



One Minute Memo[®]

Second Circuit Adopts Net Investment Method to Determine Net Equity in Madoff Bankruptcy Case

On August 16, 2011, the Second Circuit held that Irving H. Picard, the Trustee for the liquidation of Bernard L. Madoff Investment Securities LLC (“Trustee”), utilized the correct methodology to determine the “net equity” of each Madoff investor under the Securities Investor Protection Act (“SIPA”). In one of the more (perhaps the most) notorious Ponzi cases in recent history, Madoff collected money over a number of years from new and existing customers and, instead of actually investing the money in stock and options, used the new money to fund the withdrawals of principal and payments of fictitious profits of earlier customers. Under SIPA, a trustee collects and consolidates customer property for distribution to customers of the failed broker-dealer. Each customer shares ratably in this “customer fund” to the extent of his or her “net equity,” which is determined by taking the difference between the value of the securities held in each customer’s name and any indebtedness owed by each customer. SIPA requires this calculation to be based on the books and records of the debtor or otherwise to the satisfaction of the trustee.

In *Madoff*, the Trustee used the “Net Investment Method” to calculate “new equity,”- crediting cash deposited by each customer and subtracting any withdrawals or distributions. Based on this net investment methodology only those customers who deposited more cash than they withdrew were entitled to distributions from the Madoff customer fund. Despite the general understanding that Madoff never actually invested any money transferred from his customers in securities, some customers argued that they were entitled to recover the market value of securities reflected on their last Madoff customer statement - a methodology referred to as the “Last Statement Method.” The Trustee rejected the Last Statement Method, and the bankruptcy court supported the Trustee’s position, concluding that the Net Investment Method was the appropriate method to calculate customers’ claims.

On appeal, the Second Circuit agreed with the bankruptcy court. The Second Circuit initially held that the investors defrauded by Madoff constituted “customers” eligible for SIPA distributions from the customer fund. While Madoff may not have made any actual investments, the individuals that invested with him clearly deposited cash with him “for the purpose of purchasing securities.” Therefore, Madoff’s investors met the statutory requirements of being “customers” for purposes of being eligible to collect from the customer fund.

The Second Circuit also agreed with the bankruptcy court’s assessment that the Net Investment Method and not the Last Statement Method should be utilized to determine the net equity for each of Madoff’s customers, noting that “[u]se of the Last Statement Method in this case would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff’s machinations, and further noting that while SIPA speaks to the liquidation value of “securities positions,” determining such positions for purposes of the Madoff investments was impossible because Madoff never made any actual investments, and finally noting that “the account statements were wholly the invention of Madoff and do not reflect actual securities positions.” Therefore, for purposes of cash payments to customers from the customer funds, the Trustee was correct in utilizing the Net Investment Method.

While this decision clearly has an impact on Madoff investors, the Second Circuit's decision is important both for other SIPA liquidation proceedings and for Ponzi / bankruptcy cases generally. With respect to other SIPA proceedings, the Second Circuit carefully states that the Last Statement Method may be the best method for many other SIPA liquidation proceedings, particularly if the debtor actually purchased securities or if the debtor's customers authorized or directed the debtor to purchase specific stocks. In *Madoff*, however, using the Last Statement Method would result in some customers receiving a windfall because returns "were arbitrarily and unequally distributed among customers."

As to other Ponzi / bankruptcy cases, the Second Circuit noted that the SIPA liquidation is a hybrid proceeding and found that the New Investment Method applied in the Madoff case was "harmonious with provisions of the Bankruptcy Code that allow a trustee to avoid transfers made with the intent to defraud" and "avoids placing some claims unfairly ahead of others." These same issues often are raised in more typical Ponzi scheme cases, as the largest assets of a Ponzi-scheme estate are typically claims that the trustee possesses against the debtor's prepetition customers who received investment "returns." In those cases, the general rule is that the investor cannot retain any "profits" he received on his investment. One important point for future consideration is whether courts may use similar methodologies to determine whether such a Ponzi customer will be required to return any "profits" as fraudulent transfers, particularly when the underlying Ponzi scheme involved no actual investments.

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