

Madoff 'Net Winners' Lose Out

Law360, New York (September 2, 2011) -- In a decision likely to affect thousands of Madoff investors, the Second Circuit Court of Appeals on Aug. 16, 2011, unanimously upheld the method used by the liquidating trustee for Bernard L. Madoff Investment Securities LLC ("BLMIS") to calculate investors' "net equity" when determining how customer property will be distributed in the BLMIS liquidation.[1]

The ruling means that customers of the failed broker-dealers who withdrew more money than they deposited into BLMIS (the so-called "net winners") will not be able to recover additional funds until all customers who deposited more money into BLMIS than they withdrew (the so-called "net losers") recover the full amounts they deposited. Overall, the ruling makes it less likely that the net winners will be able to recover any funds in the BLMIS estate.

The decision, which affirmed the March 8, 2010, order of the bankruptcy court, should not have surprised those who have followed this case. During oral argument on appeal, each of the three judges on the appellate panel posed difficult questions to advocates for the net winners.

Narrow Holding

What was surprising was the Second Circuit's repeated emphasis in the decision that the method it was upholding for calculating "net equity" in the Madoff liquidation may be inapplicable in other, more conventional cases. No less than nine times in its 35-page decision, the court tried to limit its holding to the extraordinary facts and circumstances of the Madoff case, the largest Ponzi scheme in history, which reportedly led to investor losses of nearly \$20 billion.

The court even noted that it expected that application of the trustee's method for calculating "net equity" to cases involving other failed broker-dealers would be rare, warning that "[d]iffering fact patterns will inevitably call for differing approaches to ascertaining the fairest method for approximating 'net equity.' [2]" As a result, the meaning of "net equity" in any given case will remain uncertain.

Trustee Empowered To Determine "Net Equity"

The concept of "net equity" arises under the Securities Investor Protection Act ("SIPA") [3], which establishes procedures for liquidating failed broker-dealers and provides customers of such firms with certain protections, including the right to recover distributions of "customer property" ahead of general unsecured creditors. SIPA requires a liquidating trustee to create a fund of customer property separate from the general estate.

If, as in the Madoff case, the fund of customer property is insufficient to satisfy every customer's "net equity" claim, customers may receive an advance of up to \$500,000 for their securities claims, funded by the Securities Investor Protection Corporation ("SIPC"), a nonprofit corporation funded by registered broker-dealers and members of national securities exchanges[4], plus a pro rata distribution of funds from the estate. Because the BLMIS trustee is empowered to determine which BLMIS customers have valid "net equity" claims, the trustee's method for calculating "net equity" determines which customers will recover from SIPC and, ratably, from the estate, and which are unlikely to recover.

The Parties' Positions

The trustee's method for calculating "net equity" under SIPA, known as the net-investment method, limits recovery to net losers. Both SIPC and the U.S. Securities and Exchange Commission supported the trustee's position in the bankruptcy court and in the Second Circuit. In contrast, net winners advocated another method for calculating "net equity" known as the last-statement method — one that takes into account their legitimate expectations as investors and would entitle them to recover, consistent with the definition of "net equity" in the SIPA statute, the market value of the securities reflected on their last BLMIS customer account statements.

The Second Circuit's Reasoning

The Second Circuit sided with the trustee, upholding the net-investment method for calculating "net equity" under SIPA for customers of BLMIS, but explained that "the statutory language does not prescribe a single means of calculating 'net equity.' [5]" Instead, it suggested that when, as here, the statutory language is unclear, courts have latitude to identify "the fairest method" for determining "net equity" in a particular case.[6]

Taking into account the facts and circumstances of the BLMIS case, and reviewing the legal conclusions of the bankruptcy court de novo, including its interpretation of SIPA, the Second Circuit affirmed that the Madoff trustee cannot rely exclusively on the last-statement method to determine "net equity." In the court's view, the trades reflected on customer statements never took place and do not reflect actual securities positions.[7]

The Second Circuit cautioned it would be "legal error" for the trustee to assess "net equity" based on customer statements, as that "would require the trustee to establish each customer's 'net equity' based on a fiction created by the perpetrator of the fraud." [8] Further, the court concluded that relying on the last-statement method here would have an "inequitable consequence," for net winners would derive additional benefit at the expense of net losers, even though "the main purpose of determining 'net equity' is to achieve fair allocation of the available resources among the customers." [9]

In this case, the court agreed with the bankruptcy court that the trustee also must look to the books and records of the BLMIS estate to ascertain a customer's "net equity," as the books and records should reflect actual deposits and actual withdrawals, thus providing a measure of reliability that reliance on the fictitious account statements cannot provide.[10]

The appealing investors argued that SIPA is a consumer protection statute and the trustee's method of determining "net equity" failed to protect BLMIS net winners, who comprise the majority of BLMIS customers. Although the court agreed that the principal purpose of SIPA is to protect investors against financial losses, it distinguished between losses resulting from broker insolvency, and losses resulting from broker fraud. It held the latter category of losses may fall beyond the protections of SIPA.

Because the method for calculating “net equity” affected the determination and calculation of more than 15,000 filed customer claims in the Madoff case^[11], the “net equity” issue was the first legal issue the bankruptcy court scheduled for common briefing. Under the “net equity” scheduling order dated Sept. 16, 2009, the trustee moved for an order approving the net-investment method, which BLMIS investors could then join or oppose.

On March 1, 2010, the bankruptcy court upheld the trustee’s method for calculating “net equity.” The bankruptcy court, joined by counsel to the trustee and counsel to a cross-section of investors, then certified the issue for immediate appeal directly to the Second Circuit pursuant to 28 U.S.C. § 158(d)(2). By accepting jurisdiction pursuant to 28 U.S.C. § 158(d)(2)(A), the Second Circuit eliminated a layer of appellate review by the district court. Even with this unusually expedited disposition of the “net equity” issue, appellate review here took nearly two years.

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[1] In re Bernard L. Madoff Inv. Sec. LLC, No. 10-2378-bk(L), slip op. (2d Cir. Aug. 16, 2011) ("Decision").

[2] Id. at 16.

[3] 15 U.S.C. § 78aaa et seq.

[4] 15 U.S.C. § 78ccc.

[5] Decision at 15.

[6] Id. at 16.

[7] Id. at 23-24.

[8] Id. at 32, 33.

[9] Id. at 29.

[10] Id. at 25.

[11] Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

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