

Madoff Net Winners' Fate Turns on Outcome of *Husky* in the Supreme Court

By Bill Rochelle
ABI Editor-at-Large

Unintended consequences may benefit Madoff trustee in suits against 'net winners.'

The Supreme Court could make life miserable for so-called net winners in the Bernard Madoff Ponzi scheme, depending on how the justices rule in a case argued in the high court on March 1.

If the Supreme Court adopts the Seventh Circuit's reasoning about debts stemming from "actual fraud," Madoff's net winners may find themselves stuck with nondischargeable debts owing to the trustee and perhaps to other creditors.

The case argued on March 1 was *Husky Electronics Inc. v. Ritz*. Before talking about *Husky*, we need background on the liquidation of *Bernard L. Madoff Investment Securities LLC*, begun in 2008 in bankruptcy court in New York under the Securities Investor Protection Act.

Customers who took out more cash than they invested with Madoff are known as net winners. As the result of a raft of decisions by District Judge Jed Rakoff of Manhattan, net winners are facing the threat of judgments in favor of the trustee for fictitious profits they received in the last two years before bankruptcy. Fictitious profits mean cash the customers took out in excess of their cash investments.

Judgments in favor of the trustee would arise under Section 548(a)(1)(A) for receipt of fraudulent transfers made with actual intent to defraud. Under that section, net winners can be liable even if they didn't know there was fraud. Case law, however, says it's Madoff's intent to defraud that matters, not the customers'.

In *Husky*, the Supreme Court is reviewing an opinion by Fifth Circuit Judge Carolyn D. King dealing with Section 523(a)(2)(A) of the Bankruptcy Code, which precludes discharging a debt based on property "obtained" by "actual fraud." The Fifth Circuit held that dischargeability for actual fraud requires both misrepresentation to the creditor and reliance by the creditor. The Supreme Court granted *certiorari* because Seventh Circuit Judge Richard A. Posner wrote *McClellan v. Cantrell* in 2000 and held that there is no misrepresentation requirement so long as there was actual fraud.

If the Supreme Court sides with the Fifth Circuit and Judge King, Madoff net winners have nothing to worry about because they made no misrepresentation to their own creditors when Madoff paid them fictitious profits. It's a different matter if the Supreme Court agrees with Judge Posner's theory and holds that receipt of a fraudulent transfer with "actual intent" makes a debt nondischargeable under Section 523(a)(2)(A).

If a Madoff net winner is socked with a judgment and files his or her own bankruptcy petition, the debt to the Madoff trustee may not be discharged if the Supreme Court holds in *Husky* that misrepresentation and reliance are no prerequisite to excepting a debt from discharge under Section 523(a)(2)(A). It is even possible that other creditors might raise the same theory, because the creditor in *Husky* arguing for nondischargeability was not among those who was defrauded.

A favorable decision in *Husky* won't make nondischargeability a cakewalk for the Madoff trustee. In *Husky*, the debtor in substance was both the perpetrator and recipient of the fraudulent transfer. Unless the Madoff customer knew there was a Ponzi scheme afoot, the factual distinction might let a net winner off the hook.

Still, the Madoff trustee could argue that his judgment is nondischargeable because it represents a debt for money "obtained by . . . actual fraud." Indeed, it is that argument, based on the language of the statute, that prompted the Seventh Circuit to bar discharge of a debt.

Absent an unfavorable decision in *Husky*, Madoff net winners who didn't know there was fraud shouldn't have trouble with discharge or dischargeability in their own bankruptcies.

The Supreme Court case is *Husky Electronics Inc. v. Ritz*, 15-145 (Supreme Court), and the Madoff liquidation is *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, 08-ap-01789 (Bankr. S.D.N.Y).

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