported options trading was impossible, that the timing of his trades was impossible, that his fee structure was "unusual," that Madoff's enormous trading volume—in the billions of dollars—never appeared to impact the market, and that Madoff's trades were in fact inconsistent with his stated investment strategy. They were also aware that Madoff's operation lacked a capable auditor and internal controls and that they and other investors never received real-time electronic access to their accounts or to trade confirmations.

The Amended Complaint contained eight counts under federal and New York State law. Counts one and two alleged actual and constructive fraud and sought to recover from Legacy transfers made within two years of the Madoff bankruptcy pursuant to Section 548 of the Bankruptcy Code. Counts three through six sought to recover from Legacy transfers made within six years of the

Madoff bankruptcy for alleged actual and constructive fraudulent transfer under New York Law; count seven sought to recover from Legacy transfers as undiscovered fraudulent transfers under New York law regardless of when they occurred; and count eight sought to recover from Khronos subsequent transfers from Legacy under Section 550 of the Bankruptcy code, which allows a Trustee to recover an avoidable transfer from "any immediate or mediate transferee of" an initial transferer.

Legacy moved to dismiss the counts against it claiming that the Trustee's claims were barred by the safe harbor of Bankruptcy Code § 546(e). This safe harbor means that a Trustee may only avoid and recover intentional fraudulent transfers made within two years of a bankruptcy filing date, unless a transferee has "actual knowledge" of the Ponzi scheme, or more generally, "actual knowledge that there were no actual securities transactions being conducted." Khronos moved to dismiss count eight, arguing that the Trustee had failed to plead that the initial transfers to Legacy were avoidable because he had failed to plead "actual knowledge." Khronos also argued that the Amended Complaint insufficiently alleged that the subsequent transfers to it from Legacy originated with BLMIS.

Dismissing all but count one against Legacy, Judge Bernstein ruled that the Amended Complaint did not allege a plausible claim that Legacy had actual knowledge that BLMIS was not in fact trading securities. He explained that although the Amended Complaint sufficiently alleged the first prong of willful blindness —Legacy's strong suspicion that the BLMIS trading was not real—it did not allege that Legacy turned a blind eye to it and that in fact the opposite occurred when Legacy hired Khronos to conduct due diligence regarding Legacy's BLMIS account, and as evidenced by e-mails showing that Legacy wanted to withdraw from BLMIS not because of concerns he wasn't trading, but because they didn't understand his trading strategy and had particular concerns about timing and volume. Judge Bernstein dismissed count one, except to the extent that it seeks to avoid and recover the transfer of fictitious profits.

Dismissing count eight against Khronos, Judge Bernstein ruled that the Amended Complaint did not plead that Khronos willfully blinded itself to any red flags surrounding the BLMIS account and transfers therefrom; he again pointed to Khronos' due diligence reporting as evidence that ran counter to the Trustee's claim against it.

The safe harbor provision, as litigated by the Trustee in the morass of Madoff litigation, has, as Judge Bernstein noted, severely limited the Trustee's ability to recover transfers from BLMIS in the aftermath of Madoff's fraud. The Trustee has also battled, unsuccessfully in this case, arguments by BLMIS investors that his claims of actual knowledge and willful blindness are based in hindsight, and not in the facts that investors had at their disposal at the time they were investing with Madoff and seeking to be a part of, and replicate, Madoff's "success." No other issue in the Madoff litigation has captured the attention of institutional investors, particularly offshore feeder funds, more than the concept of "willful blindness." There is little debate (or evidence) that most investors had "actual knowledge" of the fraud, thus leaving willful blindness as the sole avenue for enhanced recovery by the Trustee. Judge Bernstein's decision sets the bar quite high, and gives defendants in these cases a fair amount of solace, by holding that knowledge of "red flags" alone doesn't equate with willful blindness. For investors who have resisted the urge to settle these claims, Judge Bernstein's decision breathes new life into defense arguments. Invariably, pending appeals, this decision will reduce both the alleged liability and the settlement value of such claims brought by the Trustee.

Investors who still face claims by the Trustee based on willful blindness of Madoff's fraud should re-evaluate their litigation strategy in light of this decision and consider a more aggressive approach to the defense of such claims.

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