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August 12, 2011

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Memorandum to: Clients and Friends

Madoff and Lehman Brothers:
Two Recent Decisions That May be
Right on the Law, but the Law is not Right

Two recent, widely-publicized decisions in the *Madoff* and *Lehman Brothers* bankruptcies raise troubling questions about the efficiency and fairness of the litigation process in cases of sophisticated securities fraud.

Litigation can be inefficient and unfair? That lead may seem as newsy as “Lindy Has Landed!” Nevertheless, these problems, when encountered, should be pointed out; not ignored as they have been despite the wide publicity of these decisions.

In *Picard v. HSBC Bank PLC*, Nos. 11 Civ. 763 (JSR), 11 Civ. 836 (JSR), 2011 WL 3200298 (S.D.N.Y. Jul. 28, 2011), the trustee for the liquidation of Bernard L. Madoff Investment Securities sought to recover over \$8 billion from HSBC and other defendants for their alleged failure to investigate and expose the Madoff Ponzi scheme that defrauded thousands of investors. The court dismissed the trustee’s claims, holding that he lacked statutory authority to pursue the claims of victimized investors. Without such statutory authority, the trustee was left to rely on the common law under which, as successor to Madoff Securities, he “stood in the shoes” of the debtor firm, not its creditors, and was barred by the common-law doctrine of *in pari delicto* from suing another wrongdoer.

The defrauded investors are not without a remedy. They may engage their own counsel to pursue their claims against third-parties.

The court’s decision is based on well-established precedent that applies not only to liquidating trustees under the Securities Investor Protection Act, but more generally to all trustees in bankruptcy. The decision appears to be correct. But the result makes no sense. The Madoff trustee has reportedly filed more than one thousand lawsuits to recover funds for the estate. These cases are based on expensive investigations of the transactions underlying these cases; investigations that had to be undertaken to assess the estate’s assets and liabilities and to fulfill the trustee’s statutory duty to investigate fraud

and misconduct and to report to the judge the potential causes of action available to the estate. (*Picard*, 2011 WL 3200298 at *3). The victimized investors as creditors of the estate will pay for the cost of these investigations as their distributions from the estate will be reduced by these costs. The creditors should not have to engage separate counsel for a contingent fee of 30% or more to reinvestigate the same transactions and pursue these cases independent of the trustee and then, at additional expense, litigate against the trustee issues arising from potential double recoveries, *i.e.*, whether recovering from third-parties bars them from receiving distributions from the estate.

The duplication of effort and expense may be the right result as a matter of law, but it's a lousy result. What's the fix? Literally, an Act of Congress, but don't count on that anytime soon.

Another problem is indicated by *In re Lehman Brothers Sec. and ERISA Litig.*, Nos. 08 Civ 5523 (LAK), 09 MC 2017 (LAK), 2011 WL 3211364 (S.D.N.Y. Jul. 27, 2011). Purchasers of \$31 billion of Lehman securities sued former Lehman senior officers, directors and others for securities fraud. Among other things, they complained that the offering materials for the securities they purchased did not adequately disclose the so-called Repo 105 transactions by which, from the second quarter of 2007 to the second quarter of 2008, Lehman allegedly transferred from its balance sheet assets in increasing amounts from \$39.1 billion to \$50.3 billion. The assets allegedly were transferred to counterparties for only a few days and then reacquired. (*Id.* at *22). The transfers were recorded as sales and Lehman reported a corresponding reduction in its net leverage ratio, the ratio of net assets to tangible equity, an indicator of the company's ability to absorb losses sustained by its riskiest assets. (*Id.* at *4). Plaintiffs complained that offering materials did not disclose the temporary effect of these large, recurrent transfers and their lack of any true business purpose.

The defendant officers and directors denied any fraudulent intent, claiming that they relied on opinions from independent outside counsel and auditors. Those opinions supported the reporting and accounting treatment of the repurchase transactions as true sales.

The court held that, although the Repo 105 transactions technically complied with the applicable accounting standards for true sales (*Id.* at *11), the complaint adequately pleaded a plausible claim that the defendant officers and directors "knew, or were reckless in not knowing, that use of the Repo 105 transactions and the manner in which they were accounted for painted a misleading picture of the company's finances." (*Id.* at *23).

In so holding, the court had to weigh the strength of the inference of fraudulent intent drawn from the allegations of the complaint against what the defendants argued was the more compelling inference that they honestly believed that the transactions were legal and properly accounted for based on the supporting professional opinions they had received. (*Id.*)

Why weigh these competing inferences? And by what measure? On a motion to dismiss a complaint, where the only consideration is whether the complaint adequately alleges a claim (*see, e.g., Ashcroft v. Iqbal*, 556 U.S. ___, 129 S. Ct. 1937, 1950 (2009)),

