

Code to Code

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Should SIPA Trustee Have Greater Power than Chapter 7 Trustee to Pursue Third-Party Claims?



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When a securities brokerage firm fails and its customer accounts cannot be expeditiously transferred to another firm, it can either be liquidated under the provisions of the Securities Investor Protection Act of 1970 (SIPA) or via a stockbroker liquidation proceeding under the provisions of chapter 7.¹ In certain respects, a liquidation proceeding under SIPA is similar to a stockbroker liquidation proceeding under chapter 7.² Notably, neither the Bankruptcy Code nor SIPA expressly confer standing upon a trustee to pursue common law claims against third parties on behalf of the beneficiaries of the liquidating estates.

However, this lack of express authority did not dissuade the SIPA trustee in the now infamous Madoff Investment Securities liquidation from pursuing common law theories against third parties in an effort to bolster recoveries for the Madoff victims. In a blow to those efforts, U.S. District Court Judge Jed Rakoff, in *Picard v. HSBC Bank PLC*,³ concluded that SIPA, like the Bankruptcy Code, does not confer standing on the trustee to pursue common law claims against third parties on behalf of the estate's creditors.

A Brief SIPA Primer and Its Relationship to the Code

Congress enacted SIPA in 1970 in response to a securities industry crisis that resulted from a rash of securities brokerage firm failures and left the general public demanding greater protection for the customers of such firms.⁴ To accomplish this goal, SIPA initiated the Securities Investor Protection Corp. (SIPC),⁵ which, among many other functions, oversees the liquidation of member firms and, where appropriate, compensates customers of the firms from a SIPC fund.⁶ Other provisions of SIPA authorize the Securities and Exchange Commission (SEC) to enact regulations requiring the firms to maintain customer

fund reserves, report on unsafe practices of the firms and police member firms for compliance with applicable financial responsibility requirements.⁷

The centerpiece of SIPC's mission is the liquidation of firms in financial crisis and, if necessary, the compensation of customers from the SIPC fund,⁸ which "essentially constitutes an insurance program designed to protect the customers of brokerage firms subject to SIPA from loss in case of financial failure."⁹ The SIPC fund is funded largely by assessments paid by SIPC member firms.¹⁰

The SIPA liquidation proceeding is typically commenced by SIPC filing an application with a federal district court for a protective decree after being alerted that a firm "is in or is approaching financial difficulty."¹¹ Thereafter, the district court will issue the protective decree and commence the SIPA liquidation proceeding so long as the debtor consents, does not contest the application or is found to be insolvent or otherwise the subject of ongoing liquidation or receivership proceedings.¹² If a protective order is issued, the federal district court appoints a SIPA trustee and then refers the SIPA liquidation proceeding to the bankruptcy court in the same judicial district.¹³ Thereafter, the bankruptcy court is charged with overseeing the liquidation.

The liquidation of most troubled entities typically takes place under chapters 7 or 11, and in fact, chapter 7 contains specific provisions applicable to the liquidation of "stockbrokers."¹⁴ Practically speaking, the Bankruptcy Code "alternative" is rarely utilized for troubled brokerage firms because the SIPC fund is nearly always needed to compensate the firm's customers, and the fund is unavailable in a Code liquidation proceeding. However, a SIPA liquidation proceeding has been described as "essentially... a bankruptcy proceeding"¹⁵—and for good reason. SIPA mandates that a SIPA liquidation proceeding is to be conducted "in accordance with Chapters 1, 3 and 5, and subchapters I and II of Chapter 7 of title 11."¹⁶

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1 Morse, Daniel, "When a Securities Brokerage Firm Goes Broke: A Primer on the Securities Investor Protection Act of 1970," 25 *Amer. Bankr. Inst. J.* 34, 1 (February 2006).

2 *Id.*

3 454 B.R. 25 (S.D.N.Y. 2011).

4 Morse, *supra* n. 1 at 1.

5 SIPC is a nonprofit membership corporation and virtually all securities brokerage firms are required to be SIPC members. See 15 U.S.C. § 78ccc(a).

6 Don, Michael E. and Wang, Josephine, "Stockbroker Liquidations under the Securities Investor Protection Act and Their Impact on Securities Transfers," 12 *Cardozo L. Rev.* 509, 513-19 (1990).

7 See 15 U.S.C. § 78ccc, *et seq.*

8 Morse, *supra* n. 1 at 1.

9 Morse, *supra* n. 1 at 2.

10 15 U.S.C. § 78ddd(c).

11 *Id.* at § 78eee(a)(1).

12 *Id.* at § 78eee(b)(1).

13 Morse, *supra* n. 1, at 3.

14 11 U.S.C. §§ 741-753.

15 *SIPC v. Ambassador Church Fin. Dev. Group Inc.*, 788 F.2d 1208, 1210 (6th Cir. 1986).

16 15 U.S.C. § 78fff(b).

The main difference between a SIPA liquidation proceeding and a liquidation under the Code is the differing goals of the two statutes. While SIPA is concerned primarily with customer protection and minimizing threats to the securities industry, the Code's liquidation provisions focus on maximizing recovery to the creditors. Thus, among the most important differences of a SIPA liquidation proceeding from a chapter 7 case are (1) the availability of the SIPC fund to compensate certain customers whose interests were not adequately protected by the failed firm; (2) that the liquidation scheme in SIPA favors, to the greatest extent possible, distributing securities to customers over maximizing the cash available to other creditors; and (3) SIPA's concern with a brokerage firm's compliance with applicable financial responsibility requirements. These provisions highlight SIPA's ultimate goal of customer protection.

The SIPA Trustee's Duties and Powers

The SIPA trustee's duties and powers are defined in SIPA and essentially mirror the duties and powers of a chapter 7 trustee appointed under the Code.¹⁷ "A [SIPA] trustee shall be vested with the same powers and title with respect to the debtor and the property of the debtor, including the same rights to avoid preferences, as a trustee in a case under Title 11."¹⁸ The powers of a chapter 7 trustee are defined by the Code and arise principally from two sources: (1) the rights of the debtor under § 541, and (2) the rights of creditors of the debtor under § 544.¹⁹ The critical issue in *Picard v. HSBC Bank PLC* was how, if at all, the SIPA trustee's powers differ from those of a chapter 7 trustee.

A chapter 7 trustee does not have standing to pursue any cause of action on behalf of the estate's creditors.²⁰ Furthermore, SIPA does not expressly grant a SIPA trustee broader statutory powers or standing than those conferred upon a chapter 7 trustee. Nevertheless, conferring standing upon a SIPA trustee to pursue certain causes of action against third parties would clearly advance SIPA's primary goal of affording greater protections for the customers of failed firms by maximizing their potential recoveries.

In *Picard v. HSBC Bank PLC*, Judge Rakoff addressed the specific issue of whether a SIPA trustee has standing to pursue common law claims against third parties to benefit the creditors of the Madoff Securities estate. Despite SIPA's mission of protecting a firm's customers, his answer was a resounding "no."

HSBC Bank: SIPA Trustee Standing Equals Chapter 7 Trustee Standing

Soon after the Madoff scheme was uncovered in December 2008, Madoff Securities entered into consolidated liquidation proceedings under SIPA. On Dec. 15, 2008, Irving H. Picard (Baker & Hostetler LLP; New York) was appointed trustee to oversee the liquidation proceedings.

On July 15, 2009, Picard commenced an adversary proceeding against a group of investors that, he alleged had

continued to feed the Ponzi scheme and that had failed to investigate Madoff Securities even after being exposed to numerous "red flags." Picard sought recovery of approximately \$8.6 billion from these investors based on common law theories of unjust enrichment, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty (collectively, the "claims").²¹ The defendants moved to dismiss Picard's complaint for lack of standing.²²

The court first explained that Picard did not have standing to bring the common law claims on behalf of the Madoff estate due to the doctrine of *in pari delicto*, or "unclean hands," because Madoff Securities had participated in the wrongful conduct. The court reiterated a Second Circuit holding that "prudential considerations deprived a trustee from even having standing to bring in federal court a common law claim that is clearly defeated by...*in pari delicto*."²³ Thus, Judge Rakoff turned to the issue of whether Picard could bring the claims on behalf of the estate's creditors.

His discussion began with a brief analysis of a bankruptcy trustee's standing. Citing the U.S. Supreme Court case of *Caplan v. Marine Midland Grace Trust Co. of New York*,²⁴ Judge Rakoff explained that the Code "does not itself confer standing on a...trustee to assert claims against third parties on behalf of the estate's creditors themselves because the trustee stands in the shoes of the debtor, not the creditors."²⁵ He then stated that "SIPA generally provides that a SIPA trustee is only 'vested with the same powers as a trustee in a case under Title 11.'"²⁶ Thus, the only question was whether SIPA conferred broader standing upon a trustee than the Code.

[T]he overarching goal of SIPA to protect the customers of failed firms cannot be fully realized unless and until the issue of a SIPA trustee's standing is addressed and, if appropriate, enhanced.

Picard's first standing argument was that SIPA confers standing upon a trustee as "bailee" of the property of Madoff Securities' customers. Thus, Picard argued that a SIPA provision that grants the trustee authority to investigate and report malfeasance by the brokerage firm was accompanied by an implied right to bring such causes of action on behalf of creditors as bailee of customer property. The court flatly rejected this implied right as going "far beyond any accepted legal principle defining implied rights of action."²⁷ Picard then argued that since SIPA defines "customer property" to include "any other property which the debtor...would have been [required] to set aside for the benefit of customers,"²⁸ and since one of the main purposes of a SIPA liquidation is to "distribute customer property... to satisfy net equity claims of customers,"²⁹ the right to bring

21 *Picard v. HSBC Bank*, 454 B.R. at 28.

22 *Id.* at 28-29.

23 *Id.* at 37.

24 406 U.S. 416 (1972).

25 *Picard v. HSBC Bank*, 454 B.R. at 29.

26 *Id.* at 39 (quoting 15 U.S.C. § 78fff-1(a)).

27 *Id.* at 30-31.

28 15 U.S.C. § 78fff-1(4).

29 *Id.* at § 78fff-1(d)(3).

17 See 15 U.S.C. § 78fff-1(b); see also 11 U.S.C. § 704 for a complete list of the chapter 7 trustee's statutory duties.

18 See 15 U.S.C. § 78fff-1(a).

19 See *Steyr-Daimler-Puch of America Corp. v. Pappas*, 852 F.2d 132 (4th Cir. 1988).

20 See, e.g., *In re Independent Clearing House Co.*, 77 B.R. 843, 855 (D. Utah 1987).

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such claims is, itself, “customer property.” Therefore, he had a right to assert the claims on their behalf. The court rejected this argument because it disagreed that “customer property” could be read so broadly. Furthermore, the court noted that if Picard’s argument were correct, SIPA’s affirmative grant of power to bring avoidance actions would be rendered unnecessary.³⁰

Picard next argued that the common law of bailments confers “bailee” standing upon the trustee to bring these actions. However, the court held that the trustee is not a “bailee” in the common law sense because it seeks, at least in part, to distribute recovered property *pro rata* pursuant to the SIPA distribution scheme. Furthermore, even if the trustee were a bailee of customer property, the defendants’ alleged actionable conduct (funneling money into the Ponzi scheme) occurred prior to any bailment of customer property, and also no bailment may occur where the “would-be bailee is a thief.”³¹

Picard next argued that he had standing to bring the claims as the “enforcer of SIPC’s subrogation rights.” Specifically, when the SIPC advanced money from the SIPC fund to Madoff Securities customers, it became subrogated to the claims held by such customers against the defendants.

Certain provisions of SIPA state that SIPC is subrogated to the rights of the debtor’s customers whom it reimburses through the SIPC fund.³² However, the court concluded that the plain language of these provisions only permits SIPC to be subrogated to such customers’ claims against the *debtor’s estate*, not against third parties. Furthermore, the court held that the SIPA priority scheme does not permit SIPC to assert any subrogation claims unless and until the debtor’s customers are made whole.³³ Thus, Picard’s “subrogation enforcer” theory of standing failed.

Finally, Picard argued that he had standing as an assignee of the claims.³⁴ SIPA authorizes the trustee to obtain assignments of claims from customers.³⁵ However, the court disposed of this argument by noting that Southern

District of New York precedent has repeatedly held that such assigned claims include only the customer’s “net-equity claims” against the debtor’s estate.³⁶

Thus, Picard could assert no theory whereby he had standing to bring common law claims against the defendants in this case. Therefore, as Judge Rakoff noted, “the powers of a SIPA trustee are...cabined by Title 11,”³⁷ and a SIPA trustee’s power to recover funds from third parties for the benefit of creditors is no greater than those of a chapter 7 trustee.

Conclusion

It is difficult to criticize the merits of Judge Rakoff’s reasoning. As a matter of statutory interpretation and construction, SIPA does tend to yield the conclusion that a trustee’s powers are “cabined by title 11.”³⁸ However, it is also clear that the decision in *HSBC Bank PLC* thwarts the “customer protection” goals of SIPA and, worse yet, negatively impacts customers of Madoff Securities who may not have the means or ability to advance common law claims on their own behalf, or who may be time-barred from prosecuting such claims.

Fraudulent conduct has been the leading cause of brokerage firm failures and the subsequent commencement of SIPA liquidation proceedings.³⁹ As such, a vastly disproportionate burden is placed on the SIPC fund because of fraud.⁴⁰ In light of *HSBC Bank PLC*, these figures indicate that SIPA is not yet adequately equipped to enhance customer protections from the malfeasance of firms and those who aid and abet their fraudulent actions. In turn, the overarching goal of SIPA to protect the customers of failed firms cannot be fully realized unless and until the issue of a SIPA trustee’s standing is addressed and, if appropriate, enhanced. The best means of accomplishing this goal are congressional review and amendments to SIPA. **abi**

³⁰ See *id.* at § 78fff-2(c)(3).

³¹ *Picard v. HSBC Bank*, 454 B.R. at 33.

³² See 15 U.S.C. §§ 78fff-3(a), 78fff-4(c).

³³ *Id.* at § 78fff-2(c)(1).

³⁴ *Id.* at 29-37.

³⁵ See *id.* at § 78fff-2(b).

³⁶ *Picard v. HSBC Bank*, 454 B.R. at 36.

³⁷ *Id.* at 30.

³⁸ *Id.*

³⁹ Joo, Thomas W., “Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence and the Subsidization of Failure,” 72 *S. Cal. L. Rev.* 1071, 1088 (1999).

⁴⁰ *Id.*

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