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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, Plaintiff-Applicant, v. BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Defendant.	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated)
In re: BERNARD L. MADOFF, Debtor.	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, *et al.*, Defendants.	Adv. Pro. No. 10-05287 (BRL) Case No. 1:11-cv-03605-JSR

MEMORANDUM OF LAW OF THE SECURITIES INVESTOR PROTECTION CORPORATION REGARDING CALCULATION OF FICTITIOUS PROFITS

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Pursuant to this Court's order of September 28, 2011, the Securities Investor Protection Corporation ("SIPC") submits this memorandum of law regarding the calculation of fictitious profits received by Defendants.[1]

STATEMENT OF THE ISSUE

SIPC addresses herein the following issue:

> Under section 548(c) of the Bankruptcy Code (11 U.S.C.) (the "Bankruptcy Code"), a transferee may retain an interest in property that is the subject of an avoidable transfer under section 548(a)(1)(A) if, among other things, the transferee has taken for "value," as that term is defined in section 548(d)(2)(A). The issue at hand is, when determining which transfers in a Ponzi scheme constitute return of principal and therefore are taken for "value," and which transfers constitute payment of fictitious profits, whether consideration should be given to the history of all transfers to a transferee or only to those transfers made in the two year period prior to the filing date.

SIPC respectfully submits that the full history of transfers to a transferee must be considered to determine whether a transferee has received transfers for "value."

STATEMENT OF THE CASE

On September 27, 2011, this Court issued the Opinion and Order ("Opinion"), dismissing nine causes of action brought by the Trustee in this case ("Trustee"). *See* Dkt. No. 40, __ F.Supp.2d ___, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011). Two causes of action now remain: (i) actual fraudulent transfer under section 548(a)(1)(A) of the Bankruptcy Code; and (ii) subordination of Defendants' claims. *Id.* at *6.

In its Opinion, with regard to the actual fraudulent transfer under Bankruptcy Code section 548(a)(1)(A) claim, the Court held that "the Trustee may recover defendants' net profits simply by proving that the defendants did not provide value for the monies received, but the

[1] For convenience, references to provisions of SIPA shall omit "15 U.S.C."

Trustee may recover the return of the defendants' principal only by proving that the defendants willfully blinded themselves to Madoff Securities' fraud." *Id.* In footnote 6 of the Opinion, the Court stated that it was not resolving "how to determine which profits the Trustee can recover." *Id*. at *4 n.6.

On September 28, 2011, the Court issued an Order ("September 28 Order") asking the parties to brief the open issue stated in footnote 6 of the opinion: "it remains an open question whether, in determining what portion of [the transfers made during the two year period prior to the filing date] should be considered principal and what portion profits, reference should be made only to that period or should be made to earlier transfers as well." Dkt. No. 41, at 1.

The Trustee's Calculations of Profits Received by Defendants

In calculating the amount of profits received by the Defendants, the Trustee analyzed the entire history of the Defendants' accounts. Amended Complaint ("Complaint"), at ¶¶ 42, 49, Appx. I Ex. B. The Trustee looked to the account as of the date of a particular transfer, credited the total amount of cash deposited by the customer up to that date, and subtracted any and all withdrawals made up to that date. The amount of any withdrawals by Defendants in excess of deposits constituted fictitious profits. *Id.* at ¶ 42. To the extent a Defendant had withdrawn less than was deposited with the debtor, the amount of the original investment remaining in the account constituted his or her "antecedent debt."

SUMMARY OF THE ARGUMENT

Bankruptcy Code Section 548(a)(1)(A) allows a trustee to avoid a transfer made with actual intent to hinder, delay, or defraud creditors. Section 548(c) insulates such a transfer from avoidance by a trustee where the transferee can demonstrate that he or she received the transfer "for value" and in "good faith."

The question of whether a transfer is of principal or profit is relevant to the defense provided in Section 548(c). All of the transfers in question from BLMIS were made to satisfy demands by the Defendants for cash withdrawals from their brokerage accounts at BLMIS. Under Bankruptcy Code Section 548(d)(2)(A), "value" includes the "satisfaction…of a(n)…antecedent debt of the debtor." To the extent Defendants withdrew "principal" from their brokerage accounts, those withdrawals were made "for value" because they satisfied BLMIS's obligation to return to the Defendants investment principal on demand. As to amounts received by the Defendants in excess of that principal – their fictitious "profits" – the Defendants could defeat the Trustee's fraudulent transfer claims, *inter alia*, only by showing that the Defendants provided some "value" for those transfers.

The Defendants have not identified any "value" that they provided for any of the subject transfers other than the amounts of principal that they deposited with the broker. Accordingly, the "for value" defense is available to a Defendant here with respect to a disputed transfer only if, and to the extent that, at the time of the transfer, BLMIS held some of the Defendant's investment principal, and thus had an "antecedent debt" to the Defendant in the amount of that unreturned principal.

The Court now asks whether, in determining the amount of BLMIS's "antecedent debt" to the Defendants (in the form of unreturned investment principal), the Court is to consider all transfers made in connection with the Defendants' brokerage investments in BLMIS, or whether, under Bankruptcy Code Section 548(a), the Court is limited to those transfers made within two years of the "filing date" of the BLMIS liquidation. The answer is straightforward: the Court must consider all transfers regardless of timing.

In the first place, for the reasons stated, the principal/profit distinction is relevant only to the question of whether the transfers in question were made to satisfy an "antecedent debt," an issue under Section 548(c), not Section 548(a). By its plain language, Section 548(c) imposes no time limit – or other limitations period – on when an "antecedent debt" may arise or be extinguished. Thus, under the plain language of Section 548(c), a debt that hypothetically arose ten years ago may qualify as an "antecedent debt" the satisfaction of which insulates a one-year old transfer from attack as fraudulent. By the same token, however, a hypothetically twelve-year old debt extinguished by transfers made years before a liquidation cannot insulate additional transfers made within a year prior to liquidation. *See, e.g, Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996).

Imposing a time constraint on the calculation of "antecedent debt" would be inconsistent with: (1) the plain language of section 548(c); (2) the Second Circuit's decision in the BLMIS liquidation regarding "net equity;" (3) other case law decided under the Bankruptcy Code and SIPA; and (4) the treatment of similarly-situated creditors equally, a core objective of both SIPA and the Bankruptcy Code.

ARGUMENT

I. THE PLAIN LANGUAGE OF SECTION 548(C) REQUIRES ANALYSIS OF THE LIFE OF DEFENDANTS' ACCOUNTS TO DETERMINE WHETHER "VALUE" WAS PROVIDED

Many courts, including Circuit Courts, have opined on the definition of antecedent debt and "value" in the context of section 548. *See, e.g, Pension Transfer Corp v. Beneficiaries under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fruehauf Trailer Corp.)*, 444 F.3d 203, 212 (3d Cir. 2006); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 595 (9th Cir. 2001). The Bankruptcy Code, in section 101(12),

defines "debt" as "liability on a claim." Ultimately, virtually "any . . . kind of enforceable executory promise is value for purposes of section 548.'" *See* 5 *Collier on Bankruptcy* ¶ 548.03[5] (Alan J. Resnick and Henry J. Sommer eds., 16th ed.), *quoting Krommenhoek v. Natural Resources Recovery, Inc. (In re Treasure Valley Opportunities, Inc.),* 166 B.R. 701, 705 (Bankr. D. Idaho 1994) . Unenforceable obligations, however, do not constitute "antecedent debt." *See, e.g., Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.)*, 84 F.3d 1286, 1290 (10th Cir. 1996) (holding that because a victim of a Ponzi scheme did not have an enforceable claim against the debtor for damages in excess of her original investment, the transfers in excess of her investment were not made on account of antecedent debt); *see also Smith v. Creative Fin. Mgmt., Inc. (In re Virginia-Carolina Fin. Corp.)*, 954 F.2d 193, 197 (4th Cir. 1992) (holding that a "common sense approach" to determine whether a transfer was made on account of antecedent debt "is to consider whether the creditor would be able to assert a claim against the estate, absent the [transfer]."); *Official Comm. of Unsecured Creditors v. Whalen (In re Enron Corp.)*, 357 B.R. 32, 48-49 (Bankr. S.D.N.Y. 2006) (holding that because the creditor had an unmatured right to payment, the transfer was made on account of an antecedent debt). Ponzi scheme victims do not have "antecedent debt" to the extent of unenforceable promises by the debtor. *Hedged Investment Assoc.,* 84 F.3d at 1290. Thus, for a debt to be antecedent, it must be an enforceable obligation, even if unmatured, contingent or disputed.

SIPC is aware of no case in which a court has held that the "for value" defense under section 548(c) is limited to antecedent debt incurred during the two years prior to the filing date. To the contrary, courts generally consider the history of the relationship between the parties to ascertain whether antecedent debt is present or whether it was extinguished. For example, in *In re Bayou Group, LLC*, 439 B.R. 284 (S.D.N.Y. 2010) ("*Bayou*"), this Court looked to the history

of transfers made to investors in a Ponzi scheme to determine whether antecedent debt was provided. *Id.* at 337-39. In *Bayou*, the investors argued that because they had rolled over their account with one of the debtor funds to another debtor fund, they should receive credit for the full amount of the rolled over account as if it constituted only principal. *Id.* at 338.[2] Because the rolled over account included both principal and profits on the investors' original investment, the Court rejected the investors' argument and found that it was required to look back to the actual value in the account – namely, the amount of the original investment. *Id.* at 338-39; *see also Donnell v. Kowell,* 533 F.3d 762, 780 (9th Cir. 2008), *cert. denied,* 129 S.Ct. 640 (2008) (considering the defendant's original investment in a Ponzi scheme four years prior to a receivership as "value"); *In re Hedged-Investments Assoc., Inc.*, 84 F.3d at 1288-89 (looking to the twelve year history of the investments to determine whether transfers constituted principal or profits). Accordingly, determination of whether a valid antecedent debt existed – and therefore whether value was provided for the transfer – requires an examination of the history of the debtor's relationship with the transferee.

II. ANALYSIS OF THE LIFE OF DEFENDANTS' ACCOUNTS IS THE ONLY METHOD HARMONIOUS WITH THE SECOND CIRCUIT'S DECISION ON "NET EQUITY"

The Second Circuit recently concluded that the only method appropriate to calculate a customer's net equity in this case is through the "Net Investment Method." *In re BLMIS*, 654 F.3d 229, 237-38 (2d Cir. 2011) (the "Net Equity Decision"). The Net Investment Method requires the Trustee to "credit[] the amount of cash deposited by the customer into his or her BLMIS account, less any amounts withdrawn from it." *Id.* at 2333. The court explained that if

[2] The transfer from fund to fund occurred approximately three years prior to the filing date of the bankruptcy. *Id.*

the Trustee credited accounts with the amounts shown on the last account statements, "[t]he inequitable consequence of such a scheme would be that those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed." *Id.* at 238.

The Net Investment Method is virtually identical to the method applied by the Trustee in the Complaint to determine whether funds transferred are principal or are fictitious profits. *See* Complaint, at ¶ 49, Appx. I Ex. B. Here, the Trustee essentially has taken a snapshot of the account as of the date of the transfer, credited the amount deposited into the account and subtracted any amounts withdrawn from it. Any other approach would be inconsistent with the approach for calculating net equity, as affirmed by the Second Circuit. Unless the whole history of the account is considered, certain customers would retain fictitious profit, at the expense of other customers. Looking to the history of an account ensures that those customers who received avoidable transfers are treated similarly to those customers who did not.

III. ANALYSIS OF THE LIFE OF DEFENDANTS' ACCOUNTS IS THE ONLY METHOD HARMONIOUS WITH ESTABLISHED PRECEDENT UNDER THE BANKRUPTCY CODE AND SIPA

The Trustee's calculations of profits in the Complaint are also entirely in line with established case law on Ponzi schemes. Indeed, examining the full history of a creditor's relationship with the debtor is the method that has been used to determine whether payments of fictitious profits constitute satisfaction of antecedent debt in Ponzi schemes similar to the BLMIS scheme.[3] *See, e.g.*, *Donnell v. Kowell,* 533 F.3d 762, 780 (9th Cir. 2008) (holding that Ponzi

[3] In Ponzi schemes where the fraudster provided a contractual rate of interest, some courts have allowed the contractual interest to constitute antecedent debt. *See, e.g.*, *In re Carrozella &*

scheme victims must return fraudulent transfers of fictitious profits, which are calculated by applying the "netting rule" to determine the amount of the initial investment); *In re Bayou Group LLC*, 439 B.R. at 337-39; *In re Dreier LLP*, 452 B.R. at 437-38 (Bankr. S.D.N.Y. June 16, 2011); *see also Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 466-69 (S.D.N.Y. 2001) ("[B]ecause of Hanover's manipulation of House Stock prices prior to and during the Final Week, the most appropriate market prices to be applied to appraise the House Stocks were those that would have prevailed . . . absent Hanover's fraud.").

In addition, the method the Trustee used in the Complaint to determine the amount of fictitious profits comports entirely with SIPC's historical treatment of Ponzi schemes. In SIPA cases, trustees in Ponzi scheme cases routinely have looked to the history of a customer's account to determine the amount of his or her net investment. *See, e.g.*, *In re New Times Securities Services, Inc.*, 371 F.3d 68, 88 (2d Cir. 2004) (holding that customers' net equity consisted of the amount of deposits minus withdrawals); *Focht v. Athens (In re Old Naples Securities, Inc.)*, 311 B.R. 607, 616-17 (M.D. Fla. 2002) (holding that claimants in a SIPA case cannot recover fictitious profits); *In re C.J. Wright & Co.,* 162 B.R. 597, 609-10 (Bankr. M.D. Fla. 1993) (holding that the customers have claims for the amount entrusted to the debtor).

The Trustee's method for determining fictitious profits is also consistent with fraudulent transfer law outside of the Ponzi scheme context. "[M]odern courts will slice through complicated transactions to compare what value the debtor gave and what value the debtor got." 5 *Collier on Bankruptcy* ¶ 548.03[6]. For example, in cases involving leverage buyout

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Richardson, 286 B.R. 480, 484-91 (D. Conn. 2002); *Lustig v. Weisz & Assosc. (In re Unified Commercial Capital)*, 2002 WL 32500567, at *8 (W.D.N.Y. Jun 21, 2002). However, this Court has held these cases inapplicable to Ponzi schemes when the debtor did not provide for a contractual rate of interest. *In re Bayou Group LLC*, 439 B.R. at 337; *see also Gowan v. Patriot Grp. (In re Dreier LLP)*, 452 B.R. 391, 437-38 , (Bankr. S.D.N.Y. 2011).

transactions, courts frequently collapse the transaction to determine the actual value received by the debtor. *See, e.g.*, *HBE Leasing Corp. v. Frank,* 48 F.3d 623, 635 (2d Cir. 1995); *Orr v. Kinderhill Corp.,* 991 F.2d 31, 35-36 (2d Cir.1993). This line of cases confirms the underlying principle behind the Trustee's method for determining the amount of Defendants' profits, as the Trustee must be satisfied that the Debtor has received fair and equivalent value in exchange for otherwise avoidable transfers.

IV. SIPA, LIKE THE BANKRUPTCY CODE, IS AN EQUITABLE STATUTE THAT REQUIRES SIMILARLY SITUATED CUSTOMERS TO BE TREATED EQUALLY

As this Court stated in *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406 (S.D.N.Y. 2001), "the underlying philosophy of the Bankruptcy Code and SIPA establishes certain equitable principles and priorities designed to maximize assets available for ratable distribution to all creditors similarly situated." *Id.* at 463. The equitable nature of bankruptcy law is well-established. *See, e.g.*, *Kothe v. R.C. Taylor Trust,* 280 U.S. 224, 227 (1929) ("[T]he broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate."). Generally, the purpose of bankruptcy law is to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done." *Pepper v. Litton,* 308 US 295, 308 (1939). The bankruptcy laws should be applied so that "substance will not give way to form, [and] technical considerations will not prevent substantial justice from being done." *Id.* at 305.

As it draws heavily on the Bankruptcy Code, indeed, making applicable to the SIPA proceeding almost all of the provisions applicable to bankruptcy liquidations, SIPA also is instilled with equitable principles. *See* SIPA § 78fff(b) (To the extent consistent with SIPA, a SIPA liquidation "shall be conducted in accordance with, and as though it were being conducted" under the straight bankruptcy provisions of title 11). For example, in a SIPA

liquidation, customers "share ratably in such customer property on the basis and to the extent of their respective net equities." *See* SIPA § 78fff-2(c)(1)(B). As a further example, in 1978, when amending SIPA, Congress confirmed that the purpose of SIPA is to treat similarly situated customers equally. *See generally First Federal Savings & Loan Assoc. of Lincoln v. Bevill, Bresler & Schulman, Inc. (In re Bevill, Bresler & Schulman, Inc.)*, 59 B.R. 353, 358-63 (D.N.J.), *appeal dismissed*, 802 F.2d 445 (3d Cir. 1986). Thus, prior to 1978, cash customers were entitled to the immediate return of their "specifically identifiable" cash and securities, and thus in a SIPA liquidation, would receive their property outright. *See* SIPA § 78fff(c)(2)(C) (1970). All other customers, including margin customers, could only share ratably in the single and separate fund. *See* SIPA § 78fff(c)(2)(B) (1970). This inequity led Congress, in 1978, to amend SIPA to prevent margin customers from bearing losses disproportionately from cash customers. *See* Pub. L. No. 95-283 § 8, 92 Stat. 249, 259 (1978); S. Rep. No. 95-763, at 2, 17 (1978) ("The bill modifies the definition of 'net equity' in order to make clear that margin and cash customers are to be treated equally . . . ."); H.R. Rep. No. 95-746, at 21 (1977). This amendment reinforced the legislative intent in SIPA to treat similarly situated customers equally.

Here, the equitable treatment of customers depends on the calculation of antecedent debt in accordance with the method approved in the Net Equity Decision. Changing the calculation only ensures a windfall for some customers and a shortfall for others. There are unlimited permutations of situations that demonstrate how the equitable treatment of customers depends on a uniform calculation of debt in this case. Beyond those hypotheticals, however, are real victims of the BLMIS Ponzi scheme who deposited real money in their BLMIS accounts. It is the goal of SIPA to protect the custody of these customers' original investments to the fullest extent

possible. Thus, reference to those original investments, regardless of when they were made, is the only appropriate measure of "value" here.

CONCLUSION

For all of the reasons stated above, calculation of Defendants' receipt of fictitious profits should be determined by looking to the history of transfers made to Defendants throughout their relationship with BLMIS.

Dated: Washington, D.C.
October 24, 2011

Respectfully submitted,

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