Federal Court Dismisses Madoff Investors' Claim

Posted by John F. Savarese, Wachtell, Lipton, Rosen & Katz, on Saturday, September 19, 2015

Editor's Note: John F. Savarese is a partner in the Litigation Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Savarese, Stephen R. DiPrima, Emil A. Kleinhaus, and Noah B. Yavitz

In a significant decision addressing claims arising out of Bernard Madoff's Ponzi scheme, the U.S. District Court for the Middle District of Florida has dismissed federal securities and other claims asserted by Madoff investors. *Dusek v. JPMorgan Chase & Co.*, No. 2:14-cv-184 (M.D. Fla. Sept. 17, 2015). The decision applies and enforces key principles of federal securities law that, taken together, limit the scope of liability for financial institutions sued in connection with frauds perpetrated by their customers, especially Ponzi schemes.

Under Section 20(a) of the Securities Exchange Act of 1934, a defendant can be held liable for "controlling" a person or entity that has violated the securities laws. The Madoff investors alleged that JPMorgan "controlled" Madoff's Ponzi scheme by providing essential banking services. The court rejected the claim on various grounds.

First, the Court rejected plaintiffs' argument that the "control" necessary to establish control-person liability under the Exchange Act could be predicated on the allegation that banking services were "indispensable" to Madoff. The Court concluded that the provision of such banking services did not establish day-to-day involvement in the affairs of Madoff's firm or power over the corporate policy behind the Ponzi scheme. The Court further concluded that it was not plausible that the bank would knowingly involve itself in an "inevitably doomed" Ponzi scheme in order to garner fees.

Second, the Court held that plaintiffs, as investors who withdrew more money from the Ponzi scheme than they invested, had no damages under the federal securities laws. In short, the Court held that the "net winners" in a Ponzi scheme cannot use the federal securities laws to recover fake profits that did not represent out-of-pocket losses.

The Court's decision is the latest in a series of Madoff-related decisions in which federal courts have enforced well-established limitations on federal securities claims. It demonstrates that financial institutions have powerful defenses against claims seeking to hold them liable for their customers' securities frauds.