

When Bad Things Happen To Good People: Good Faith Is Not Enough When Investing in (What Later Turns Out To Be) a Ponzi Scheme

September 30, 2022

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What happens when a good faith investor learns it invested in a Ponzi scheme and is presented with a claim to return money it withdrew from its account and fights the good fight to protect its investment?

On September 20, 2022, the Court of Appeals for the Second Circuit affirmed the district court's decision granting a motion for summary judgment in favor of Irving Picard, the S.I.P.C. appointed trustee liquidating Bernard L. Madoff Investment Securities L.L.C. ("B.L.M.I.S.") and ruling that defendants J.A.B.A. Associates L.P. ("J.A.B.A.") and the general partners of J.A.B.A.: Audrey Goodman, Bruce Goodman, Andrew Goodman, and the estate of James Goodman, were required to pay to the trustee the amount of \$2,925,000 together with 4% pre-judgment interest. Considering that the litigation started in 2010 and went through three levels of the court system, the award of pre-judgment interest adds a material amount to the total due to the trustee.

Who Are The Parties?

J.A.B.A. is a former customer of Bernard L. Madoff who had no knowledge of his fraudulent conduct. Irving H. Picard, the trustee, sued it, alleging that it received voidable transfers from B.L.M.I.S. in the last two years of his operation, from December 11, 2006, to December 11, 2008. The initial claim filed on December 10, 2010, asserted against the defendants, was for \$6,065,000 of withdrawals that J.A.B.A. allegedly received in the six-year period prior to the bankruptcy filing. However, in an earlier decision, the Court of Appeals for the Second Circuit ruled that the trustee is limited to recovery of the Two-Year Transfers. See *Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. L.L.C.* ("Ida Fishman"), 773 F.3d 411, 423 (2d Cir. 2014).

As set forth in the Second Circuit's and the underlying district court's decision, B.L.M.I.S. was a securities broker-dealer through which the infamous Bernard Madoff operated three business units: (1) a proprietary trading business; (2) a market-making business; and (3) an investment advisory business (the "I.A. Business"). B.L.M.I.S. collected funds from brokerage customers and purported to invest those funds on behalf of the customers, but it did not actually invest the money. Instead, it sent its customers fabricated statements using historical trading activity and returns that had never been generated and therefore were reflecting fictitious trades and gains. When customers sought to withdraw money from the accounts, B.L.M.I.S. satisfied those requests with the proceeds of other customers' investments that were held in a commingled checking account. See, e.g., *In re Bernard L. Madoff Inv. Sec. L.L.C.*, 773 F.3d at 415. The scheme collapsed in 2008.

Analysis

The finding that the trustee was allowed to claw back the amount transferred out of the B.L.M.I.S. money is not surprising. It is

well settled that when a corpus of customer property is insufficient to pay customer claims, a S.I.P.A. trustee may recover certain transfers by the debtor pursuant to Section 548(a)(1)(A) of the Bankruptcy Code. 15 U.S.C. § 78fff-2(c)(3) and 11 U.S.C. § 548(a)(1)(A). A trustee may avoid and recover transfers of fictitious profits where (1) a transfer of an interest of the debtor in property, (2) was made within two years of the bankruptcy petition date, (3) and the transfer was made with “actual intent to hinder, delay, or defraud” a creditor. *Adelphia Recovery Tr. v. Bank of Am., N.A.*, Nos. 05-cv-9050, 03-MD-1529, 2011 WL 1419617, at *2 (S.D.N.Y. Apr. 7, 2011), *aff’d sub nom. Adelphia Recovery Tr. v. Goldman, Sachs & Co.*, 748 F.3d 110 (2d Cir. 2014). Defendants claimed that the S.I.P.C. trustee did not have the standing to pursue the claims and that the account out of which the money was transferred was held in the name of Madoff, not B.L.M.I.S. Both the District Court and the Court of Appeals found these arguments unpersuasive.

The novelty here is the somewhat harsh determination concerning pre-judgment interest. The defendants sought to overturn the award of pre-judgment interest as an abuse of discretion because they were innocent victims of fraud and should not have been penalized for defending themselves in court. J.A.B.A. argued that (1) there was no statutory basis for an award of pre-judgment interest under 11 U.S.C. § 548; (2) pre-judgment interest was inappropriate where the defendants did nothing wrong; (3) the trustee was responsible for any delay; and (4) the district court’s award of 4 percent interest was excessive and punitive.

The Court of Appeals found that the lack of explicit authorization in the Bankruptcy Code for an award of pre-judgment interest was not dispositive, and that pre-judgment interest had been awarded against other similarly situated six defendants in related S.I.P.A. litigation. See, e.g., *Securities Investor Protection Corp. v. 7 Bernard L. Madoff Investment Securities L.L.C.*, No. 08–01789 (S.M.B.), 2018 W.L. 8 1442312, at *15 (S.D.N.Y. Bankr. March 22, 2018), report and recommendation adopted, 9 596 B.R. 451 (S.D.N.Y. 2019 *aff’d*, 976 F.3d 184 (2d Cir. 2020); *Picard v. Nelson*, 610 B.R. 197, 238 (Bankr. S.D.N.Y. 2019); *Picard v. BAM, L.P.*, 624 B.R. 55, 65-66 (Bankr. S.D.N.Y. 2020).

The court further held that wrongdoing by the Defendants was not a pre-requisite to an award of interest. While defendants certainly had a right to litigate their case, they benefited from other customers’ stolen property and had not returned it for over a decade. The Court of Appeals was satisfied that the district court appropriately balanced the equities and surveyed other cases where pre-judgment interest was awarded, ranging from 9 percent to 4 percent. S.I.P.C., 528 F. Supp. 3d at 246.

Takeaway

The moral of the story here is that when presented with a settlement offer, litigants and their lawyers must carefully analyze how interest impacts the litigation strategy and decide whether it is worth spending money and time pursuing appeals, not just based on existing case law, but the trend in which the law is moving and the reasons behind it.

For further information, please feel free to reach out to [Albena Petrakov](#).