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Claims Chat

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Discerning Derivative Claims

TelexFree *Continues the Legacy of the* Madoff *Cases*

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The U.S. Court of Appeals for the First Circuit issued an opinion on Oct. 9, 2019, in *In re TelexFree LLC*[1] that cites the holdings of the Second Circuit in two *Madoff* Ponzi scheme cases, implicating significant consequences for Ponzi scheme litigation in bankruptcy courts across the nation.

The *Madoff* Cases

Prior to discussing the *TelexFree* opinion, a general overview of the cited *Madoff* cases is instructive. While there have been numerous published opinions arising from the infamous Ponzi scheme perpetrated by Bernard L. Madoff Investment Securities LLC (BLMIS), two such opinions are implicated by the *TelexFree* case: *Marshall v. Picard (In re Bernard L. Madoff Inv. Sec. LLC) (Madoff II)*[2] and *Picard v. Fairfield Greenwich Ltd. (Madoff III)*.[3]

Madoff II, issued by the Second Circuit in January 2014, addressed the impact of a permanent injunction entered in the liquidation case of BLMIS instituted by the Securities Investment Protection Corp. and referred to the U.S. Bankruptcy Court for the Southern District of New York. This injunction enjoined state law tort actions that two of BLMIS's defrauded investors were attempting to assert against the estate of Jeffry M. Picower, one of Madoff's alleged co-conspirators and other related defendants (the "Picower defendants").[4] In the liquidation action, governed by the Securities Investor Protection Act (SIPA), a trustee was appointed for BLMIS's expeditious and orderly liquidation.[5] In the SIPA litigation, the trustee commenced an adversary proceeding against the Picower defendants asserting claims of fraudulent transfers, avoidable preferences, and turnover under state law and the Bankruptcy Code.[6]

While this adversary proceeding was ongoing, the investors filed a putative class action in the U.S. District Court for the Southern District of Florida, asserting claims of civil conspiracy, conversion and conspiracy to violate the Florida Civil Remedies for Criminal Practices Act.[7] The SIPA trustee was made aware of this lawsuit and sought and obtained a preliminary injunction enjoining the Florida litigation on May 3, 2010.[8]

Ultimately, the SIPA trustee settled the adversary proceeding and obtained a permanent injunction enjoining any action "that is duplicative or derivative of the claims brought by the Trustee."[9] The Florida plaintiffs appealed the entry of the permanent injunction to the U.S. District Court for the Southern District of New York, which affirmed, and subsequently to the U.S. Court of Appeals for the Second Circuit.[10] On appeal, the Second Circuit determined that the claims being sought in the Florida litigation were "derivative" of those claims settled by the SIPA trustee and that the claims of conspiracy asserted by the Florida litigants were an attempt to "plead around" the injunction entered in New York.[11]

Madoff III is, in a sense, an inverse of *Madoff II*. In *Madoff III*, the SIPA trustee was seeking to intervene in three lawsuits, none of which directly involved the property of the BLMIS estate as a party, to stay those proceedings.[12] Rather than directly addressing claims held by the BLMIS estate, the three lawsuits in which the trustee sought

1 No. 18-2001, 2019 WL 5558088, at *1 (1st Cir. Oct. 29, 2019).
2 740 F.3d 81 (2d Cir. 2014).
3 762 F.3d 199 (2d Cir. 2014).
4 740 F.3d at 83.
5 *Id.* at 84-85.
6 *Id.* at 85.
7 *Id.* at 85-86.
8 *Id.* at 86.
9 *Id.* at 86-87.
10 *Id.* at 87.
11 *Id.* at 96.
12 762 F.3d at 202.

to intervene were brought by investors in "feeder funds" — funds that channeled investments into the Ponzi scheme.[13]

In contrast to *Madoff II*, where the claims being asserted were duplicative of those settled by the trustee, the claims in the *Madoff III* cases only impacted the BLMIS estate by potentially diverting money that could be collected by the estate, were it to assert actions against the feeder funds itself.[14] The trustee attempted to assert that the claims against the feeder funds were stayed by the automatic stay and were, in substance, fraudulent-transfer claims that were the sole property of the BLMIS estate.[15] The trustee further argued that the claims against the feeder funds were, again, an attempt to "plead around" the automatic stay and designation as fraudulent-transfer claims.[16]

The Second Circuit rejected the trustee's arguments, holding that the claims asserted by the clients of the feeder funds were distinct from — and therefore not derivative of — the claims of the BLMIS estate.[17] This was so, first and foremost, because the feeder funds owed direct fiduciary duties to their clients that were implicated by the complaints in those cases.[18] The duties owed to the estate and those owed to the feeder fund clients were distinct and therefore not derivative. Even though the estate could be tangentially impacted by the settlement of these cases because there will be less target money for claims asserted by the estate against the feeder funds, this contingent impact on the estate was insufficient to allow the trustee to stay the litigation against the feeder funds, as it had done in *Madoff II*.

The lesson to be gleaned from *Madoff II* and *Madoff III* is relatively straightforward: A bankruptcy trustee has sole standing to bring claims of the bankruptcy estate, but that authority has limits and cannot extend to any claim tangentially related to the claims of the estate. With this background in mind, the *TelexFree* decision comports with and expands this rationale to the First Circuit.

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The TelexFree Ponzi Scheme and Related Bankruptcy Litigation

The appeal before the First Circuit in *TelexFree* was from bankruptcy court orders adopted by the U.S. District Court for the District of Massachusetts arising out of the bankruptcies of TelexFree LLC, TelexFree Inc. and TelexFree Financial Inc. (collectively, "TelexFree"), which orchestrated one of the largest Ponzi/pyramid schemes in U.S. history. Designed to look like a legitimate business, TelexFree was a combination of a Ponzi scheme and a pyramid scheme. Reduced to its essentials, new participants paid previous investors. Those who paid more than they invested were called "net winners," and those who took out less were referred to as "net losers," the same nomenclature used in the *Madoff* cases.

To generate recoveries for distribution to all net losers, the TelexFree trustee brought fraudulent-transfer and preference suits against the net winners under §§ 547 and 548. The fraudulent-transfer suits were based on the idea that money paid to the net winners was actually stolen from the net losers.

The dispute in the *TelexFree* case was over who would be allowed to seek to recover payments made by new participants in the scheme to the existing participants who recruited them (the "contested funds"). The trustee was attempting to recoup these contested funds through avoidance actions, while victims represented by the Plaintiffs' Interim Executive Committee (PIEC) were asserting unjust-enrichment claims to recover the same sums.

Critically, the trustee originally allowed the PIEC litigation to move forward without issue, as the claims asserted in those cases were against the financial institutions, lawyers and leaders of the Telexfree scheme.[19] However, when the PIEC litigants asserted claims directly seeking to obtain the contested funds from the "net winners" — the same funds sought from the trustee — the trustee sought to intervene, arguing that such claims were derivative of the estate's fraudulent-transfer claims.[20]

The *TelexFree* Opinion

In its opinion, the First Circuit upheld the district court's rationale, which cited the holdings in *Madoff II* and *Madoff III*, which, in turn, had adopted the bankruptcy court's analysis that the PIEC's unjust-enrichment claims were barred by the automatic stay under 11 U.S.C. § 362(a)(3) based on the following findings: (1) the trustee has standing to bring the avoidance actions because the contested funds were "interests of the debtor in property" under 11 U.S.C. §§ 547 and 548; (2) these avoidance actions were themselves "property of the estate" under 11 U.S.C. § 541; and (3) the unjust-enrichment claims were acts to "obtain" or "control" property of the estate (*i.e.*, the avoidance actions) — and thus were barred by 11 U.S.C. § 362(a) — because they are "derivative" of the avoidance actions under the analyses set forth in the Second Circuit's *Madoff* cases. The net effect of these rulings was to permit the trustee to pursue the contested funds and stop PIEC's efforts to pursue those funds.

On appeal, the First Circuit addressed "only arguments that the appellant makes as to why the bankruptcy court erred in ruling that their unjust enrichment claims are stayed pursuant to § 362(a)(3). Those arguments ... are: (1) that the

13 *Id.*
14 *Id.* at 208.
15 *Id.* at 207.
16 *Id.* at 208.
17 *Id.*
18 *Id.*

19 *TelexFree LLC*, No. 18-2001, 2019 WL 5558088, at *4.
20 *Id.*
21 *Id.* at *1.

avoidance action claims are not property of the estate within the meaning of that stay provision because the bankruptcy court's 'standing' finding is flawed; and (2) that, in any event, the unjust enrichment claims do not seek to 'obtain' or 'control' the 'property of the estate' within the meaning of that stay provision because those claims are not 'derivative' of the avoidance action claims under the derivative analyses the Second Circuit employed in the Madoff cases."[21]

As to the first argument regarding the alleged lack of standing by the trustee to sue net winners (on the theory that the avoidance actions were not estate property), the court soundly rejected the theory, stating:

> We affirm the district court's finding that TelexFree had a property interest in the Contested Funds for the purposes of Darr's Avoidance Actions under both §§ 547 and 548, and therefore that Darr has standing to bring his claims. The bankruptcy court carefully evaluated the substance of the TelexFree scheme when it approved the trustee's net-equity formula. The formula recognizes that membership fees paid directly to TelexFree — in which TelexFree indisputably would have had a property interest — are functionally the same as membership fees that were paid to recruiting participants as part of a triangular transaction. Where membership fees were paid directly to TelexFree, recruiting participants were compensated with credits, which, according to the terms of the contract, they could redeem for cash at a later point using money generated largely from membership fees. In the triangular model, new participants gave their membership fees in cash directly to already-recruited participants.
>
> In both situations, participants engaged in a system designed and implemented by TelexFree. New participants knew, or should have known, that the recruiting participant was acting at TelexFree's behest and that the recruiting participant had no authority to let a new participant into the TelexFree scheme unilaterally. On joining the scheme, the new participant received an invoice and user account from TelexFree. Membership in the scheme was governed by a contract that TelexFree wrote. The new participants would have never paid the recruiting participants but for TelexFree's promise that they could join the scheme.[22]

The court also rejected two arguments set forth by PIEC for why the trustee lacked standing. First, the court rejected the contention that the trustee could not sue because the contracts with the company were fraudulent and *void ab initio*. According to the court, the transactions were, "at most," voidable, but not void.[23]

Second, PIEC took the position that the doctrine of *in pari delicto* barred the trustee's suits. Again, the First Circuit held otherwise, saying that *in pari delicto* "does not defeat [the trustee's] standing to bring avoidance actions."[24] Finally, the court held that the claims brought by PIEC were derivative of the trustee's claims and were thus barred by the automatic stay:

> This brings us to the issue of whether PIEC's unjust-enrichment claims are derivative of Darr's Avoidance Actions and thus an impermissible attempt to obtain possession of or exercise control over Darr's Avoidance Actions in violation of 11 U.S.C. § 362(a)(3). The bankruptcy court ruled the unjust-enrichment claims brought by PIEC are derivative of the trustee's Avoidance Actions because they seek to accomplish the same thing as the trustee's actions and to go about it in the same way. That is, PIEC has admitted that the proposed classes' efforts to prove unjust enrichment will not focus on any supposed wrongdoing by individual Net Winners. Rather, PIEC seeks to prove its unjust-enrichment case through the overall fraudulent scheme created by TelexFree. That is what the trustee seeks to do.[25]

With the *TelexFree* decision expanding the impact of *Madoff II* and *Madoff III*, trustees in Ponzi scheme cases will need to be more diligent in seeking to stay ancillary litigation related to the bankruptcy case.

Conclusion

The *TelexFree* opinion from the First Circuit is important in its effect of expanding the scope of the *Madoff* rationale to a new circuit. Presumably, *Madoff II* and *Madoff III* had already impacted the trustee's litigation of the *TelexFree* case, as evidenced by the trustee's decision not to stay the PIEC litigation until such time as it had a solid argument that the claims asserted by the PIEC were derivative of the estate's claims.

With the *TelexFree* decision expanding the impact of *Madoff II* and *Madoff III*, trustees in Ponzi scheme cases will need to be more diligent in seeking to stay ancillary litigation related to the bankruptcy case. Trustees will need to do a thorough analysis of how connected the outside litigation is to the claims of the estate in order to avoid running up costs seeking to enjoin litigation to which it lacks standing. abi

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22 *Id.* at *6.
23 *Id.*
24 *Id.*
25 *Id.* at *9.